



Consolidated Financial Statements of

MKANGO RESOURCES LTD

For the three and nine months ended September 30, 2012 and 2011

Unaudited interim consolidated financial statements

In accordance with National Instrument 51-102 released by the Canadian Securities administrators, the Company discloses that its auditors have not reviewed these interim consolidated financial statements for the nine months ended September 30, 2012 and 2011.

MKANGO RESOURCES LTD
Interim Consolidated Statement of Financial Position
Reported in US dollars

As at	Notes	September 30, 2012	December 31, 2011
ASSETS			
Current			
Cash and cash equivalents	6	\$ 645,898	\$ 3,739,420
Restricted cash		4,241	-
Accounts receivable		13,391	7,101
Prepaid		49,841	11,204
Total currents assets		713,371	3,757,725
Property and equipment	7	6,928	8,775
Total assets		720,299	3,766,500
LIABILITIES			
Current			
Accounts payable and accrued liabilities		64,378	132,850
Due to related party	8	15,343	15,343
Warrants - derivative financial instruments	9(b)	32,611	843,051
Total current liabilities		112,332	991,244
EQUITY			
Share capital	9(a)	5,632,076	5,632,076
Contributed surplus	9(c)	1,919,118	1,736,877
Accumulated deficit		(6,943,227)	(4,593,697)
Total equity		\$ 607,967	\$ 2,775,256
Total liabilities and equity		\$ 720,299	\$ 3,766,500
Going concern	2		
Commitments	11		
Subsequent events	14		

Refer to accompanying notes to the consolidated financial statements.

Approved on behalf of the Board:

(signed) "Eugene Chen"

Eugene Chen, Director

(signed) "David Berg"

David Berg, Director

MKANGO RESOURCES LTD
Interim Consolidated Statement of Comprehensive Loss
Reported in US dollars

	Notes	Three Months Ended		Nine Months Ended	
		September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Expenses					
General and administrative		\$ 246,475	\$ 166,706	\$ 954,195	\$ 480,810
Mineral exploration expenditures		96,046	918,725	1,878,022	2,062,687
Depreciation	7	615	-	1,846	-
Share based payments	9(d)	24,641	280,521	182,241	1,355,499
Loss before undernoted		367,777	1,365,952	3,016,304	3,898,996
Other items					
Interest income		500	(1,273)	(2,386)	(8,862)
Unrealized (gain) loss on revaluation of warrants	9(b)	(147,313)	(184,131)	(823,639)	(184,131)
Realized foreign exchange (gain) loss		16,857	943	18,631	(5,643)
Foreign exchange (gain) loss on translation		80,983	325,007	140,620	129,602
Total comprehensive loss attributable to common shareholders		(318,804)	(1,506,498)	(2,349,530)	(3,829,962)
Net loss per share - basic and diluted		\$ (0.01)	\$ (0.04)	\$ (0.06)	\$ (0.10)
Weighted average shares outstanding basic and diluted		37,442,855	37,397,927	37,442,855	37,383,514

Refer to accompanying notes to the consolidated financial statements.

MKANGO RESOURCES LTD
Interim Consolidated Statement of Cash Flows
Reported in US dollars

	Notes	Nine Months Ended	
		September 30, 2012	September 30, 2011
Cash flow from operating activities			
Loss for the period		\$ (2,349,530)	\$ (3,829,962)
Adjustments			
Share based payments	9(d)	182,241	1,355,499
Unrealized gain (loss) on revaluation of warrants	9(b)	(823,639)	(184,131)
Reclassify expense to current asset		(196,252)	-
Depreciation	7	1,846	941
Foreign exchange loss (gain)		18,631	129,602
Change in non-cash operating capital			
Accounts receivable and prepaid		(44,927)	(25,626)
Accounts payable and accrued liabilities		(68,472)	(518,274)
Cash used by operating activities		(3,280,102)	(3,071,951)
Cash flow from financing activities			
Advances from related party		-	24,602
Refund of deposit		153,406	-
Repayments to related party		-	(414,708)
Cash from (used by) financing activities		153,406	(390,106)
Effect of exchange rate changes on cash		33,174	(98,910)
Change in cash		(3,093,522)	(3,560,967)
Cash at the beginning of the period		3,739,420	7,840,140
Cash reclassified to restricted cash		4,241	-
Cash at the end of the period		\$ 650,139	\$ 4,279,173

Refer to accompanying notes to the consolidated financial statements.

MKANGO RESOURCES LTD
Interim Consolidated Statement of Changes in Equity
Reported in US dollars

	Share capital	Contributed Surplus	Deficit	Total
Balance at December 31, 2010	\$ 5,606,017	\$ 457,501	\$ (989,698)	\$ 5,073,820
Share based payments	-	1,074,978	-	1,074,978
Total comprehensive loss for the period	-	-	(2,323,464)	(2,323,464)
Balance at June 30, 2011	\$ 5,606,017	\$ 1,532,479	\$ (3,313,162)	\$ 3,825,334
Share based payments	-	204,398	-	204,398
Stock options exercised	24,582	-	-	24,582
Share issue costs	1,477	-	-	1,477
Total comprehensive loss for the period	-	-	(1,280,535)	(1,280,535)
Balance at December 31, 2011	\$ 5,632,076	\$ 1,736,877	\$ (4,593,697)	\$ 2,775,256
Share based payments	-	182,241	-	157,600
Total comprehensive loss for the period	-	-	(2,349,530)	(2,349,530)
Balance at September 30, 2012	\$ 5,632,076	\$ 1,919,118	\$ (6,943,227)	\$ 607,967

Refer to accompanying notes to the consolidated financial statements.

