

**PETAQUILLA MINERALS LTD.**

**CONSOLIDATED FINANCIAL STATEMENTS**

**Year Ended May 31, 2010, Year Ended May 31, 2009, One Month  
Ended May 31, 2008, and Year Ended April 30, 2008**

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### **Management Report on Internal Control over Financial Reporting**

The management of Petaquilla Minerals Ltd. (“Petaquilla” or the “Company”) is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934. Petaquilla’s internal control system was designed to provide reasonable assurance to the Company’s management and board of directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

An internal control material weakness is a deficiency, or aggregation of deficiencies, such that the risk of material misstatements in financial statements will not be prevented or detected on a timely basis by employees in the normal course of their work. An internal control significant deficiency, or aggregation of deficiencies, is one that could result in a misstatement of the financial statements that is more than inconsequential.

During the prior year, the Company identified a material weakness in internal controls related to the fact that the Company’s policies and procedures over cash disbursements were not being followed at one of the Company’s operating subsidiaries. As a result of this the Company redesigned the internal controls for operating subsidiaries by replacing all signing authorities at these operations with senior level employees. The Company has also performed a review of transactions to test if policies and procedures are now being followed and is satisfied that this internal control weakness has been remediated.

The Company’s management assessed the effectiveness of Petaquilla’s internal controls over financial reporting as of May 31, 2010.

In making the assessment of internal control over financial reporting, the Company’s management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework. Petaquilla’s management believes that, as of May 31, 2010 (“the Evaluation Date”), the Company’s internal control over financial reporting was effective as of the Evaluation Date based on those criteria.

During the period covered by this report, other than the change made with respect to cash disbursements, as previously discussed, there were no changes in the Company’s internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

The effectiveness of the Company’s internal control over financial reporting, as of May 31, 2010, has been audited by Ernst & Young LLP, Independent Registered Accountants, who also audited the Company’s consolidated financial statements for the year ended May 31, 2010, as stated in their report which appears on the following page.

#### **PETAQUILLA MINERALS LTD.**

By: /s/ Julie van Baarsen  
Julie van Baarsen, Chief Financial Officer  
(principal financial and accounting officer)

By: /s/ Joao Manuel  
Joao Manuel, President and Chief Executive Officer  
(principal executive officer)

## INDEPENDENT AUDITORS' REPORT ON FINANCIAL STATEMENTS

To the Shareholders of  
**Petaquilla Minerals Ltd.**

We have audited the consolidated balance sheets of **Petaquilla Minerals Ltd.** [the "Company"] as at May 31, 2010 and 2009 and the consolidated statements of operations and comprehensive loss, shareholders' deficiency and cash flows for the years ended May 31, 2010 and 2009, the one month period ended May 31, 2008, and the year ended April 30, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company, as at May 31, 2010 and 2009, and the results of its operations and its cash flows for the years ended May 31, 2010 and 2009, the one month period ended May 31, 2008, and the year ended April 30, 2008, in conformity with Canadian generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as at May 31, 2010, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 30, 2010 expressed an unqualified opinion thereon.

Vancouver, Canada,  
August 30, 2010.

*Ernst & Young LLP*

Chartered Accountants

**COMMENTS BY AUDITORS FOR U.S. READERS ON  
CANADA - U.S. REPORTING CONFLICT**

In the United States, reporting standards for auditors require the addition of an explanatory paragraph, following the opinion paragraph, when the financial statements are affected by conditions and events that cast substantial doubt on the company's ability to continue as a going concern, such as those described in note 1 to the 2010 consolidated financial statements. Our report to the shareholders dated August 30, 2010, is expressed in accordance with Canadian reporting standards which do not permit a reference to such events and conditions in the auditors' report when these are adequately disclosed in the financial statements.

Vancouver, Canada,  
August 30, 2010.

*Ernst & Young LLP*

Chartered Accountants

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROLS  
UNDER STANDARDS OF THE PUBLIC COMPANY ACCOUNTING  
OVERSIGHT BOARD (UNITED STATES)**

To the Shareholders of  
**Petaquilla Minerals Ltd.**

We have audited **Petaquilla Minerals Ltd.'s** [the "Company"] internal control over financial reporting as of May 31, 2010 based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission [the COSO criteria]. The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, 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.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of May 31, 2010, based on the COSO criteria.

We also have audited, in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as at May 31, 2010 and 2009 and the consolidated statements of operations and comprehensive loss, shareholders' deficiency and cash flows for the years ended May 31, 2010 and 2009, the one month period ended May 31, 2008, and the year ended April 30, 2008 and our report dated August 30, 2010 expressed an unqualified opinion thereon.

*Ernst + Young LLP*

Vancouver, Canada,  
August 30, 2010.

Chartered Accountants

**PETAQUILLA MINERALS LTD.**  
**CONSOLIDATED BALANCE SHEETS**

(in United States Dollars) (See Note 1 Nature of Operations and Going Concern Uncertainty)

	May 31, 2010	May 31, 2009
<b>ASSETS</b> (Notes 13, 14, and 15)		
<b>Current</b>		
Cash and cash equivalents (Note 23)	\$ 4,625,649	\$ 3,575,168
Receivables	116,326	144,225
Inventory (Note 3)	3,634,715	1,038,999
Prepaid expenses	690,152	591,847
<b>Total current assets</b>	<u>9,066,842</u>	<u>5,350,239</u>
<b>Restricted cash</b> (Note 8)	566,708	707,480
<b>Long term stockpile inventory</b> (Note 3)	1,107,316	-
<b>Deposit on equipment and construction materials</b>	816,461	1,762,945
<b>Property, plant and equipment</b> (Notes 4 and 13)	9,916,595	12,879,658
<b>Mineral properties</b> (Note 5)	<u>58,788,273</u>	<u>60,843,501</u>
<b>Total assets</b>	<u>\$ 80,262,195</u>	<u>\$ 81,543,823</u>
<b>LIABILITIES AND SHAREHOLDERS' DEFICIENCY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	\$ 17,586,683	\$ 8,746,892
Current portion of deferred services and materials (Note 12)	3,153,394	120,000
Current portion of obligations under capital leases (Note 13)	4,136,032	5,054,987
Current portion of long-term debt (Note 10)	35,465	160,993
Senior secured notes (Note 14)	26,646,631	15,653,483
Convertible senior secured notes (Note 15)	44,837,991	-
<b>Total current liabilities</b>	<u>96,396,196</u>	<u>29,736,355</u>
<b>Long term debt</b> (Note 10)	80,235	-
<b>Deferred services and materials</b> (Note 12)	-	3,123,394
<b>Obligations under capital leases</b> (Note 13)	440,229	4,391,168
<b>Senior secured notes</b> (Note 14)	-	13,754,019
<b>Convertible senior secured notes</b> (Note 15)	-	34,794,455
<b>Asset retirement obligation</b> (Note 24)	4,698,650	4,664,720
<b>Total liabilities</b>	<u>101,615,310</u>	<u>90,464,111</u>
<b>Commitments and contingencies</b> (Notes 21 and 25)		
<b>Shareholders' deficiency</b>		
Share Capital		
Authorized		
Unlimited common shares and preferred shares without par value (Note 16)		
Issued and outstanding		
125,281,951 (May 31, 2009 – 96,040,121) common shares	102,334,997	89,208,668
Treasury shares, at cost		
44,200 (May 31, 2009 – 44,200) common shares	(122,193)	(122,193)
Warrants (Notes 16 and 18)	13,209,412	14,109,097
Contributed surplus (Note 16)	16,219,808	13,897,197
Equity component of convertible senior secured notes (Note 15)	495,121	495,121
Accumulated comprehensive loss (Note 2)	(6,733,242)	(6,733,242)
Deficit	<u>(146,757,018)</u>	<u>(119,774,936)</u>
<b>Total shareholders' deficiency</b>	<u>(21,353,115)</u>	<u>(8,920,288)</u>
<b>Total liabilities and shareholders' deficiency</b>	<u>\$ 80,262,195</u>	<u>\$ 81,543,823</u>

**On behalf of the Board:**

"Richard Fifer" - Director

"David Kaplan" - Director

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

**PETAQUILLA MINERALS LTD.****CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS**

(in United States Dollars)

	Year ended May 31 2010	Year ended May 31 2009	One month ended May 31 2008	Year ended April 30 2008
<b>METAL SALES</b>	\$ 27,827,935	-	-	-
<b>COST OF SALES</b>	16,523,160	-	-	-
<b>AMORTIZATION AND DEPLETION</b>	4,839,420	-	-	-
	<u>6,465,355</u>	<u>-</u>	<u>-</u>	<u>-</u>
<b>EXPENSES</b>				
Accounting and legal (Note 19)	\$ 1,775,357	\$ 1,944,302	\$ 15,536	\$ 1,306,921
Accretion of asset retirement obligation (Note 24)	325,287	331,504	52,098	305,692
Consulting fees (Note 19)	663,796	370,248	21,170	943,250
Filing fees	64,303	115,295	280	87,005
Investor relations and shareholder information	502,690	475,092	54,595	1,012,822
Office administration	1,609,746	2,187,020	213,168	2,711,908
Rent	119,920	240,693	1,630	122,495
Donations and community relations	1,240,479	949,271	-	-
Exploration and development costs (Note 6)	4,304,303	7,761,862	562,237	11,690,204
Stock-based compensation (Note 17)	1,351,106	898,454	77,890	5,561,247
Travel	906,989	1,014,530	121,849	857,907
Debt issuance costs (Notes 11, 14 and 15)	613,244	6,398,825	3,894,873	-
Wages and benefits (Note 19)	3,428,470	2,916,615	177,329	1,668,455
Total expenses	<u>(16,905,690)</u>	<u>(25,603,711)</u>	<u>(5,192,655)</u>	<u>(26,267,906)</u>
<b>OTHER INCOME (EXPENSE)</b>				
Foreign exchange (loss) gain	(93,159)	(8,157,720)	295,059	1,342,442
Interest income	52,394	169,366	78,658	51,926
Interest on long-term debt (Notes 10 and 13)	(501,574)	(37,382)	(15,613)	(68,465)
Asset usage fees	-	(4,155)	(695)	126,775
Gain on sale of equity investment (Note 7)	-	40,604,938	-	4,347,077
Power and drilling services	90,000	156,597	70,094	76,430
Loss from equity investment (Note 7)	-	(2,396,011)	(779,846)	(8,301,371)
Gain on dilution of equity investment (Note 7)	-	2,238,492	-	12,582,085
Redemption loss on senior secured notes	(240,000)	(13,130,982)	-	-
Mark-to-market loss on senior secured notes and convertible senior secured notes	(15,849,408)	(14,939,298)	-	-
Total other income (expenses)	<u>(16,541,747)</u>	<u>4,503,845</u>	<u>(352,343)</u>	<u>10,156,899</u>
<b>Net loss for the period</b>	<u>(26,982,082)</u>	<u>(21,099,866)</u>	<u>(5,544,998)</u>	<u>(16,111,007)</u>
<b>Other comprehensive (loss) gain:</b>				
<b>Unrealized (loss) gain on translating financial statements to U.S. dollar reporting currency (Note 2)</b>	<u>-</u>	<u>(4,648,716)</u>	<u>487,574</u>	<u>716,555</u>
<b>Comprehensive loss for the year</b>	<u><u>\$(26,982,082)</u></u>	<u><u>\$(25,748,582)</u></u>	<u><u>\$(5,057,424)</u></u>	<u><u>\$(15,394,452)</u></u>
<b>Basic and diluted loss per share</b>	<u><u>\$(0.25)</u></u>	<u><u>\$(0.22)</u></u>	<u><u>\$(0.06)</u></u>	<u><u>\$(0.17)</u></u>
<b>Weighted average number of common shares outstanding (basic and diluted)</b>	<u>107,740,441</u>	<u>96,019,488</u>	<u>93,131,030</u>	<u>93,131,030</u>