MKANGO RESOURCES LTD

Notes to the Interim Consolidated Financial Statements

For the nine months ended September 30, 2012 and 2011

1. GENERAL INFORMATION

The principal business of Mkango Resources Ltd (the “Company” or “Mkango”) is rare earth element and associated minerals exploration and development in the Republic of Malawi, Africa.

The Company was incorporated under the name Alloy Capital Corp. (“Alloy”) on November 13, 2007 under the laws of the Province of Alberta, Canada. On December 20, 2010, Alloy was acquired through a “reverse takeover” by Lancaster Exploration (“Lancaster”). The articles of the Company were amended to change the name of the Company from Alloy Capital Corporation to Mkango Resources Ltd. Mkango’s head office is located at 1400, 700 – 2nd Street SW, Calgary, Alberta Canada, T2P 4V5.

Lancaster was incorporated August 3, 2007 by Memorandum and Articles of Association issued pursuant to the provisions of the BVI Companies Act. Lancaster's registered office is located at 56 Administration Drive, Wickhams Cay 1, Road Town, Tortola, British Virgin Islands.

On May 19, 2011, a related company, Lancaster Exploration Limited, was incorporated under the laws of Blantyre, Malawi.

2. GOING CONCERN

These interim consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. Should the Company be unable to continue as a going concern, it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due. These interim consolidated financial statements do not reflect the adjustments or reclassification of assets and liabilities which would be necessary if the Company were unable to continue its operations.

The Company is in the process of acquiring, exploring and developing its mineral interests. The recoverability of the amounts shown for mineral interests are dependent upon the existence of an economically recoverable mineral resource, the ability of the Company to obtain necessary financing to complete the development of such mineral resources, and upon future profitable production. The operations of the Company for the next 12 months will be funded by the equity raised during the share issuance which closed December 20, 2010.

3. REVERSE TAKEOVER

On December 20, 2010, the Company completed a reverse takeover of Alloy Capital Corp. (“Alloy”) (the “Transaction”). Alloy, classified as a capital pool company as defined in the TSXV Policy 2.4, had no significant assets other than cash, and had no commercial operations

The Company is considered to be the accounting acquirer for accounting purposes as the former shareholders of the Company control the consolidated group subsequent to the Transaction. The Transaction is not considered to be a business combination for accounting purposes as Alloy is not considered to be a business for accounting purposes. The Transaction has been accounted for in the consolidated financial statements as the continuation of the financial statements of the Company, together with an issuance of shares, equivalent to the shares held by the former shareholders of Alloy, and a recapitalization of the equity of Mkango. Fair value was based on the latest trading price of Alloy’s shares before the control was transferred.

The consideration of \$401,039 was allocated between the identifiable assets and liabilities as follows: \$312,737 to cash, \$8,625 to accounts receivable, \$15,171 to accounts payable and \$94,848 was expensed as a public company listing expense. No deferred tax asset was recognized. The following table outlines the net assets acquired:

Cash	\$312,737
Other receivables	8,625
Current liabilities	(15,171)
Total net assets acquired	\$306,191

MKANGO RESOURCES LTD

Notes to the Interim Consolidated Financial Statements

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4. BASIS OF PRESENTATION

(a) Statement of Compliance

These interim consolidated financial statements for the nine months ended September 30, 2012 have been prepared in accordance with International Accounting Standard (“IAS”) 34 Financial Reporting. These financial statements have been prepared in accordance with the accounting policies the Company adopted as of December 31, 2011. Those accounting policies are based on the IFRS standards and International Financial Reporting Committee (“IFRIC”) interpretations that are applicable.

The interim consolidated financial statements were authorized for issuance by the Board of Directors of the Company on November 29, 2012.

(b) Basis of presentation and measurement

The interim consolidated financial statements are presented in compliance with IFRS as issued by the International Accounting Standards Board (“IASB”).

The transaction between Lancaster and the Company was deemed a recapitalization takeover whereby Lancaster is considered the parent for accounting purposes. The interim consolidated financial statements are issued under the name of the legal parent, Mkango Resources Ltd, but are described as a continuation of the financial statements of the legal subsidiary, Lancaster Exploration.

These interim consolidated financial statements have been prepared on an accrual basis under the historical cost convention, except cash flow information.

(c) Functional and presentation currency

The interim consolidated financial statements are presented in US dollars, which is the functional currency of the Company and its subsidiaries. All values are rounded to the nearest dollar.