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

**PETAQUILLA MINERALS LTD.****CONSOLIDATED STATEMENTS OF SHAREHOLDERS' DEFICIENCY**  
(in United States dollars)

	Number of Common Shares	Amount of Common Shares	Contributed Surplus	Warrants	Accumulated Other Comprehensive Loss	Accumulated Deficit
Balance as at May 31, 2008	95,958,641	\$ 89,002,273	\$ 14,714,276	\$ 11,771,374	\$ (2,084,526)	\$ (98,675,070)
Exercise of stock options	81,480	206,395	(168,732)	-	-	-
Stock-based compensation	-	-	869,890	-	-	-
Senior secured notes finders warrants	-	-	-	215,230	-	-
Senior secured notes warrants	-	-	-	706,802	-	-
Expiration of warrants	-	-	263,263	(263,263)	-	-
Warrant issue costs	-	-	-	(102,546)	-	-
Repricing of senior secured notes warrants	-	-	(1,781,500)	1,781,500	-	-
Net loss	-	-	-	-	-	(21,099,866)
Exchange difference from translation of financial statements to US reporting currency	-	-	-	-	(4,648,716)	-
Balance as at May 31, 2009	96,040,121	\$ 89,208,668	\$ 13,897,197	\$ 14,109,097	\$ (6,733,242)	\$(119,774,936)
Non-brokered private placements, net of finders' fees	28,000,080	12,226,321	-	319,736	-	-
Exercise of stock options	768,750	542,201	(187,487)	-	-	-
Stock-based compensation	-	-	1,351,106	-	-	-
Expiration of warrants	-	-	1,158,992	(1,158,992)	-	-
Exercise of warrants	473,000	357,807	-	(60,429)	-	-
Net loss	-	-	-	-	-	(26,982,082)
Balance as at May 31, 2010	125,281,951	\$102,334,997	\$ 16,219,808	\$ 13,209,412	\$ (6,733,242)	\$(146,757,018)

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

**PETAQUILLA MINERALS LTD.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in United States Dollars)

	Year ended May 31, 2010	Year ended May 31, 2009	One month ended May 31, 2008	Year ended April 30, 2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>				
Net loss for the period	\$(26,982,082)	\$(21,099,866)	\$(5,544,998)	\$(16,111,007)
Items not affecting cash:				
Accretion of asset retirement obligation	325,287	331,504	52,098	305,692
Amortization and depletion	4,839,420	-	-	-
Amortization included in office administration	361,198	336,602	35,511	344,968
Gain on dilution of equity investment	-	(2,238,492)	-	(12,582,085)
Gain on sale of equity investment	-	(40,604,938)	-	(4,347,077)
Loss from equity investment	-	2,396,011	779,846	8,301,371
Stock-based compensation	1,351,106	898,454	77,890	5,561,247
Stock-based compensation included in exploration and development expenses	-	(28,564)	12,113	581,068
Amortization included in exploration and development expenses	-	4,033,720	368,809	2,901,942
Debt issuance costs	613,244	6,398,825	3,894,872	-
Redemption loss on senior secured notes	240,000	13,130,982	-	-
Mark-to-market loss on senior secured notes and convertible senior secured notes	15,849,408	14,939,298	-	-
Interest paid on senior secured notes and convertible senior secured notes	(2,526,291)	-	-	-
Unrealized foreign exchange losses (gains)	-	8,651,025	(397,753)	(234,748)
Changes in non-cash working capital items:				
Decrease (increase) in receivables	27,899	306,660	(187,614)	(153,297)
(Increase) decrease in prepaid expenses	(98,305)	(281,592)	343,861	(202,481)
(Increase) in inventory	(3,274,719)	(1,038,999)	-	-
Deferred services and materials	(90,000)	(156,597)	(70,094)	(76,430)
(Decrease) increase in accounts payable and accrued liabilities	9,864,683	(1,984,118)	(9,498,857)	9,042,977
Net cash provided by (used in) operating activities	500,846	(16,010,085)	(10,134,316)	(6,667,860)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>				
Net proceeds from exercise of warrants and options	652,092	37,662	-	1,625,520
Proceeds from issue of shares	13,216,313	-	-	12,142,274
Share issuance costs	(670,256)	-	-	(458,397)
Advances from (to) Petaquilla Copper Ltd.	-	-	-	17,682,808
(Repayment of) proceeds from bank overdraft	-	(2,100,000)	(32,125)	896,935
Proceeds from senior secured notes	-	40,587,500	27,412,500	-
Repayment of senior secured notes	(1,200,000)	(64,238,852)	-	-
Proceeds from convertible senior secured notes	-	34,000,000	-	-
Payment of capital lease obligations	(4,869,894)	(2,824,140)	(60,390)	(700,022)
Debt issuance costs	(613,244)	(6,286,138)	(3,894,872)	-
Repayment of long-term debt	(160,993)	(436,230)	(45,005)	(534,993)
Proceeds from bridge financing	4,788,826	-	-	-
Repayment of bridge financing	(4,788,826)	-	-	-
Net cash provided by (used in) financing activities	6,354,018	(1,260,198)	23,380,108	30,654,125
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>				
Acquisition of property, plant and equipment	(1,138,477)	(1,631,883)	-	(6,579,011)
Pre-production revenue credited to mineral properties	22,779,059	653,941	-	-

Pre-production cost of sales included in mineral properties	(24,275,977)	(1,260,127)	-	-
Deposit on equipment	-	(1,762,945)	-	-
Investment in mineral properties	(3,310,056)	(31,073,461)	(1,289,902)	(13,909,888)
Redemption (purchase) of performance bond and restricted cash	140,772	-	-	511,315
Proceeds (purchase) from sale of equity investment	-	43,238,852	-	-
Net cash (used in) provided by investing activities	(5,804,679)	8,164,377	(1,289,902)	(19,977,584)
<b>Impact of exchange rate changes on cash and cash equivalents</b>	296	(169,063)	(872,009)	(3,849,118)
<b>Change in cash and cash equivalents</b>	1,050,481	(9,274,969)	11,083,881	159,563
<b>Cash and cash equivalents, beginning of period</b>	3,575,168	12,850,137	1,766,256	1,606,693
<b>Cash and cash equivalents, end of period</b>	\$4,625,649	\$3,575,168	\$12,850,137	\$1,766,256

**Supplemental disclosure with respect to cash flows** (Note 23)

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

**PETAQUILLA MINERALS LTD.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(in United States Dollars)

Year Ended May 31, 2010, Year Ended May 31, 2009, One Month Ended May 31, 2008 and Year Ended April 30, 2008

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**1. NATURE OF OPERATIONS AND GOING CONCERN UNCERTAINTY**

Petaquilla Minerals Ltd. (“the Company” or “Petaquilla”) was incorporated in the Province of British Columbia.

The Company is engaged in the mining and mineral exploration of gold-bearing mineral properties in Panama and operates under the rules and regulations of Ley Petaquilla No. 9 of February 26, 1997 which is a contractual arrangement between the Company and the Government of Panama. In accordance with Ley Petaquilla, the Ministry of Commerce and Industry of the Government of Panama issued a letter to the Company dated November 18, 2009, authorizing Petaquilla’s subsidiary, Petaquilla Gold, S.A., to initiate commercial production at its Molejon gold mine. Commercial production was subsequently achieved on January 8, 2010. The Company is also pursuing exploration activities centered on its 842 square kilometres of concessions in the Province of Colon, Panama.

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles on a going concern basis which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. The Company has experienced recurring operating losses and has accumulated an operating deficiency of \$146,757,018 at May 31, 2010 (May 31, 2009 - \$119,774,936) and a shareholders’ deficiency of \$21,353,115 at May 31, 2010 (May 31, 2009 - \$8,920,288). Also the Company had a working capital deficiency of \$87,329,354 at May 31, 2010 (May 31, 2009 - \$24,386,116). Working capital is defined as current assets less current liabilities and provides a measure of the Company’s ability to settle liabilities that are due within one year with assets that are also expected to be converted to cash within one year. (See Note 26).

The Company is currently in discussions with lenders to refinance its senior secured notes and convertible senior secured notes however, there is no guarantee that management will be successful in its efforts. Therefore, the use of generally accepted accounting principles that are applicable to a going concern may not be appropriate as there is substantial doubt about the Company’s ability to continue as a going concern. These consolidated financial statements do not include any adjustments to the amounts and classifications of assets and liabilities that might be necessary should the Company be unable to continue as a going concern.

The operating cash flow and profitability of the Company are affected by various factors including the amount of gold produced and sold, the market price of gold, operating costs, interest rates, environmental costs, the level of exploration activity, labour risk, risk of business disruption due to environmentalist activities, and political risk. The Company seeks to manage the risks associated with its business; however, many of the factors affecting these risks are beyond the Company’s control.

**2. SIGNIFICANT ACCOUNTING POLICIES**

These consolidated financial statements and accompanying notes have been prepared in conformity with Canadian Generally Accepted Accounting Principles (“GAAP”). For a description of the differences between Canadian GAAP and United States GAAP for the Company, see note 27.

These consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries Adrian Resources (BVI) Ltd. (a British Virgin Island corporation), Petaquilla Minerals, S.A. (a Panama corporation), Instituto Petaquilla, S.A. (a Panama corporation), Petaquilla Gold, S.A. (a Panama corporation), Brigadas Verdes, S.A. (a Panama corporation), Aqua Azure, S.A. (a Panama corporation), Panamanian Development and Infrastructure Ltd. (formerly Petaquilla Infrastructure Ltd.) (a British Columbia corporation), Petaquilla Infraestructura Ltd. (a British Virgin Island corporation), Panama Desarrollo De Infraestructuras, S.A. (formerly Petaquilla Hidro, S.A.) (a Panama corporation), Panama Central Electrica, S.A. (a Panama corporation) and a 50.2% interest in Petaquilla Infraestructura, S.A. (a Panama corporation). The Company proportionately consolidates its 69% interest in a joint venture investment, Compania Minera Belencillo, S.A. (“Belencillo”) (a Panama corporation).