(d) Use of estimates and judgments

The preparation of the interim consolidated financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

In preparing these interim consolidated financial statements, the significant judgments made by management applying the Company’s accounting policies and the key sources of estimation uncertainty are outlined in:

- Measurement of share based payments (Note 9d)
- Measurement of warrant valuation (Note 9b)
- Foreign exchange (Note 10)
- Determination of fair values (Note 10)

(e) New standards and interpretations not yet adopted

IFRS 9, ‘Financial Instruments’ was issued in November 2009 as the first step in its project to replace IAS 39 ‘Financial Instruments: Recognition and Measurement’. IFRS 9 introduces new requirements for classifying and measuring financial assets that must be applied starting January 1, 2013, with early adoption permitted. The IASB intends to expand IFRS 9 during the intervening period to add new requirements for classifying and measuring financial liabilities, de-recognition of financial instruments, impairment and hedge accounting.

IFRS 10, ‘Consolidated Financial Statements’ was issued in May 2011 and will supersede the consolidation requirements in SIC-12 ‘Consolidation – Special Purpose Entities’ and IAS 27 ‘Consolidated and Separate Financial Statements’ effective for annual periods beginning on or after January 1, 2013, with early application permitted. IFRS 10 builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company. The standard also provides additional guidance to assist in the determination of control where this is difficult to assess. The Company is currently assessing the impact of this standard.

IFRS 11, ‘Joint Arrangements’ was issued in May 2011 and will supersede existing IAS 31, ‘Joint Ventures’ effective for annual period beginning on or after January 1, 2013, with early application permitted. IFRS 11 provides for the

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Notes to the Interim Consolidated Financial Statements

For the nine months ended September 30, 2012 and 2011

4. BASIS OF PRESENTATION (continued)

accounting of joint arrangements by focusing on the rights and obligations of the arrangement, rather than its legal form (as is currently the case). The standard also eliminates the option to account for jointly controlled entities using the proportionate consolidation method. The Company is currently assessing the impact of this standard.

IFRS 12, 'Disclosure of Interests in Other Entities' was issued in May 2011 and is a new and comprehensive standard on disclosure requirements for all forms of interests in other entities, including subsidiaries, joint arrangements, associates and unconsolidated structured entities. IFRS 12 is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. The Company is currently assessing the impact of this standard.

IFRS 13, 'Fair Value Measurement' was issued in May 2011 and is effective prospectively for annual periods beginning on or after January 1, 2013. IFRS 13 replaces fair value measurement guidance contained in individual IFRSs, providing a single source of fair value measurement guidance. The standard provides a framework for measuring fair value and establishes new disclosure requirements to enable readers to assess the methods and inputs used to develop fair value measurements and for recurring valuations that are subject to measurement uncertainty and the effect of those measurements on the financial statements. The Corporation is currently assessing the impact, if any, that the adoption of this standard will have on its Consolidated Financial Statements.

IAS 27 replaced the existing IAS 27 'Consolidated and Separate Financial Statements'. IAS 27 contains accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements. IAS 27 requires an entity preparing separate financial statements to account for those investments at cost or in accordance with IFRS 9 Financial Instruments. IAS 27 is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted.

The amendment to IAS 19, issued in June 2011, revises the accounting for defined benefit plans to: eliminate the option to defer recognition of actuarial gains and losses (the "corridor approach") by recognizing these in other comprehensive income as they occur; immediately recognize all past service costs; replace interest cost and expected return on plan assets with a net interest amount that is calculated by applying the discount rate to the net defined benefit liability (asset); and revise the disclosure requirements. Accounting for termination benefits was also revised. The amendment is effective for annual periods beginning on or after January 1, 2013.

IAS 28 was amended in 2011 which prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures. IAS 28 is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted.

The application of these standards, amendments and interpretations are not anticipated to have a material impact on the results or financial position of the Company.

5. SIGNIFICANT ACCOUNTING POLICIES

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the Company's interim consolidated financial statements.

(a) Principles of consolidation

The accompanying interim consolidated financial statements of the Company include the accounts of the Company and its wholly owned subsidiaries. All intercompany balances and transactions are eliminated upon consolidation.

(b) Intangible Exploration and Property and Equipment Assets

(i) Recognition and measurement

Exploration and evaluation ("E&E") expenditures

Exploration and evaluation costs which would typically include pre-licensing, preliminary property evaluation, drilling and directly attributable general and administrative costs are recognized in the statement of comprehensive loss as mineral exploration expenditures, including the costs of acquiring licenses pending determination of technical feasibility and commercial viability.

The technical feasibility and commercial viability of extracting a resource is considered to be determinable based on several factors including the assignment of proven reserves. Upon determination of technical feasibility and

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Notes to the Interim Consolidated Financial Statements

For the nine months ended September 30, 2012 and 2011

5. SIGNIFICANT ACCOUNTING POLICIES (continued)

commercial viability, the costs incurred prospectively are capitalized to a separate category within property and equipment referred to as mineral interests.

Property and equipment ("P&E") expenditures

Items of property and equipment, which include mineral interests, are measured at cost less accumulated depletion and depreciation and accumulated impairment losses. Development and production assets are grouped into cash generating units ("CGU") for impairment testing and categorized within property and equipment as mineral interests. Plant and equipment is comprised of drilling and mining servicing assets, office equipment and other corporate assets. When significant parts of an item of property and equipment, including mineral interests, have different useful lives, they are accounted for as separate items (major components).

Property and equipment assets, categorized as mineral interests, are assessed for impairment if facts and circumstances suggest that the carrying amount exceeds the recoverable amount. For purposes of impairment testing, property and equipment assets categorized as mineral interests are grouped by CGU.

Gains and losses on disposal of an item of property and equipment, including mineral interests, are determined by comparing the proceeds from disposal with the carrying amount of property and equipment and are recognized within the consolidated statement of comprehensive loss.

(i) Subsequent costs

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property and equipment are capitalized only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are recognized in the consolidated statement of comprehensive loss, as incurred. Such capitalized costs generally represent costs incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and is accumulated on a property by property basis. The carrying amount of any replaced or sold component is derecognized. The costs of the day-to-day servicing of property and equipment are recognized in the consolidated statement of comprehensive loss, as incurred.

(ii) Depletion and depreciation

The net carrying value of development or production assets will be depleted using the unit of production method by reference to the ratio of production in the year to the related proven and probable reserves, taking into account estimated future development costs necessary to bring those mineral reserves into production. Future development costs are estimated taking into account the level of development required to produce the reserves.

Office equipment is recorded at cost and is depreciated over the estimated useful life of the asset using the declining balance based on a 20% rate. Depreciation methods, useful lives and residual values are reviewed at each reporting date.

(c) Impairment

(i) Financial assets

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of the estimated future cash flows discounted at the original effective interest rate. Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

All impairment losses are recognized in the consolidated statement of comprehensive loss.

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized. For financial assets measured at amortized cost the reversal is recognized in the consolidated statement of comprehensive loss.

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Notes to the Interim Consolidated Financial Statements
For the nine months ended September 30, 2012 and 2011

5. SIGNIFICANT ACCOUNTING POLICIES (continued)

(ii) Non-financial assets

The carrying amounts of the Company's non-financial assets are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated.

For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets (the "cash-generating unit" or "CGU"). The recoverable amount of an asset or a CGU is the greater of its value in use and its fair value less costs to sell.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Value in use is generally computed by reference to the present value of the future cash flows expected to be derived from production of proven and probable reserves.

An impairment loss is recognized if the carrying amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses are recognized in the consolidated statement of comprehensive loss. Impairment losses recognized in respect of CGU's are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the unit (group of units) on a pro rata basis.

Impairment losses recognized in prior years are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depletion and depreciation or amortization, if no impairment loss had been recognized.

(iii) Non-financial assets (continued)

An impairment loss is recognized if the carrying amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses are recognized in the consolidated statement of comprehensive loss. Impairment losses recognized in respect of CGU's are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the unit (group of units) on a pro rata basis.

Impairment losses recognized in prior years are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depletion and depreciation or amortization, if no impairment loss had been recognized.

(d) Decommissioning obligation

The Company's activities give rise to dismantling, decommissioning and site disturbance re-mediation activities. A provision is made for the estimated cost of site restoration and capitalized in the relevant asset category.

Decommissioning obligations are measured at the present value of management's best estimate of expenditures required to settle the present obligation at the reporting date. Subsequent to the initial measurement, the obligation is adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The increase in the provision due to the passage of time is recognized as finance costs whereas increases/decreases due to changes in the estimated future cash flows are capitalized. Actual costs incurred upon settlement of the decommissioning obligations are charged against the provision to the extent the provision was established.

(e) Foreign currency translation

The functional and presentation currency of Mkango and its subsidiaries is the United States dollar. Assets and liabilities are translated into the presentation currency at the current exchange rate in effect at the reporting date.

Income and expense items are translated at the exchange rate in effect at the date of the transaction or, where the exchange rate does not fluctuate significantly, an average rate which approximates the actual rate in effect at the date of the transaction.

MKANGO RESOURCES LTD

Notes to the Interim Consolidated Financial Statements
For the nine months ended September 30, 2012 and 2011

5. SIGNIFICANT ACCOUNTING POLICIES (continued)

Exchange differences arising upon consolidation between the transactional and functional currency, if any, are recognized as an expense in unrealized foreign exchange gain (loss).

(f) Taxation

Income tax expense comprises current and deferred tax. Income tax expense is recognized in profit or loss except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized using the statement of financial position 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 on the initial recognition of assets or liabilities in a transaction that is not a business combination. 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 temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, 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 taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

(g) Loss per share

Basic loss per share is calculated by dividing the loss attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period. Diluted earnings per share is determined by adjusting the weighted average number of common shares outstanding for the effects of dilutive instruments.

(h) Share based payments

The Company has issued options to directors, officers, employees and non-employees to purchase common shares. The fair value of options determined using the Black-Scholes option pricing model on the date they are granted to employees is recognized as compensation expense with a corresponding increase in contributed surplus over the vesting period. The fair value of options to non-employees is recognized each reporting date as compensation expense with a corresponding increase in contributed surplus over the vesting period. A forfeiture rate is estimated on the grant date and is adjusted to reflect the actual number of options that vest.