**PETAQUILLA MINERALS LTD.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(in United States Dollars)

Year Ended May 31, 2010, Year Ended May 31, 2009, One Month Ended May 31, 2008 and Year Ended April 30, 2008

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**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

Variable interest entities (“VIEs”), which include, but are not limited to, special purpose entities, trusts, partnerships, and other legal structures, as defined by the Accounting Standards Board in Accounting Guideline (“AcG”) 15, Consolidation of Variable Interest Entities (“AcG 15”) are entities in which equity investors do not have the characteristics of a “controlling financial interest” or there is not sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. VIEs are subject to consolidation by the primary beneficiary who will absorb the majority of the entities’ expected losses and/or expected residual returns. The Company has determined that it is the primary beneficiary of Azuero Mining Development, S.A. (a Panama corporation) and this VIE is consolidated with the accounts of the Company in these consolidated financial statements. The Company does not have access to the assets of Azuero Mining Development, S.A. and the creditors of Azuero Mining Development, S.A. do not have recourse against the Company.

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

**Use of estimates**

The preparation of consolidated financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the amount of revenues and expenses reported during the period. Actual results could differ from these estimates.

Significant estimates used in the preparation of the consolidated financial statements include, but are not limited to, the estimated recoverable tonnes of ore from the mine and the estimated tonnes of waste material to be mined, the expected economic life of the mine, the estimated future operating results and net cash flows from the mine, the anticipated costs of reclamation and mine closure obligations, the recoverability of accounts receivable, the useful life of property, plant and equipment, the amount and likelihood of contingencies, the discount rate and expected redemption date used for valuation of senior secured and convertible senior secured notes, the valuation allowance for future income tax assets and the accounting for stock-based compensation and warrants.

**Cash and cash equivalents**

Cash and cash equivalents are classified as held for trading and include short-term, highly liquid investments with original maturities of three months or less that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. The Company places its deposits with financial institutions with high credit standings. The Company regularly maintains cash balances in financial institutions in excess of insured limits.

**Inventory**

Finished goods, work-in-process, and stockpiled ore are valued at the lower of average production cost and net realizable value. Production costs include the cost of raw materials, direct labor, mine-site overhead expenses, royalties and amortization and depletion of mining assets. Supplies are valued at the lower of average cost or replacement cost.

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**2. SIGNIFICANT ACCOUNTING POLICIES (continued)****Property, plant and equipment**

Equipment is recorded at cost less accumulated amortization, which is provided on the declining balance basis at rates as follows:

Furniture and fixtures	20%
Computer equipment	30%
Equipment under capital lease	30%
Equipment	30%
Vehicles	30%
Computer software	50%
Buildings	4%

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Plant is depleted on a unit-of-production basis over the estimated economic life of the mine to which it relates. Tailings ponds are depleted on a straight line basis over their estimated useful life, which ranges from one to two years.

**Mineral properties**

Exploration and development costs are expensed until such time as reserves are proven and financing to complete development has been obtained. Acquisition costs of mineral properties and tangible development costs incurred thereon, are deferred until the property to which they relate is placed into production, sold or abandoned. The carrying values of mineral properties are, where necessary, written down to fair value if carrying value is not recoverable. Costs relating to properties abandoned are written off when the decision to abandon is made.

Prior to the attainment of commercial production, all revenues from metal sales and all production and selling costs related to those sales are capitalized as part of mineral properties. After the start of commercial production, all revenue and applicable costs are recorded in the consolidated statement of operations. The start of commercial production is defined as the point in time when 70% of the designed production capability is achieved and this is maintained for thirty consecutive days.

The Company follows the cost reduction method of accounting for the receipt of property option and similar payments. Cash and other property payments received from the Company's exploration partners are credited to the respective property until all capitalized costs are recovered; thereafter, such payments are included in income. Option payments are exercisable at the discretion of the optionee and are only recognized when received.

**Restricted cash**

The Company has elected to classify restricted cash as held for trading.

**Receivables**

Receivables are classified as loans and receivables and are measured at amortized costs. Receivables consist of refundable government value added taxes and travel advances.

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**2. SIGNIFICANT ACCOUNTING POLICIES (continued)****Asset retirement obligation**

An asset retirement obligation is a legal obligation associated with the retirement of tangible long-lived assets that the Company is required to settle. The Company recognizes the fair value of a liability for an asset retirement obligation in the period in which it is incurred when a reasonable estimate of fair value can be made. The carrying amount of the related long-lived asset is increased by the same amount as the liability. Subsequently, these capitalized asset retirement costs will be amortized to expense over the life of the related assets using the unit-of-production method. At the end of each period, the liability is increased to reflect the passage of time (accretion expense) and adjusted for changes in the estimated future cash flows underlying any initial fair value measurements (an increase or decrease in asset retirement costs).

**Impairment of long-lived assets**

A long-lived asset which includes property and related costs and equipment is tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. An impairment loss is recognized when the carrying amount of a long-lived asset exceeds its fair value. For purposes of recognition and measurement of an impairment loss, a long-lived asset is grouped with other assets and liabilities to form an asset group, at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. Estimates of future cash flows used to test recoverability of a long-lived asset include only the future cash flows that are directly associated with, and that are expected to arise as a direct result of, its use and eventual disposition.

**Foreign currency translation**

Prior to March 1, 2009, the Canadian dollar was determined to be the measurement currency of the Company's operations and these operations have been translated into United States dollars up until this date using the current rate method as follows: all assets and liabilities are translated into United States dollars at the exchange rate prevailing at the balance sheet date; all revenue and expense items are translated at the average rate of exchange for the period; and the resulting translation adjustment is recorded as accumulated other comprehensive income ("AOCI"), a separate component of shareholders' equity. Subsequent to the change in measurement currency described below, the AOCI balance will remain the same until the entities which gave rise to the AOCI balance are disposed of. In addition, unrealized gains and losses due to movements in exchange rates on balances held in foreign currencies are shown separately on the Consolidated Statement of Cash Flows.

Due to several financings in U.S. dollars, the most recent in March 2009, as well as the commencement of startup operations in Panama and expected revenue generation in U.S. dollars, it has been determined that as of March 1, 2009, the United States dollar is the reporting and measurement currency of the Company's operations and therefore these operations have been translated using the temporal method from that date onward. Under this method, foreign currency monetary assets and liabilities are translated into United States dollars at the exchange rates prevailing at the balance sheet date; non-monetary assets denominated in foreign currencies are translated using the rate of exchange at the transaction date; and foreign exchange gains and losses are included in the determination of earnings.

**Revenue Recognition**

Revenue from the sale of metals is recognized in the accounts when persuasive evidence of an arrangement exists, title and risk passes to the buyer, collection is reasonably assured and the price is reasonably determinable. During the pre-operating period, revenues and related expenses are recognized as a reduction / increase to mineral properties.

**PETAQUILLA MINERALS LTD.**

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**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Debt issuance costs**

Debt issuance costs, which include legal fees, trustee fees, due diligence fees, finders' fees, and finders' warrants, are expensed in the year that they are incurred.

**Interest expense**

Interest expense on financing related to project development, construction and mill equipment is capitalized to mineral properties to be amortized over the recoverable reserves on a unit-of-production basis. Interest on operating long-term debt is expensed to operations as it is incurred since it relates to the acquisition of equipment used for general corporate purposes rather than for production.

**Loss per share**

The Company uses the treasury stock method to compute the dilutive effect of options, warrants and similar instruments. Under this method, the dilutive effect on loss per share is recognized as a result of the use of the proceeds that could be obtained upon exercise of options, warrants and similar instruments. It assumes that the proceeds would be used to purchase common shares at the average market price during the period. For all periods presented, all outstanding options and warrants were anti-dilutive since the proceeds to be received would be below the market value of the Company's shares, and the Company incurred a net loss for all periods presented.

**Stock-based compensation**

The Company accounts for all stock-based payments and awards using the fair value-based method. Under the fair value-based method, stock-based payments to non-employees are measured at the fair value of the consideration received, or the fair value of the equity instruments issued, or liabilities incurred, whichever is more reliably measurable. The fair value of stock-based payments to non-employees is periodically re-measured until counterparty performance is complete, and any change therein is recognized over the vesting period of the award and in the same manner as if the Company had paid cash instead of paying with or using equity instruments. The cost of stock-based payments to non-employees that are fully vested and non-forfeitable at the grant date is measured and recognized at that date. Compensation cost attributable to awards to employees is measured at fair value at the grant date and recognized over the vesting period.

**Income taxes**

Future income taxes are recorded using the liability method under which future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using the enacted or substantively enacted tax rates expected to apply when the asset is realized or the liability settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income or loss in the period that substantive enactment or enactment occurs. To the extent that the Company does not consider it more likely than not that a future tax asset will be recovered, it provides a valuation allowance against the excess.

**Adoption of new accounting policies**

In February 2008, the CICA issued a new Handbook Section 3064 - Goodwill and Intangible Assets ("Section 3064"), which replaces CICA Handbook Sections 3062 - Goodwill and Other Intangible Assets ("Section 3062") and 3450 - Research and Development Costs and EIC-27- Revenues and Expenditures during the Pre-Operating Period. Various changes have been made to other sections of the CICA Handbook for consistency purposes. Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets. Standards concerning goodwill are unchanged from the standards included in Section 3062. The new Section was

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**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

applicable to the Company's financial statements for its fiscal year beginning June 1, 2009. The adoption of this section did not have a material impact on the Company's consolidated financial statements.

In June 2009 the Company adopted the amendments to CICA Section 3862, Financial Instruments Disclosures, to include enhanced disclosures on the liquidity risk of financial instruments and new disclosures on fair value measurements of financial instruments. The adoption of these amendments did not result in a material impact on the Company's consolidated financial statements.

**Accounting Policies to be Implemented Effective June 1, 2011**

In January 2009, the CICA issued Handbook Sections 1582 – Business Combinations (“Section 1582”), 1601 – Consolidated Financial Statements (“Section 1601”) and 1602 – Non-controlling Interests (“Section 1602”) which replaces CICA Handbook Sections 1581 – Business Combinations and 1600 – Consolidated Financial Statements. Section 1582 establishes standards for the accounting for business combinations that is equivalent to the business combination accounting standard under International Financial Reporting Standards (“IFRS”). Section 1582 is applicable for the Company's business combinations with acquisition dates on or after January 1, 2011. Early adoption of this Section is permitted. Section 1601, together with Section 1602, establishes standards for the preparation of consolidated financial statements. Section 1601 is applicable for the Company's interim and annual consolidated financial statements for its fiscal year beginning June 1, 2011. Early adoption of this Section is permitted. If the Company chooses to early adopt any one of these Sections, the other two sections must also be adopted at the same time.

**3. INVENTORY**

	May 31, 2010	May 31, 2009
Supplies	\$1,505,310	\$ 1,038,999
Ore stockpiles	1,398,074	-
Work in process	404,870	-
Finished goods	1,433,777	-
	4,742,031	1,038,999
Less: Ore stockpiles which will not be consumed for more than one year	1,107,316	-
	<u>\$3,634,715</u>	<u>\$1,038,999</u>

The amount of inventories recognized as an expense during the year is included in cost of sales in the Consolidated Statement of Earnings.