(i) Cash and cash equivalents

Cash comprises of cash on hand and term deposits held with banks.

(j) Financial instruments

(i) Non-derivative financial instruments:

Non-derivative financial instruments comprise cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities and due to related party. Non-derivative financial instruments are recognized initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition non-derivative financial instruments are measured as described below:

Financial assets at fair value through profit or loss ("FVTPL")

An instrument is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Financial instruments are designated at fair value through profit or loss if the Company manages such investments and makes purchase and sale decisions based on their fair value in accordance with the Company's risk management or investment strategy. Upon initial recognition, attributable transaction costs are recognized in profit or loss when incurred. Financial instruments at fair value through profit or loss are measured

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Notes to the Interim Consolidated Financial Statements

For the nine months ended September 30, 2012 and 2011

5. SIGNIFICANT ACCOUNTING POLICIES (continued)

at fair value, and changes therein are recognized in profit or loss. The Company has classified cash and cash equivalents as fair value through profit or loss.

Loans and receivables

Other non-derivative financial instruments, such as accounts receivable are measured at amortized cost using the effective interest method, less any impairment losses.

Other financial liabilities

Other non-derivative financial instruments, such as accounts payable and accrued liabilities and due to related party are measured at amortized cost using the effective interest method, less any impairment losses.

(i) Derivative financial instruments:

Warrants are derivative financial instruments designated as FVTPL and are measured at fair value with changes in fair value recognized in the consolidated statement of comprehensive loss.

(ii) Share capital:

Common shares are classified as equity. Incremental costs directly attributable to the issue of common shares and share options are recognized as a deduction from equity, net of any tax effects.

(k) Provisions

The Company makes a distinction between:

- Provisions: present obligations, either legal or constructive, arising from past events, the settlement of which is expected to give rise to an outflow of resources the amount and timing of which are uncertain; and
- Contingent liabilities: possible obligations that arise from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more future events not wholly within the control of the Company, or present obligations arising from past events the amount of which cannot be estimated reliably or whose settlement is not likely to give rise to an outflow of resources.

Provisions are recognized when the liability or obligation giving rise to the indemnity or payment arises, to the extent that its amount can be reliably estimated and it is probable that the commitment will have to be settled. Contingent liabilities are not recognized in the consolidated financial statements, but rather are disclosed.

6. RESTRICTED CASH

The Malawi Revenue Authority, customs and excise division ("MRA"), required a \$4,812 bank guarantee from the Company in order to allow drilling equipment to be imported into the country for its Stage 2 drilling program. Historically the Company's importer was the guarantor, but as a result of changes made by the MRA, this role is now limited to banks and insurance companies.

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7. PROPERTY AND EQUIPMENT

	Cost	Accumulated Amortization	Net Book Value
Balance at December 31, 2010	\$ 288	-	\$ 288
Additions	9,732		9,732
Less Depreciation	-	(940)	(940)
Balance at September 30, 2011	10,020	(940)	9,080
Less Depreciation	-	(305)	(305)
Balance at December 31, 2011	10,020	(1,245)	8,775
Less Depreciation	-	(1,847)	(1,847)
Balance at September 30, 2012	\$ 10,020	\$ (3,092)	\$ 6,928

8. RELATED PARTY TRANSACTIONS

- a) All expenses of Lancaster from incorporation to December 20, 2010, were paid by Leo Mining and Exploration Ltd. ("Leo Mining") on behalf of Lancaster. The Company is considered related by virtue of common directors and officers who have an ownership in and exercise significant influence over both companies. As of September 30, 2012 Lancaster had a payable to Leo Mining in the amount of \$15,343 (2011 - \$27,843). The amount is part of an agreement between the Company and Leo Mining in an effort to help fund operations prior to the Company going public. The amount is unsecured and due on demand. Interest of 2% is to be incurred on the outstanding amount annually; however this has been waived for 2010, 2011 and 2012. During the third quarter of 2010, the former shareholder, Leo Mining, forgave \$195,401 of the outstanding loan. During 2011, the Company repaid \$414,708 of the funds advanced by the related party during the nine months ended September 30, 2011. There was no repayment made during the nine months ended September 30, 2012.

The Company and Leo Mining have formalized their relationship with respect to services provided by Leo Mining. A written agreement sets out the types of services to be provided and the costs associated with such services. Generally the Company shall pay all disbursements made by Leo Mining on its behalf. During the year the Company has not engaged in services with Leo Mining.

- b) For the nine months ended September 30, 2012, the Company recorded \$275,728 (2011 - \$270,840) for directors fees, legal fees and key management fees and related costs. Included in accounts payable and accrued liabilities at September 30, 2012, was \$26,984 (2011 - \$26,956) due to directors and officers. The amounts owed are unsecured, due on demand and non-interest bearing.