**4. PROPERTY, PLANT AND EQUIPMENT**

	May 31, 2010			May 31, 2009		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Equipment under capital leases	10,808,073	6,011,701	4,796,372	10,808,072	3,956,113	6,851,959
Equipment	9,294,346	5,322,109	3,972,237	8,744,787	3,737,484	5,007,303
Buildings	472,530	39,160	433,370	472,783	21,098	451,685
Vehicles	433,348	109,208	324,140	167,499	27,257	140,242
Computer equipment	262,105	121,475	140,630	221,489	69,909	151,580
Computer software	214,132	168,788	45,344	201,187	129,915	71,272
Land	188,533	-	188,533	189,353	-	189,353
Furniture and fixtures	28,302	12,333	15,969	25,016	8,752	16,264
	<u>\$21,701,369</u>	<u>\$ 11,784,774</u>	<u>\$9,916,595</u>	<u>\$20,830,186</u>	<u>\$ 7,950,528</u>	<u>\$ 12,879,658</u>

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**5. MINERAL PROPERTIES**

As at May 31, 2010, the Company has capitalized \$58,788,273 in mineral property costs, net of revenue of \$27,908,659. A total of \$60,843,501, net of revenue of \$653,941 was capitalized in mineral property costs as at May 31, 2009.

	May 31, 2010	May 31, 2009
Plant	\$ 46,876,372	\$ 47,610,795
Plant equipment	2,973,133	2,973,133
Camp	5,553,824	5,252,168
Tailings ponds	1,599,202	-
Site improvements under construction	238,734	-
Asset retirement obligation (Note 24)	3,166,947	3,458,304
Capitalized interest expense	1,999,794	1,549,101
Depletion	(3,619,733)	-
	<b>\$ 58,788,273</b>	<b>\$ 60,843,501</b>

*Molejon Property – Panama*

The Molejon Property is located in the District of Donoso, Province of Colon, Panama. The project forms part of the Petaquilla Concession. The Company, through Petaquilla Gold, S.A., owns a 100% interest in the Molejon gold deposit, as well as all other gold and precious metal mineral deposits that might be developed within the Petaquilla Concession, subject to a graduated 5% - 7% net smelter return, based on the gold price at the time of production. A phased Mine Development Plan was approved by Ministerial Resolution of the Government of Panama in September 2005. The Company proceeded with the development of the property and construction of the processing mill and commercial production was achieved on January 8, 2010.

**6. EXPLORATION AND DEVELOPMENT COSTS**

Exploration and development costs incurred to develop the Company's Molejon property and for exploration of other properties are detailed below:

	Year ended May 31, 2010	Year ended May 31, 2009	One month ended May 31, 2008
Temporary camp costs	\$ 1,182,676	\$ -	\$ -
Engineering and geologists	769,598	1,180,721	39,107
Trenching	637,277	78,024	22,862
Drilling costs	486,291	1,603,544	40,581
Logistics	264,593	153,229	7,921
Topography	202,893	7,599	1,956
Assaying	186,941	-	-
Transportation	161,666	-	-
Engineering and design	123,053	145,285	25,224
Communications	96,372	49,396	-
Data management	74,004	-	-
Environment	60,009	162,859	8,153
Bridges and roads	38,819	376,049	1,693
Property permits	20,111	-	33,818
Amortization on operating equipment	-	4,033,720	368,809
Stock-based compensation	-	(28,564)	12,113
	<b>\$ 4,304,303</b>	<b>\$ 7,761,862</b>	<b>\$ 562,237</b>

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**6. EXPLORATION AND DEVELOPMENT COSTS (continued)**

	Year ended April 30, 2008
Drilling costs	\$ 5,845,024
Trenching	370,845
Engineering and geologists	1,058,073
Environment	117,545
Logistics	85,810
Engineering and design	335,193
Transportation	102,686
Communications	62,370
Topography	37,797
Technical support	9,824
Bridges and roads	(4,083)
Amortization on operating equipment	2,901,942
Stock-based compensation (Note 16)	581,068
Interest expense	186,110
	<u>\$ 11,690,204</u>

**7. INVESTMENT IN PETAQUILLA COPPER LTD.**

The Company initially owned 22,233,634 of the issued shares of Petaquilla Copper Ltd. ("Copper") at a cost of \$439,367 (CAD\$ 500,000). Subsequent to the spin out of Copper, the Company accounted for Copper on an equity basis. Under the equity method, the Company recorded the percentage of net income (loss) that would be attributed to the investment by adjusting the carrying value of the investment. If the percentage of loss from the investee was greater than the carrying cost, the amount was not reduced below zero. Dilution gains arose whenever Copper issued equity at a price greater than the carrying value of the equity investment.

On September 19, 2008, the Company disposed of its 20,418,565 common shares of Copper to a wholly-owned subsidiary of Inmet Mining Corporation at a price of CAD\$ 2.20 per common share, for proceeds of \$43,238,852 (CAD\$ 44,920,843). The Company did not incur any transaction costs in disposing of the shares.

**8. RESTRICTED CASH**

The Company has \$566,708 in term deposits (May 31, 2009 - \$707,480) which are being held to guarantee credit cards and a performance bond for compliance with environmental laws in Panama. Interest rates on these deposits range from 0.5% to 4.875%.

**9. OPERATING CREDIT LINE FACILITY**

The Company has an operating credit line facility with Banco Bilbao Vizcaya Argentaria (Panama) S.A. ("BBVA") up to a maximum of \$13,379,554. The facility is converted to capital leases when the asset purchases are completed. The facility has a fixed rate of 9% on \$11,018,456 and 6% on \$2,361,098, is secured by the assets purchased and is registered with the Public Registry of the Republic of Panama. At May 31, 2010 there is a remaining credit line balance of \$332,511 available upon which the Company may draw.

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**10. LONG-TERM DEBT**

During the current year, the Company arranged bank loan financing of \$115,700 for the purchase of vehicles. The loan is secured by the purchased vehicles.

The following table summarizes the loans outstanding as at May 31, 2010 and May 31, 2009:

	May 31, 2010	May 31, 2009
Vehicle loan, repayable at \$3,733 per month, including interest at 10%, due May 2013	\$ 115,700	-
Equipment loan, repayable at \$7,445 per month including interest at 9.0%, paid out October 2009	-	\$ 29,891
Equipment loan, repayable at \$18,095 per month including interest at 9.25%, paid out January 2010	-	125,575
Vehicle loan, repayable at \$793 per month, including interest at 9.25%, paid out January 2010	-	5,527
	<u>115,700</u>	<u>160,993</u>
Less: current portion	<u>(35,465)</u>	<u>(160,993)</u>
	<u>\$ 80,235</u>	<u>\$ -</u>

**11. SENIOR SECURED NOTE BRIDGE FINANCING FROM RELATED PARTIES**

On November 6, 2009 the Company offered for issue a new series of notes pursuant to the Company's senior secured note and convertible senior secured note indenture up to \$5,000,000 of financing ("Bridge Financing") to companies related to directors. The Bridge Financing was repaid in whole in January 2010 along with a restructuring fee of \$500,000.

**12. DEFERRED SERVICES AND MATERIALS TO BE PROVIDED TO IMN RESOURCES INC.**

On September 30, 2007, Petaquilla Gold S.A. ("Gold"), a subsidiary of the Company entered into a Service Agreement with Minera Panama S.A. ("MPSA") (formerly Petaquilla Copper S.A.) to provide electric generation, aggregate for construction and the rental of a drill machine (collectively, the "services") for a 3-year period. In return for receiving certain benefits and assurances, payment for services was assumed and prepaid by IMN Resources Inc. ("IMN") (formerly Petaquilla Copper Ltd.), a wholly owned subsidiary of Inmet Mining Corporation, in the amount of \$4,404,000. Services provided to date include the rental of a drill and the generation of electricity.

	May 31, 2010	May 31, 2009
	\$ 3,153,394	\$ 3,243,394
Current portion	<u>3,153,394</u>	<u>120,000</u>
Non-current portion	<u>\$ -</u>	<u>\$ 3,123,394</u>

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**13. CAPITAL LEASE OBLIGATIONS**

The Company entered into four capital lease arrangements with Banco Bilbao Vizcaya Argentaria (Panama) S.A. ("BBVA") for the purchase of equipment to advance the Molejon project into production.

The equipment includes but is not restricted to: ball mills, a Metso crushing plant, cranes and an aggregate crushing plant.

As a condition of the leases, the equipment will serve as collateral throughout the amortization period and will be registered with the Public Registry of the Republic of Panama. Further, IMN has pledged a term deposit in the amount of \$2,361,098 (May 31, 2009 - \$2,361,098) as additional security.

Future minimum lease payments on the capital lease obligations are as follows:

	May 31, 2010	May 31, 2009
2010	\$ -	\$ 5,741,567
2011	4,376,667	4,164,972
2012	447,080	461,907
	4,823,747	10,368,446
Less imputed interest of 9%	(247,486)	(922,291)
Total	4,576,261	9,446,155
Current obligation	4,136,032	5,054,987
Long-term obligation	\$ 440,229	\$ 4,391,168

**14. SENIOR SECURED NOTES**

	May 31, 2010	May 31, 2009
Senior secured notes due to related parties	\$ 20,672,235	\$ -
Senior secured notes due to third parties	5,974,396	29,407,502
	26,646,631	29,407,502
Less estimated current portion	26,646,631	15,653,483
	\$ -	\$ 13,754,019

At May 31, 2010, there are 21,301 senior secured notes ("Notes") outstanding (May 31, 2009 - 26,468).

The Notes bear interest at an annual rate of 15%. Semi-annual principal repayments on the Notes range from \$nil to \$8,000,000 depending upon the weighted average market price of gold during the six months prior to the payment date as follows:

Weighted Average Market Gold Price	Aggregate Pro Rata Principal Payment
Over \$1,000	\$8,000,000
\$900 to \$1,000	\$6,000,000
\$800 to \$900	\$4,000,000
Less than \$800	-

The Notes mature five years from date of issuance at 120% of principal. The Company has the right to redeem the Notes at any time at 120% of the principal amount plus any accrued or unpaid interest on the Notes. After 18 or 24 months from the date of issuance of the Notes, depending upon the agreement reached with the Note holders, the holders of the Notes can give six months notice to cause the Company to purchase all of the Notes then outstanding at a price equal to the sum of (a) 120% of the principal amount of such Notes to be purchased and (b) accrued and unpaid interest on the principal amount of the Notes. On an annual basis, the Note holders can cause the Company to redeem Notes equal to 35% of Distributable Cash.

**PETAQUILLA MINERALS LTD.**

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**14. SENIOR SECURED NOTES (continued)**

Distributable Cash is defined as cash available after:

- a) satisfaction of the Company's debt obligations (principal and interest);
- b) satisfaction of the Company's general and administrative expenses, capital expenditures and other expense obligations;
- c) deduction for income tax obligations; and
- d) retaining reasonable working capital or other reserves.

Reasonable working capital and other reserves are to be defined mutually between the Company and the Note holders. As of May 31, 2010 neither of these has been defined.

The Company initially issued 60,000 Notes. Each Note was issued with 382 share purchase warrants. Each warrant entitled the holder to purchase one common share at CAD\$ 2.30 for a period of five years from the date of purchase. On April 17, 2009 the Company repriced these warrants to entitle the holder to purchase one common share at CAD \$0.65 for the remainder of the warrant period with the provision that, if the closing trading price of the Company's common shares on the TSX is CAD\$ 1.00 or more for a period of 30 consecutive trading days, the Company has the option to require the earlier exercise of the warrants. The effect of repricing the warrants was an increase in the value of the warrants of \$1,781,500 and a decrease in contributed surplus for the same amount.

On September 30, 2008 the Company redeemed 36,032.376 Notes at 120% of their principal value for a total payment of \$43,238,852, resulting in a loss of \$10,983,735.

On October 1, 2008, the Company issued an additional 20,000 Notes under the \$60 million senior secured notes indenture for net proceeds of \$15,874,958. These Notes contain the same terms and conditions as the previous issue under the indenture with the exception of the 382 share purchase warrants. These Notes did not include any warrants.

On March 25, 2009, the Company redeemed 17,500 Notes at 120% of their principal value for a total payment of \$21,000,000, resulting in a loss of \$2,147,247.

On September 15, 2009 the Company redeemed 5,000 Notes at 120% of their principal value plus interest for a total payment of \$6,208,844. This payment was financed in part by a \$5,129,600 prepayment on forward gold sales of 5,600 ounces at a net price of \$916 per ounce.

There were two additional scheduled repayments of principal, premium and interest totalling \$9,443,405 that were due in March 2010 and May 2010. Of the amounts due, the Company has paid out \$857,594. Under the terms of the Indenture an event of default has occurred and the Notes are currently due on demand at the option of the Note holders or the Trustee. (See Note 26).

The Notes have been accounted for in accordance with HB 3855 "Financial Instruments – Recognition and Measurement", HB 3862 "Financial Instruments – Disclosure" and HB 3863 "Financial Instruments – Presentation". Under this guidance, the Company valued the liability component of the Notes and assigned the difference to the warrants. On the valuation dates, the value of the Notes was calculated to be \$58,474,937 and the amount allocated to the warrants was \$1,525,063. Prepaid interest of \$9,000,000 was applied as a reduction of the Notes. The liability component was initially estimated as approximating the value of a two-year bond with no put or call features using a discount rate of 26.65%. The senior secured notes contain an embedded derivative as a result of the call and put options. The Company is unable to fair value the embedded derivative component separately and thus has classified the combined contract as a financial liability that is held for trading. At May 31, 2010, the Notes have been adjusted to their fair market value of \$26,646,631. Fair market value was estimated as approximating the value of a one-month bond with no put or call features and a 12% discount rate.

During the fiscal year ended May 31, 2010 the Company incurred Nil (year ended May 31, 2009 – \$3,931,861) in financing costs related to the Notes. These costs were expensed in the period in which they

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**14. SENIOR SECURED NOTES (continued)**

were incurred in accordance with the Company's accounting policy.

The Notes are guaranteed, on a joint and several basis, by all of the assets of the Company and of the Company's subsidiaries.

At May 31, 2010, of the 21,301 senior secured notes outstanding, 16,486 senior secured notes are due to companies related to directors of the Company.

**15. CONVERTIBLE SENIOR SECURED NOTES**

	May 31, 2010	May 31, 2009
Convertible notes due to related parties	\$ 44,397,509	-
Less estimated current portion	<u>44,397,509</u>	<u>-</u>
	<u>\$ -</u>	<u>-</u>
Convertible notes due to third parties	\$ 440,482	\$ 34,794,455
Less estimated current portion	<u>440,482</u>	<u>-</u>
	<u>\$ -</u>	<u>\$ 34,794,455</u>

On March 25, 2009 the Company closed \$40,000,000 of a convertible senior secured note ("Convertible Notes") financing. The Convertible Notes bear interest at an annual rate of 15%, of which the first year is prepaid. The Convertible Notes mature two years from the date of issuance at 110% of the principal. The Company has the right to redeem the Convertible Notes at any time at 110% of the principal amount plus any accrued or unpaid interest. Each Convertible Note in the principal amount of \$1,000 is convertible into common shares at CAD\$ 2.25 per share.

On an annual basis, the Convertible Note holders can cause the Company to redeem Convertible Notes equal to 35% of Distributable Cash. Distributable Cash is defined as cash available after:

- a) satisfaction of the Company's debt obligations (principal and interest);
- b) satisfaction of the Company's general and administrative expenses, capital expenditures and other expense obligations;
- c) deduction for income tax obligations; and
- d) retaining reasonable working capital or other reserves.

Reasonable working capital and other reserves are to be defined mutually between the Company and the Note holders. As of May 31, 2010 neither of these has been defined.

Commencing in September 2010, on a semi-annual basis, the Company is required to make principal payments under each holder's Convertible Notes ranging from \$nil to \$8,000,000 depending upon the weighted average market price of gold for the six months prior to the payment date as follows:

Weighted Average Market Gold Price	Aggregate Pro Rata Principal Payment
Over \$1,000	\$ 8,000,000
\$900 to \$1,000	\$ 6,000,000
\$800 to \$900	\$ 4,000,000
Less than \$800	-

Interest of \$829,545 on the Convertible Notes was due on May 15, 2010. Of this amount the Company has paid \$342,406. Under the terms of the Indenture an event of default has occurred and the Convertible Notes are currently due on demand at the option of the Convertible Note holders or the Trustee. (See Note 26)

The Convertible Notes have been accounted for in accordance with HB 3855 "Financial Instruments –

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**15. CONVERTIBLE SENIOR SECURED NOTES (continued)**

Recognition and Measurement,” HB 3862 “Financial Instruments – Disclosure,” HB 3863 “Financial Instruments – Presentation” and EIC 164 “Convertible and Other Debt Instruments with Embedded Derivatives”. Under this guidance, the Company valued the liability component of the Convertible Notes and assigned the difference to the conversion feature. On the valuation date, the value of the liability component of the Convertible Notes was calculated to be \$39,504,879. The conversion feature was valued at \$495,121. Prepaid interest of \$6,000,000 was applied as a reduction of the Convertible Notes. The liability component was initially estimated as approximating the value of a two-year bond with no put or call features using a discount rate of 20.58%. The convertible senior secured notes contained an embedded derivative as a result of the call option. The Company is unable to fair value the embedded derivative component separately and thus has classified the combined contract as a financial liability that is held for trading. At May 31, 2010, the convertible notes were adjusted to their fair market value of \$44,837,991. Fair market value was estimated as approximating the value of a one-month bond with no put or call features using a 12% discount rate.

The Company incurred \$2,466,964 in financing costs in fiscal 2009 related to the Convertible Notes. These costs have been expensed in the period in which they were incurred in accordance with the Company’s accounting policy.

The Convertible Notes are guaranteed, on a joint and several basis, by all of the assets of the Company and of the Company’s subsidiaries. The indebtedness represented by the Convertible Notes is senior to all other indebtedness of the Company and ranks pari passu with the previously issued senior secured notes.

**16. SHARE CAPITAL, WARRANTS AND CONTRIBUTED SURPLUS**

At May 31, 2010, the Company had unlimited authorized common shares without par value and unlimited authorized preferred shares without par value. The Board of Directors will assign the rights and privileges to each series of preference shares upon issue.

In October 2007, the Company closed the first tranche of a non-brokered private placement of 2,093,500 units at CAD\$ 3.00 per unit for gross proceeds of \$6,611,749. Each unit consisted of one common share and one-half of one common share purchase warrant, with each whole warrant exercisable into a common share at a price of CAD\$ 3.50 per share for a period of two years following the close of the private placement. The Company paid \$234,104 and agreed to issue 74,125 share purchase warrants as finders’ fees in connection with part of the private placement. The fair value of the finders’ warrants was \$55,357.

In December 2007, the Company closed the second tranche of the non-brokered private placement announced in October 2007 of 339,000 units at CAD\$ 3.00 per unit for gross proceeds of \$1,018,732. Each unit consisted of one common share and one-half of one common share purchase warrant, with each whole warrant exercisable into a common share at a price of CAD\$ 3.50 per share for a period of two years following the close of the private placement. The Company paid \$43,574 and agreed to issue 12,500 share purchase warrants as finders’ fees in connection with part of the private placement. The fair value of the finders’ warrants was \$8,318.

In January 2008, the Company closed the third tranche of the non-brokered private placement announced in October 2007 of 708,000 units at CAD\$ 3.00 per unit for gross proceeds of \$2,106,098. Each unit consisted of one common share and one-half of one common share purchase warrant, with each whole warrant exercisable into a common share at a price of CAD\$ 3.50 per share for a period of two years following the close of the private placement. The Company paid \$104,115 and agreed to issue 35,000 share purchase warrants as finders’ fees in connection with part of the private placement. The fair value of the finders’ warrants was \$22,764.

In May 2008, the Company closed the first tranche of its senior secured notes issuing 32,250 units for gross proceeds of \$32,250,000. Each unit of \$1,000 consisted of one Note and a warrant to purchase 382 common shares. Each warrant entitled the holder to purchase one common share at CAD\$ 2.30 for a period

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**16. SHARE CAPITAL, WARRANTS AND CONTRIBUTED SURPLUS (continued)**

of five years from the date of purchase. The Company agreed to issue 492,780 share purchase warrants as finders' fees in connection with this tranche of the private placement. The fair value of the finders' warrants was \$638,354.

In June 2008, the Company closed the second tranche of its senior secured notes issuing 10,000 units for gross proceeds of \$10,000,000. Each unit of \$1,000 consisted of one Note and a warrant to purchase 382 common shares. Each warrant entitled the holder to purchase one common share at CAD\$ 2.30 for a period of five years from the date of purchase. The Company agreed to issue 152,800 share purchase warrants as finders' fees in connection with this tranche of the private placement. The fair value of the finders' warrants was \$104,496.

In July 2008, the Company closed the third tranche of its senior secured notes issuing 17,750 units for gross proceeds of \$17,750,000. Each unit of \$1,000 consisted of one Note and a warrant to purchase 382 common shares. Each warrant entitled the holder to purchase one common share at CAD\$ 2.30 for a period of five years from the date of purchase. The Company agreed to issue 271,220 share purchase warrants as finders' fees in connection with this tranche of the private placement. The fair value of the finders' warrants was \$110,736.

On April 17, 2009 the Company repriced the warrants issued with the Notes to allow the holder to purchase one common share at CAD \$0.65 for the remainder of the warrant period with the provision that, if the closing trading price of the Company's common shares on the TSX is CAD\$ 1.00 or more for a period of 30 consecutive trading days, the Company has the option to require the earlier exercise of the warrants. The effect of repricing the warrants was an increase in the value of the warrants by \$1,781,500 and a decrease in contributed surplus by the same amount.