The transactions were conducted in the normal course of operations and measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

- c) Key management remuneration to directors and executives

	2012	2011
Salary	\$ 244,881	\$ 238,549
Share based awards	228,719	595,077
Total compensation	\$ 473,600	\$ 833,626

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9. SHARE CAPITAL

a) Common Shares

The Company is authorized to issue an unlimited number of common and preferred shares without nominal or par value. The Company has not issued any preferred shares to date. The holders of common shares are entitled to one vote for each share on all matters submitted to a shareholder vote and are entitled to share in all dividends that the Company's board of directors, in its discretion, declares from available funds.

	Ref	Number	Amount
Opening balance January 1, 2010		1,000	\$ 1,000
Outstanding common shares of Alloy at RTO	(iii)	5,004,474	443,787
Share consolidation (2.5:1)	(iii)	(3,002,684)	
Elimination of Lancaster shares and Alloy share capital		(1,000)	(443,787)
Acquisition of Lancaster	Note 3	19,852,899	401,039
Non-brokered offering	(i)	10,696,499	5,254,716
Brokered offering	(ii)	4,825,000	2,370,310
Share issue costs		-	(877,284)
Warrants valuation	Note 9 (b)	-	(1,543,764)
Closing balance December 31, 2010		37,376,188	\$ 5,606,017
Stock options exercised	(iv)	66,667	24,583
Share issue costs refunded			1,476
Closing balance September 30, 2012 and December 31, 2011		37,442,855	\$ 5,632,076

- (i) On December 20, 2010, the Company issued 10,696,499 units at C\$0.50 per unit pursuant to the non-brokered offering. The C\$5,348,250 (US\$5,254,716) gross proceeds of the non-brokered offering were allocated between common shares C\$4,265,443 (US \$4,190,845) and warrants C\$1,082,807 (US \$1,063,870) based on their relative fair value on the grant date. As compensation, 272,970 finders' warrants were issued. The finders' warrants entitle the holder to acquire one finders' unit at an exercise price of C\$0.50 for a term of 24 months from issuance. Each finders' unit consists of one common shares and one-half of one (1/2) warrant. Each whole warrant entitles the holder to acquire a common share at an exercise price of C\$0.75 for a period of 24 months from issuance of the finders' unit warrant. The resulting 136,485 finders' unit warrants were valued at US\$315,283 (note 9b).
- (ii) On December 20, 2010, the Company issued 4,825,000 units at C\$0.50 per unit pursuant to the brokered offering co-lead by Haywood Securities Inc. and Byron Securities Limited (the "Agents"). The C\$2,412,500 (US \$2,370,310) gross proceeds of the brokered offering were allocated between common shares C\$1,924,065 (US \$1,890,417) and warrants C\$488,435 (US \$479,894) based on their relative fair value on the grant date. The agents received 337,750 agents warrants. The agents' warrants entitle the holder to acquire one agents' unit at an exercise price of C\$0.50 for a term of 24 months from issuance. Each agent's unit consists of one common share and one-half of one (1/2) warrant. Each whole warrant entitles the holder to acquire a common share at an exercise price of C\$0.75 for a period of 24 months from issuance of the agents' unit warrant. The resulting 168,875 agents' unit warrants were valued at US\$142,218 (note 9b).
- (iii) Pursuant to the Qualifying Transaction on December 20, 2010, the Company consolidated its issued and outstanding common shares on a 2.5:1 basis. After the consolidation, Mkango had 2,001,790 common shares issued and outstanding.
- (iv) On October 31, 2011, 66,667 stock options were exercised at US\$0.369 for a cash payment of US\$24,583.

b) Warrants

Upon adoption of IFRS at January 1, 2010, the Company recorded an adjustment as a result of accounting for share purchase warrants issued using the principles of IAS 32, Financial Instruments: Recognition and Measurement (Note 5). As the exercise price of the share purchase warrants is fixed in Canadian dollars and the functional currency of the Company is the US dollar, the warrants are considered a derivative, as a variable amount of cash in the Company's

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Notes to the Interim Consolidated Financial Statements

For the nine months ended September 30, 2012 and 2011

9. SHARE CAPITAL (Continued)

functional currency will be received on exercise. At September 30, 2012 the fair value of share purchase warrants issued and outstanding with Canadian dollar exercise prices was \$32,611 (2011 - \$1,359,633). The share purchase warrants are re-measured at fair value at each statement of financial position reporting date with the change in fair value recognized in the statement of net loss and comprehensive during the period of change. The change in fair value for the three and nine months ended September 30, 2012 resulted in a gain of \$147,313 (2011 \$184,131) and \$823,639 (2011 \$184,131), respectively. Warrants issued do not include warrants issued to brokers and agents since they fall into the scope of IFRS 2.

	Exercise Price	Years	Number of Warrants	Fair Value
Balance at December 31, 2010	\$0.75	2.0	7,760,750	\$1,543,764
<i>Change in fair value</i>				
Warrants issued - Non-Brokered Offering	\$0.75	1.2	5,348,250	(126,889)
Warrants issued - Brokered Offering	\$0.75	1.2	2,412,500	(57,242)
Balance at September 30, 2011	\$0.75	1.2	7,760,750	\$1,359,633
<i>Change in fair value</i>				
Warrants issued - Non-Brokered Offering	\$0.75	1.0	5,348,250	(355,999)
Warrants issued - Brokered Offering	\$0.75	1.0	2,412,500	(160,583)
Balance at December 31, 2011	\$0.75	1.0	7,760,750	\$843,051
<i>Change in fair value</i>				
Warrants issued - Non-Brokered Offering	\$0.75	0.2	5,348,250	(558,507)
Warrants issued - Brokered Offering	\$0.75	0.2	2,412,500	(251,933)
Balance at September 30, 2012	\$0.75	0.2	7,760,750	\$32,611

The warrant fair value calculation for 2012 is presented below. The net impact to the statement of net loss and comprehensive loss is a gain of \$810,051 for the nine months ended September 30, 2012.

The change in the derivative liability for the nine month period ended September, 2012 is as follows:

Warrants Issued	Issued (1)	USD Fair value estimate at December 31, 2011	Fair value estimate adjustments	USD Fair value estimate at September 30, 2012
Canadian \$0.75	7,760,750	\$ 843,051	(810,440)	\$ 32,611

(1) Warrants issued do not include the 305,360 brokers and agent warrants.

2011 Disclosure Correction

Initially, the Company and its Auditors determined that the warrants qualified as an equity instrument under the interpretation provided by IFRS 2, and they were reported using the accounting treatment for equity in the financial statements ended December 31, 2010, March 31, 2011 and June 30, 2011. Under the equity accounting method, the warrants were not revalued to fair value at the end of each reporting period but remained fixed at the initial warrant valuation of \$1,543,764 which was calculated at December 20, 2010. The fair value impact on net income for the period from December 20, 2010 (date of issue) to December 31, 2010 was a loss of \$37,137 with a warrant fair value of \$1,580,708. If the revaluation had been reported during 2011, the net impact as of June 30, 2011 would have been a loss of \$3,120. Under the accounting treatment prescribed by IAS 32, the change in fair value of the warrants for each reporting period would have been recalculated as shown below:

For the period ended,	March 31, 2011	June 30, 2011	September 30, 2011	Change in net income
Warrant valuation, for the period	\$2,848,161	\$1,577,587	\$1,396,578	
Opening valuation	1,580,708	2,848,161	1,577,587	
Unrealized expense loss (gain) for the period	\$1,267,454	(\$1,270,574)	(\$181,011)	(\$184,131)

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9. SHARE CAPITAL (Continued)

c) Contributed surplus

	Number of warrants	Amount
Balance January 1, 2010	-	\$ -
Finders' unit warrants - Non-Brokered Offering (note 8a)	136,485	315,283
Agents' unit warrants - Brokered Offering (note 8a)	168,875	142,218
Balance December 31, 2010	305,360	457,501
Share based payments	-	1,813,000
Balance September 30, 2011	305,360	\$2,270,501
Share based payments	-	(533,624)
Balance December 31, 2011	305,360	1,736,877
Share based payments	-	182,241
Balance September 30, 2012	305,360	\$ 1,919,118

d) Share based payments

The Company has a rolling stock option plan established to recognize contributions made by key personnel, to provide incentive to qualified parties to increase their proprietary interest in the Company and thereby encourage their continued association with the Company. The number of options granted under the Plan is limited to 10% in the aggregate of the number of issued and outstanding common shares of the Company at the date of the grant of the options.

The compensation expense relating to stock options that has been recognized in the interim consolidated statement of comprehensive loss for the nine months ended September, 2012 and 2011 is \$182,241 and \$1,355,499 respectively. The corresponding amount has been recognized in contributed surplus. The options vest over an 18 month period with 25% vesting immediately upon grant and the remaining options vesting every 6 months thereafter.

The following table provides a summary of the status of the Company's stock option plan and changes during the periods ended:

	Options Outstanding	Weighted Average Exercise Price	Options Exercisable	Weighted Average Remaining Contractual Life (years)
Balance at January 1, 2010 and December 31, 2010	200,000	0.38	200,000	1.2
Granted - January 17, 2011	2,350,000	0.50	2,350,000	8.4
Granted - June 16, 2011	62,500	0.65	62,500	1.8
Granted - June 2011	330,000	0.55	247,500	8.8
Options exercised - August 2011	(66,667)	0.38	(66,667)	-
Balance at September, 2012	2,875,833	\$0.50	2,793,333	8.0

The fair value of each option granted is estimated as of the grant date using the Black-Scholes option pricing model. The following assumptions were used in arriving at the fair value of \$0.50 per option:

Risk free interest rate	3.25%
Expected life	10 years
Expected volatility	95%
Dividends	Nil
Forfeiture rate	5%

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Notes to the Interim Consolidated Financial Statements
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9. SHARE CAPITAL (Continued)

e) Escrowed shares

There are no common shares held in escrow at September 30, 2012. The final release occurred on June 5, 2012.

10. FINANCIAL INSTRUMENTS

Determination of fair values

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

- Level 1 - quoted prices in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - inputs for the asset or liability that are not based on observable market data.

Cash and cash equivalents and warrant derivative liability are measured at level 1.