In December 2009, the Company closed a non-brokered private placement of 24,000,000 common shares at a price of CAD \$0.50 per share, raising gross proceeds of \$11,328,236. In connection with the closing of the private placement, the Company has paid finders' fees in the amount of \$566,412.

In May 2010, the Company issued 4,000,080 units at a price of CAD\$ 0.50 per unit, raising gross proceeds of \$1,888,077. Each unit consisted of one common share and one-half of one common share purchase warrant. Each warrant entitles the holder to purchase one additional common share of the Company for a period of two years at an exercise price of CAD\$ 0.85 per share. The Company paid finders' fees of \$103,844 plus 100,002 warrants exercisable for a period of two years at an exercise price of CAD\$ 0.85 per share. The fair value of the finders' warrants was \$15,225.

**17. STOCK OPTIONS**

On November 18, 2008, the Company received approval for its stock option plan which authorizes the board of directors to grant incentive stock options to directors, officers and employees. The maximum number of shares reserved for issuance under the Company's Plan is 10,700,000.

The aggregate number of common shares reserved for issuance to any person may not exceed 5% of the number of outstanding common shares. The exercise price of the options will be determined by the five day volume weighted average price of the Company's shares prior to the date of the grant. Options granted must be exercised no later than 10 years after the date of grant or such lesser period as may be determined by the Board. The Board may at its discretion in any granting of an option set a vesting period whereby the option may only be exercisable in pre-determined instalments.

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**17. STOCK OPTIONS (continued)**

Stock option transactions are summarized as follows:

	Number of Shares	Weighted Average Exercise Price (CAD\$)
Balance at May 31, 2008	8,115,134	1.83
Granted	1,370,000	0.85
Exercised	(81,480)	0.50
Expired	(909,676)	2.17
Forfeited	(58,125)	2.32
Balance at May 31, 2009	8,435,853	1.64
Granted	5,365,000	0.37
Exercised	(768,750)	0.48
Cancelled	(3,245,080)	2.08
Forfeited	(1,532,653)	1.65
Expired	(30,000)	0.26
Balance at May 31, 2010	8,224,370	0.75
Number of stock options exercisable	5,103,120	0.95

At May 31, 2010, the following stock options were outstanding as follows:

Number of Shares Outstanding	Exercise Price (CAD\$)	Expiry Date
786,000	0.54	February 1, 2011
118,800	0.26	July 11, 2011
1,617,070	2.01	January 15, 2012
100,000	2.25	June 20, 2012
50,000	2.49	July 12, 2012
300,000	0.52	December 1, 2013
100,000	0.39	March 1, 2014
75,000	0.62	July 13, 2014
3,500,000	0.23	November 18, 2014
100,000	0.84	January 1, 2015
525,000	0.87	January 5, 2015
537,500	0.57	March 25, 2015
350,000	0.53	April 30, 2015
65,000	0.48	May 13, 2015
8,224,370		

The weighted average fair value of stock options granted is estimated to be approximately CAD\$ 0.35, CAD\$ 0.22, CAD\$ 1.18 and CAD\$ 1.65 for the year ended May 31, 2010, the year ended May 31, 2009, the one month ended May 31, 2008 and the year ended April 30, 2008 respectively, by using the Black-Scholes options pricing model with the following weighted average assumptions:

	Year Ended May 31, 2010	Year Ended May 31, 2009	One Month Ended May 31, 2008	Year Ended April 30, 2008
Risk-free interest rate	1.88%	2.45%	3.05 %	4.44 %
Expected dividend yield	-	-	-	-
Expected stock price volatility	82%	64%	74 %	87 %
Expected option life in years	3.0	4.90	5.00	5.00

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**18. SHARE PURCHASE WARRANTS**

Share purchase warrant transactions are summarized as follows:

	Number of Shares	Weighted Average Exercise Price (CAD\$)
Balance at April 30, 2008	24,634,715	1.94
Issued	12,812,280	2.30
Balance at May 31, 2008	24,634,715	2.13
Issued	11,024,520	0.65
Expired	(705,955)	3.50
Balance at May 31, 2009	34,953,280	1.03
Issued	2,100,042	0.85
Exercised	(473,000)	0.65
Expired	(1,691,875)	3.50
Balance at May 31, 2010	34,888,447	0.90

In October 2007, the Company closed a non-brokered private placement of 2,093,500 units at CAD\$ 3.00 per unit for gross proceeds of \$6,611,749. Each unit consisted of one common share and one-half of one common share purchase warrant, with each whole warrant exercisable into a common share at a price of CAD\$ 3.50 per share for a period of two years following the close of the private placement. The Company paid \$234,104 and agreed to issue 74,125 share purchase warrants as finders' fees in connection with part of the private placement. The fair value of the warrants issued on this tranche of the private placement was \$758,116. The fair value of the finders' warrants was \$55,357.

In December 2007, the Company closed the second tranche of the non-brokered private placement announced in October 2007 of 339,000 units at CAD\$ 3.00 per unit for gross proceeds of \$1,018,732. Each unit consisted of one common share and one-half of one common share purchase warrant, with each whole warrant exercisable into a common share at a price of CAD\$ 3.50 per share for a period of two years following the close of the private placement. The Company paid \$43,574 and agreed to issue 12,500 share purchase warrants as finders' fees in connection with part of the private placement. The fair value of the warrants issued on this tranche of the private placement was \$103,725. The fair value of the finders' warrants was \$8,318.

In January 2008, the Company closed the third tranche of the non-brokered private placement announced in October 2007 of 708,000 units at CAD\$ 3.00 per unit for gross proceeds of \$2,106,098. Each unit consisted of one common share and one-half of one common share purchase warrant, with each whole warrant exercisable into a common share at a price of CAD\$ 3.50 per share for a period of two years following the close of the private placement. The Company paid \$104,115 and agreed to issue 35,000 share purchase warrants as finders' fees in connection with part of the private placement. The fair value of the warrants issued on this tranche of the private placement was \$210,713. The fair value of the finders' warrants was \$22,764.

In May 2008, the Company closed the first tranche of its senior secured notes financing issuing 32,250 units for gross proceeds of \$32,250,000. Each unit of \$1,000 consisted of one Note and a warrant to purchase 382 Common shares. Each warrant entitled the holder to purchase one common share at CAD\$ 2.30 for a period of five years from the date of purchase. The Notes mature at 120% of the principal amount and carry 15% interest of which the first year's interest was prepaid at the date the funds were received. The Company paid \$1,635,230 and agreed to issue 492,780 share purchase warrants as finders' fees in connection with this tranche of the private placement. The fair value of the finders' warrants was \$638,354.

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**18. SHARE PURCHASE WARRANTS (continued)**

In June 2008, the Company closed the second tranche of its senior secured notes financing issuing 10,000 units for gross proceeds of \$10,000,000. Each unit of \$1,000 consisted of one Note and a warrant to purchase 382 common shares. Each warrant entitled the holder to purchase one common share at CAD\$ 2.30 for a period of five years from the date of purchase. The Notes mature at 120% of the principal amount and carry 15% interest of which the first year's interest was prepaid at the date the funds were received. The Company agreed to issue 152,800 share purchase warrants as finders' fees in connection with this tranche of the private placement. The fair value of the finders' warrants was \$104,196.

In July 2008, the Company closed the third tranche of its senior secured notes financing issuing 17,750 units for gross proceeds of \$17,750,000. Each unit of \$1,000 consisted of one Note and a warrant to purchase 382 common shares. Each warrant entitled the holder to purchase one common share at CAD\$ 2.30 for a period of five years from the date of purchase. The Notes mature at 120% of the principal amount and carry 15% interest of which the first year's interest was prepaid at the date the funds were received. The Company agreed to issue 271,220 share purchase warrants as finders' fees in connection with this tranche of the private placement. The fair value of the finders' warrants was \$110,734.

On April 17, 2009 the Company re-priced the warrants issued with the Notes to entitle the holder to purchase one common share at CAD\$ 0.65 for the remainder of the warrant period. Under the revised terms of the warrants, if the common shares of the Company trade at a weighted average trading price of CAD\$ 1.00 or more per share for 30 consecutive trading days, the holders of the warrants must exercise the warrants within 30 days. The re-pricing of the warrants resulted in an increase in the value of the warrants by \$1,781,500 and a decrease in contributed surplus by the same amount.

In December 2009, the Company closed a non-brokered private placement of 24,000,000 common shares at a price of CAD \$0.50 per share, raising gross proceeds of \$11,328,236. In connection with the closing of the private placement, the Company has paid finders' fees in the amount of \$566,412.

On May 21, 2010, the Company issued 4,000,080 units at a price of CAD\$ 0.50 per unit, raising gross proceeds of \$1,888,077. Each unit consisted of one common share and one-half of one common share purchase warrant. Each warrant entitles the holder to purchase one additional common share of the Company for a period of two years at an exercise price of CAD\$ 0.85 per share. The Company paid finders' fees of \$94,404 plus 100,002 warrants exercisable for a period of two years at an exercise price of CAD\$ 0.85 per share. The fair value of the finders' warrants was \$15,225.

The weighted average fair value of the warrants issued is estimated to be approximately CAD\$ 0.16, CAD\$ 0.54, CAD\$ 1.28, CAD\$ 0.69 for the year ended May 31, 2010, the year ended May 31, 2009, the one month ended May 31, 2008 and the year ended April 30, 2008 respectively, by using the Black-Scholes options pricing model with the following assumptions:

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	Year Ended May 31, 2010	Year Ended May 31, 2009	One Month Ended May 31, 2008	Year Ended April 30, 2008
Risk-free interest	1.69%	3.29%	3.18%	4.00%
Expected dividend yield	-	-	-	-
Expected stock price volatility	99%	43%	74%	47%
Expected warrant life in years	2.00	5.00	5.00	2.00

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**18. SHARE PURCHASE WARRANTS (continued)**

At May 31, 2010, the following warrants were outstanding as follows:

<b>Number of Warrants Outstanding</b>	<b>Exercise Price (CAD\$)</b>	<b>Expiry Date</b>
9,424,605	\$1.54	October 17, 2011
2,100,042	\$0.85	May 21, 2012
12,716,780	\$0.65	May 21, 2013
3,595,300	\$0.65	June 4, 2013
7,051,720	\$0.65	July 9, 2013
<u>34,888,447</u>		

**19. RELATED PARTY TRANSACTIONS**

Related party transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the transacting parties.