The carrying value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximates the fair value due to their short term nature and maturity. Warrants with an exercise price in a currency other than the functional currency are to be recorded as a derivative liability and carried at fair value, see Note 9b. The fair value of the due to related party is equal to the carrying value due to it being due on demand (Note 8).

Financial risk management

The Company's Board of Directors monitors and manages the financial risks relating to the operations of the Company. These include foreign currency, interest rate, liquidity and credit risks.

Foreign currency rate risk

The functional and reporting currency of the Company is the United States dollar. The Company enters into transactions denominated in the Canadian Dollar, the United States dollar and the UK Pound Sterling. The Company raised equity in the Canadian dollar in 2010 and purchased sufficient working capital to fund 12 months of expenditures denominated in the United States dollar and the UK Pound Sterling during 2011 when exchange rates were favorable. These currencies represent 90% of the Company's expenditures. As at September 30, 2012 and 2011, the following balances were held by the Company:

	As at September 30,	
	2012	2011
Canadian dollar	\$ 148,818	\$ 1,270,858
United States dollar	438,568	2,312,599
UK Pound Sterling	62,753	695,716
	<u>\$ 650,139</u>	<u>\$ 4,279,173</u>

The Company also incurs 10% of its expenditures in the Malawi Kwacha. The Kwacha is subject to currency fluctuations which may adversely affect the Company's financial position. In order to mitigate this risk, the Company holds the minimum funds required to fund its monthly obligations, in the Malawi Kwacha. As at September 30, 2012 and 2011, the Company held \$6,191 and \$144, respectively, in Kwacha funds.

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10. FINANCIAL INSTRUMENTS (continued)

Interest rate risk

The Company's exposure to interest rate risk relates primarily to its cash and cash equivalents at banks. However, the interest rate risk is expected to be minimal. The Company does not presently hedge against interest rate movements.

Liquidity risk

Liquidity risk includes the risk that, as a result of the Company's operational liquidity requirements:

- a) The Company will not have sufficient funds to settle a transaction on the due date;
- b) The Company will be forced to sell financial assets at a value which is less than the fair value; or
- c) The Company may be unable to settle or recover a financial asset at all. The Company's operating cash requirements including amounts projected to complete the Company's existing capital expenditure program are continuously monitored and adjusted as input variables change. As these variables change, liquidity risks may necessitate the Company to conduct equity issues or obtain project debt financing.

The Company manages its liquidity risk by maintaining adequate cash and cash equivalents. The Company is actively seeking additional funding to improve its exposure to liquidity risk. The Company continually monitors its actual and forecast cash flows to ensure that there are adequate reserves to meet the maturing profiles of its financial assets and liabilities.

The following table outlines the maturities of the Company's liabilities:

	Contractual Cash Flows	Less than 1 Year
Accounts payable and accrued liabilities	\$ 64,378	\$ 64,378
Loan from related party	15,343	15,343
Total	\$ 79,721	\$ 79,721

Credit risk

The Company's principal financial assets are cash and cash equivalents. The credit risk on cash and cash equivalents is limited because the majority are deposited with banks with high credit ratings assigned by international credit-rating agencies. Accounts receivable consists of GST and interest on investments with a credible financial institution.

11. CAPITAL COMMITMENTS

The Company was granted the Phalombe Licence for the Songwe property on January 21, 2010. The future spending commitments for exploration expenses up to 2013 with the Government of Malawi based on a foreign exchange rate for the local currency to US dollars of MK306, are as follows:

Exploration commitments	\$ 142,157
Ground rent	41,928
Total commitment	\$ 184,085

On September 10, 2010, the Company was granted an additional exploration licence by the Malawi Minister of Natural Resources, Energy and Environment in respect of an area of 468 km² in Thambani, Mwanza District, Malawi. The Company has not undertaken any activity on such licence area to date. The future spending commitments for exploration expenses up to 2013 with the Government of Malawi are as follows:

Exploration commitments	\$ 162,414
Ground rent	15,295
Total commitment	\$ 177,709

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11. CAPITAL COMMITMENTS (continued)

In November 2011, the Company was notified by the Malawi government that the ground rent had increased from 100 Kwacha (\$0.33 USD) per square kilometer to 10,000 Kwacha (\$32.68 USD) per square kilometer of licensed area.

The Company expects to use the funds received from private placement equity raises to meet these commitments.

12. CAPITAL MANAGEMENT

The Company's total capital resources for the nine months ended September, 2012 is \$607,967 which consists of total equity. The Company closed an equity issue on December 20, 2010 which has provided liquidity through 2011 and is anticipated to meet working capital requirements through 2012. The Company's objective when managing its capital is to have sufficient capital to maintain its ongoing operations, pursue its strategic opportunities and maintain a flexible capital structure which optimizes the cost of capital at an acceptable risk. The Company manages its capital structure and makes adjustments to it based on the funds available to the Company. The Company does not presently utilize any quantitative measures to monitor its capital. The Company has no externally imposed capital requirements.

13. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the current year's presentation.

14. SUBSEQUENT EVENTS

There have been no subsequent events as of the date of this report.