During the year ended May 31, 2010:

- a) The Company paid consulting fees of \$120,685 to a company controlled by a director (year ended May 31, 2009 – Nil, one month ended May 31, 2008 – Nil, year ended April 30, 2008 – Nil)
- b) The Company paid fees of \$489,908 (year ended May 31, 2009 - \$220,176, one month ended May 31, 2008 - \$4,998 and year ended April 30, 2008 - \$96,624) to a company controlled by the Chairman.
- c) The Company paid wages of \$62,795 to a company controlled by a former officer (year ended May 31, 2009 – Nil, one month ended May 31, 2008 – Nil, year ended April 30, 2008 – Nil)
- d) The Company paid wages of Nil (year ended May 31, 2009 - \$32,158, one month ended May 31, 2008 - \$30,812 and year ended April 30, 2008 - \$17,122) to companies controlled by a former director.
- e) The Company paid for goods and services of \$166,134 (year ended May 31, 2009 - \$155,805, one month ended May 31, 2008 – Nil and year ended April 30, 2008 - \$127,326) to companies controlled by the Chairman.
- f) The Company paid for services of \$1,203,967 to a company related to an officer of a subsidiary company. In prior years this company was not a related party.
- g) The Company paid debt issuance costs of \$500,000 for a senior secured note bridge financing of \$4,789,206. (Note 11) In prior years this company was not a related party.
- h) The Company paid legal fees of \$273,178 (year ended May 31, 2009 - \$269,526, one month ended May 31, 2008 – Nil and year ended April 30, 2008 - \$107,329), share issue costs of Nil (year ended May 31, 2009 - Nil, one month ended May 31, 2008 – Nil and year ended April 30, 2008 - \$162,523) and financing costs of Nil (year ended May 31, 2009 - \$104,272, one month ended May 31, 2008 - \$95,257 and year ended April 30, 2008 – Nil) to a law firm controlled by a former officer and a law firm controlled by a former director.
- i) Of the total mark-to-market losses on Notes and Convertible Notes, \$8,875,394 was attributable to Notes and Convertible Notes held by companies related to two directors.

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**19. RELATED PARTY TRANSACTIONS (continued)**

At May 31, 2010, excluding related party Notes and related party Convertible Notes (Notes 14 and 15), \$981,511 was owed to related parties.

**20. INCOME TAXES**

A reconciliation of income taxes at statutory rates with the reported taxes is as follows:

	Year ended May 31, 2010	Year ended May 31, 2009	One month ended May 31, 2008	Year ended April 30, 2008
Statutory tax rate	29.38%	30.38%	30.67%	33.08%
(Loss) for the period	\$(26,982,082)	\$(21,099,866)	\$(5,544,998)	\$(16,111,008)
Income tax recovery	(7,925,987)	(6,409,084)	(1,700,651)	(5,329,521)
Permanent differences	(199,709)	(4,746,965)	(145,691)	508,419
Income tax rate change and differential	2,608,282	5,551,802	630,937	4,933,488
Foreign exchange	522,046	(1,131,760)	-	-
Cost of previously unrecognized tax pools	-	1,480,781	-	-
Change in functional currency foreign exchange impact	-	4,010,847	-	-
Other	(2,142,158)			
Change in valuation allowance	7,137,526	1,244,379	1,215,405	(112,386)
Income tax recovery	-	-	-	-

The significant components of the Company's future income tax assets (liabilities) are as follows:

	May 31, 2010	May 31, 2009
Future income tax assets (liabilities)		
Non-capital and other loss carry-forwards	\$ 9,684,260	\$ 4,573,299
Equipment and exploration properties	51,814	48,335
Deferred financing costs	1,951,713	2,261,949
Foreign exchange gain on notes	-	(556,181)
Senior secured notes	1,333,938	(442,636)
Other	12,852	12,285
Total future income tax assets	\$ 13,034,577	\$ 5,897,051
Valuation allowance	(13,034,577)	(5,897,051)
Net future income tax assets	-	-

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**20. INCOME TAXES (continued)**

The Company has non-capital losses of \$38,737,039 for deduction against future years' taxable income in Canada. If unutilized, these losses will expire, beginning in 2014, as follows:

2014	402,747
2015	845,293
2026	1,851,858
2027	4,957,604
2028	3,883,399
2029	5,835,886
2030	20,960,252
	\$38,737,039

The Company will not be subject to any income taxes in Panama until all of the debt incurred by all of the affiliated / subsidiary companies has been repaid in full, the timing of which cannot be estimated due to the uncertainty inherent in the future price of gold. At that time the Company will be able to claim accelerated write-offs for all Panamanian subsidiaries.

**21. COMMITMENTS**

	Less than 1 Year	2 Years	3 Years	4-5 Years	More than 5 Years
Office lease	\$ 63,479	\$ 15,867	Nil	Nil	Nil
Equipment lease	\$ 4,376,668	\$447,080	Nil	Nil	Nil
Senior secured notes	\$26,895,996	Nil	Nil	Nil	Nil
Convertible senior secured notes	\$45,257,594	Nil	Nil	Nil	Nil
Long term debt	\$ 44,800	\$ 44,800	\$44,800	Nil	Nil
Fundacion Petaquilla	\$1,200,000	\$1,200,000	\$1,200,000	\$1,200,000	\$3,600,000
Asset retirement obligation	Nil	Nil	Nil	Nil	\$7,312,356

The Company has committed funding of \$100,000 per month to Fundacion Petaquilla for the life of the Molejon mine. Fundacion Petaquilla promotes a sustainable development culture, administering social programs in the area around the Molejon property.

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**22. FINANCIAL INSTRUMENTS AND CAPITAL MANAGEMENT**

The Company thoroughly examines the various financial instrument risks to which it is exposed and assesses the impact and likelihood of those risks. These risks may include credit risk, liquidity risk, currency risk, and interest rate risk. Where material, these risks are reviewed and monitored by the Board of Directors.

**(a) Fair Values**

The fair value of the Company's current assets and liabilities including cash and cash equivalents, receivables, restricted cash and accounts payable and accrued liabilities approximates their carrying values due to the immediate or short-term maturity of these financial instruments. The carrying amounts of the Company's long term debt and obligations under capital leases approximate fair value due to their interest rates being in line with market rates.

The Company's senior secured notes and convertible senior secured notes are measured on initial recognition using the residual method (see Notes 14 and 15). Subsequent fair value measurement is based on a discounted cash flow model using a discount rate of 12.0% at May 31, 2010 (May 31, 2009 – 20.58%) and a maturity date of June 30, 2010 based on the assumption that the Company would obtain refinancing of the notes by that date. For 2009, the maturity date was set at two years from date of issue based on the ability of the note holders to demand repayment after two years and the expectation that note holders would make this demand.

The amendments to Section 3862 (Note 2) introduce a fair value hierarchy that reflects the significance of inputs used in making fair value measurements as follows:

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 (i.e. as prices of) or indirectly (i.e. derived from prices); and

Level 3 – inputs for the asset or liability that are not based on observable market data.

At May 31, 2010, the levels in the fair value hierarchy into which the Company's financial assets and liabilities measured and recognized in the balance sheet at fair value are categorized are as follows:

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	Level 1	Level 2	Level 3
Senior secured notes	-	-	\$ 26,646,631
Convertible senior secured notes	-	-	44,837,991

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Year Ended May 31, 2010, Year Ended May 31, 2009, One Month Ended May 31, 2008 and Year Ended April 30, 2008

**22. FINANCIAL INSTRUMENTS AND CAPITAL MANAGEMENT (continued)**

An analysis of these notes including related gains and losses during the year is as follows:

	Year ended May 31, 2010	Year ended May 31, 2009
Balance at beginning of year		
Senior secured notes	\$ 29,407,502	\$ 26,785,359
Convertible senior secured notes	34,794,455	-
	<u>64,201,957</u>	<u>26,785,359</u>
Payments	(8,822,558)	(64,238,852)
Issues net of prepaid interest	-	74,587,500
Redemption losses included in net income	240,000	13,130,982
Mark-to-market losses included in net income	15,849,408	14,939,298
Unrealized foreign exchange loss (gain) included in net income	-	(1,002,330)
Other	15,815	-
	<u>15,815</u>	<u>-</u>
Balance at end of year	<u>\$ 71,484,622</u>	<u>\$ 64,201,957</u>

**(b) Financial Instrument Risk Exposure*****Credit risk***

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss. Financial instruments that potentially subject the Company to credit risk consist of cash and cash equivalents, restricted cash, and accounts receivable. The Company has reduced its credit risk by investing its cash and cash equivalents and restricted cash in term deposits with financial institutions that operate globally. There is also minimal risk associated with accounts receivable as the payment for gold sales is received prior to the gold being credited to the customer's account at the refinery.

Therefore, the Company is not exposed to significant credit risk and overall the Company's credit risk has not changed significantly from the prior year.

***Liquidity risk***

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company has in place a planning and budgeting process to help determine the funds required to ensure the Company has the appropriate liquidity to meet its operating and growth objectives. The Company has historically relied on issuance of shares, senior secured debt, convertible senior secured debt and leasing arrangements to develop the Molejon gold project and may require doing so again in the future. On an annual basis the Company may be required to pay 35% of its distributable cash as defined in its senior secured notes and convertible senior secured notes indenture (Notes 14 and 15).

The Company has been unable to meet all of its obligations with respect to scheduled repayments of principal, premium and interest on its Notes and interest on its Convertible Notes. Total payments of \$10,272,950 were due in March and May 2010. Of this total, the Company has paid \$1,200,000. Under the terms of the Indenture an event of default has occurred and the Notes and Convertible Notes are due on demand at the option of the Note holders and Convertible Note holders or the Trustee.

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**22. FINANCIAL INSTRUMENTS AND CAPITAL MANAGEMENT (continued)**

Subsequent to year end, the Company entered into a prepaid gold forward facility with Deutsche Bank AG (“Deutsche Bank”) for \$45,000,000. Upon the satisfaction of certain conditions precedent and successful completion of this transaction, net proceeds of approximately \$41,000,000 will be used to extinguish a portion of the Company’s Notes and Convertible Notes. (See Note 26)

***Market risk***

***(i) Currency risk***

Financial instruments that impact the Company’s net earnings or other comprehensive income due to currency fluctuations include: Canadian dollar denominated cash and cash equivalents, restricted cash, accounts receivable and accounts payable. As the Company conducts the vast majority of its activities in United States dollars, changes in the exchange rate between the Canadian dollar and the United States dollar have a minimal effect on the Company’s net earnings and other comprehensive income.

***(ii) Interest rate risk***

Interest rate risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate due to changes in market interest rates. Cash and cash equivalents and restricted cash bear interest at fixed rates.

Other current financial assets and liabilities are not exposed to interest rate risk because they are non-interest bearing.

The operating credit line facility, capital leases, and long-term debt bear interest at a fixed rate and are also not exposed to interest rate risk.

***(c) Capital Management***

The Company’s objectives of capital management are intended to safeguard the entity’s ability to support the Company’s normal operating requirements on an ongoing basis, continue the development and exploration of its mineral properties and support any expansionary plans.

The capital structure of the Company consists of long term debt (Note 10), leases (Note 13), Notes (Note 14), Convertible Notes (Note 15) and equity attributable to common shareholders, comprised of issued capital, contributed surplus and deficit. The Company manages the capital structure and makes adjustments in light of changes in economic conditions and the risk characteristics of the Company’s assets.

To effectively manage the entity’s capital requirements, the Company has in place a planning and budgeting process to help determine the funds required to ensure the Company has the appropriate liquidity to meet its operating and growth objectives. The Company has historically relied on issuance of shares, senior secured debt, convertible senior secured debt and leasing arrangements to develop the project and may require doing so again in the future.

The Company is monitoring market conditions to secure funding at the lowest cost of capital. The Company is exposed to various funding and market risks which could curtail its access to funds.

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**23. SUPPLEMENTAL DISCLOSURE WITH RESPECT TO CASH FLOWS**

	Year ended May 31, 2010	Year ended May 31, 2009	One month ended May 31, 2008	Year ended April 30, 2008
<b>Non-cash investing and financing activities</b>				
Finder's fees	\$ 15,226	\$ -	\$ 638,354	\$ 86,439
Share issue costs	(15,226)	-	(638,354)	(86,439)
Debt issuance costs	-	112,686	-	-
Share capital warrants exercised	60,429	-	-	-
Warrants exercised	(60,429)	(112,686)	-	-
Share capital warrants issued in private placement	(304,511)	-	-	-
Warrants granted in private placement	304,511	-	-	-
Settlement of advances for deferred services	-	-	-	(4,404,000)
Mineral properties	(291,357)	-	-	-
Asset retirement obligation	291,357	-	-	-
Share capital options exercised	187,488	-	-	-
Contributed surplus options exercised	(187,488)	-	-	-
Senior secured note repayment through forward sales agreement	(5,129,600)	-	-	-
Deposits on equipment transferred to capital assets	946,484	-	-	-
Settlement of advances for property, equipment and mineral properties	-	-	-	(3,394,847)
Shares issued for legal settlement	-	-	-	264,438
Mineral properties financed through payables	5,242,659	5,147,462	1,441,668	2,539,496
Property and equipment financed through payables	-	1,071,255	-	-
Property and equipment acquired through credit line facility and capital leases	115,700	2,058,197	-	10,541,877
Amortization capitalized to mineral properties	1,825,067	-	-	-
Amortization allocated to ending inventory	146,696	-	-	-
Depletion allocated to ending inventory	281,617	-	-	-
Deferred services and materials financed by a reduction in amounts payable to IMN	90,000	156,597	11,271	135,252
Interest paid in cash	\$ 4,165,274	\$ 14,224,440	\$ 5,751,180	\$ 68,618
Income taxes paid in cash	-	-	-	-

	May 31, 2010	May 31, 2009
Cash and cash equivalents consist of:		
Cash	\$4,625,649	\$3,440,168
Term deposits	-	135,000
	<u>\$4,625,649</u>	<u>\$3,575,168</u>

**24. ASSET RETIREMENT OBLIGATION**

**PETAQUILLA MINERALS LTD.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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The Company's asset retirement obligation relates to site restoration and cleanup costs for its Molejon gold project located in Panama.

A reconciliation of the provision for asset retirement obligation is as follows:

Balance at May 31, 2008	\$4,333,216
Accretion	331,504
Balance at May 31, 2009	4,664,720
Accretion	325,287
Adjustment for change in estimate of timing of cash flows	(291,357)
Balance at May 31, 2010	\$4,698,650

The provision for asset retirement obligation is based upon the following assumptions:

- The total undiscounted cash flow required to settle the obligation is approximately \$7,300,000;
- Asset retirement obligation payments are expected to occur during fiscal years 2016 and 2017;
- A credit adjusted risk-free rate of 7.65% has been used to discount cash flows.

**25. CONTINGENCIES**

- On November 13, 2008 the Autoridad Nacional del Ambiente ("ANAM"), the environmental agency of the Government of the Republic of Panama, issued a Resolution purporting to fine the Company and its present and former affiliates US\$ 1,000,000 for alleged violations of environmental laws that took place on the main Petaquilla Copper Concession in 2005 and an additional US\$ 934,695 for damages. On November 26, 2008, ANAM, by Resolution, approved the Company's Environmental Impact Study ("EIS") Category III submitted in July 2007 for the Molejon Gold Project. The Resolution sets out a number of conditions to be satisfied before the Company can attain full commercial production. Based on the approval of the EIS, the Company filed for reconsideration by ANAM to have the fines reduced to nil. In January 2009, the Company was advised that ANAM had not accepted the Company's request for reconsideration that the amount of the financial sanctions purportedly levied against the Company and its present and former affiliates be reduced to nil. On March 10, 2009, the Supreme Court of the Republic of Panama suspended the imposition of ANAM's fine until the matter of the Company's appeal is resolved. It is the Company's contention that the Company is required to comply with the Ministry of Industry and Commerce and ANAM's authority is limited to making recommendations. Therefore, the Company does not believe that ANAM has the ability to issue a fine under the terms of Ley Petaquilla 9 and, as such, no amount has been recorded.
- The Ministry of Industry and Commerce has indicated that the Government of Panama would like to increase royalties on metal sales from 2% to 4%. This would require a legislative change and the timing and degree of certainty of this are not known at this time. The effect of increasing royalties by 2% on the Company's operations and financial position for the current year would be an increase in cost of sales of \$502,386 and an increase in accounts payable of \$502,386.
- During the year ending May 31, 2008, the Company was served with a claim by a former officer in the amount of \$250,000. This matter will be going to mediation in fiscal 2011. The Company believes that the claim is without merit and has not recorded a liability as the outcome is uncertain and the amount that could be paid, if any, is not determinable.
- The Company is engaged in certain other legal actions in the ordinary course of business and believes that the ultimate outcome of these actions will not have a material adverse effect on our operating results, liquidity or financial position.

**26. SUBSEQUENT EVENTS**

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**PETAQUILLA MINERALS LTD.**

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Subsequent to May 31, 2010 the following events took place:

- 1) On August 17, 2010, the Company entered into a Forward Gold Purchase Agreement with Deutsche Bank, AG (“Deutsche Bank”). Subject to the satisfaction of certain conditions precedent and the successful completion of the transaction, Deutsche Bank will make an upfront payment of \$45,000,000 in exchange for the Company delivering 68,243 ounces of gold over a five year period. Based on the price of gold at the time of delivery, Deutsche Bank may be required to make additional payments to the Company as gold is delivered. If the transaction is completed, the upfront payment, net of estimated restructuring, legal and finder’s fees of approximately \$4,000,000, will be used to prepay a portion of the Notes and Convertible Notes (See Notes 14 and 15).
- 2) As a condition precedent to completing the forward gold sale with Deutsche Bank, the holders of the Notes and Convertible Notes will be required to enter into an Inter-Creditor Agreement with Deutsche Bank and the Company. While these agreements are not final, management expects that the impact of the Inter-Creditor Agreement on the Notes and Convertible Notes will be as follows:
  - a) the security for the Notes and Convertible Notes will become subordinated to the security granted under the Forward Gold Purchase Agreement with Deutsche Bank;
  - b) no interest or principal payments will be required on the Notes or Convertible Notes for the first six months after the effective date of the Inter-Creditor Agreement. After the first six months, the Company is only required to make scheduled interest payments on the Notes and Convertible Notes as they become due until the Notes and Convertible Notes mature five years and one day after closing of the Forward Gold Purchase Agreement with Deutsche Bank;
  - c) until the Company’s obligations under the Forward Gold Purchase Agreement with Deutsche Bank are satisfied, the holder of the Notes and Convertible Notes are not permitted to take any action as a result of an event of default that has occurred pursuant to the indenture (See Notes 14 and 15);
  - d) if the Company is able to negotiate new financing arrangements satisfying certain conditions, the proceeds of such financing will be used to prepay the outstanding balance of principal, premium and interest on the Notes and Convertible Notes.
- 3) If the Forward Gold Purchase Agreement with Deutsche Bank is successfully completed, the Company has agreed to pay the Chairman \$100,000 as a bonus for partial prepayment of the Notes and Convertible Notes. When the Company repays the remaining amount outstanding on the Notes and Convertible Notes, the Chairman will be entitled to receive an additional bonus payment of \$150,000.
- 4) As a condition precedent to the completion of the Forward Gold Purchase Agreement with Deutsche Bank, Daniel Small resigned as a director of the Company on August 16, 2010.
- 5) In August 2010, the holders of the Notes and Convertible Notes requested an additional 2% in interest on the outstanding balance payable, effective March 15, 2010, as consideration for the holders not issuing a written notice that an event of default had occurred which could have required immediate repayment of the Notes and Convertible Notes. The Company has agreed to pay this additional interest.
- 6) The term of 188,800 options, which were to expire on July 11, 2010, was extended for one year and 100,000 options were exercised.

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**ACCOUNTING PRINCIPLES**

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). Material variations in the accounting principles, practices and methods used in preparing these financial statements from United States Generally Accepted Accounting Principles ("U.S. GAAP") are described and quantified below.

**Loss for the periods**

	<b>Year ended May 31, 2010</b>	<b>Year ended May 31, 2009</b>
(Loss) for the period – Canadian GAAP	\$(26,982,082)	\$(21,099,866)
Gain on dilution of equity investment (a)	-	(2,238,492)
Mineral properties expensed under U.S. GAAP (b)	(3,411,935)	(17,562,548)
Revenue recognized (i)	27,948,475	653,941
Cost of goods sold (i)	(24,275,977)	(1,260,127)
Amortization (i)	(1,825,067)	(640,425)
Amortization of ball mills included in mineral properties under U.S. GAAP (i)	(419,345)	-
Depletion of mineral properties under Canadian GAAP (i)	3,338,116	-
Loss of variable interest entity under US GAAP (k)	69,765	-
Expensing of opening inventory reclassified in prior year	(2,868,999)	-
Write down of inventory in finished goods and work in progress	-	(2,404,695)
Change in fair value of warrants denominated in Canadian dollars under U.S. GAAP (j)	1,692,320	22,871,582
Change in fair value of share capital issued with warrants denominated in Canadian dollars under U.S. GAAP (j)	58,824	-
-Foreign exchange on difference in mineral properties expensed under U.S. GAAP	-	(9,639,262)
Foreign exchange on difference in senior secured notes under U.S. GAAP	-	3,180,313
Additional loss relating to redemption and modification of senior secured note agreement under U.S. GAAP (f)	-	(18,712,488)
Net loss – U.S. GAAP	\$(26,675,905)	\$(46,852,067)
Other comprehensive (loss) gain		
Unrealized (loss) gain on translating financial statements to U.S. reporting currency	-	(4,648,716)
Foreign exchange on difference in mineral properties expensed under U.S. GAAP	-	9,639,262
Foreign exchange on difference in senior secured notes under U.S. GAAP	-	(3,180,313)
Comprehensive loss for the year	\$(26,675,905)	\$(45,041,834)
Basic and diluted loss per share – U.S. GAAP	\$(0.25)	\$(0.49)

**PETAQUILLA MINERALS LTD.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**ACCOUNTING PRINCIPLES (continued)****Loss for the periods**

	<b>One month ended May 31, 2008</b>	<b>Year ended April 30, 2008</b>
(Loss) for the period – Canadian GAAP	\$(5,544,998)	\$(16,111,007)
Gain on dilution of equity investment (a)	-	(12,582,085)
Mineral properties expensed under U.S. GAAP (b)	(1,884,160)	(22,680,970)
Foreign exchange on difference in mineral properties expensed under U.S. GAAP	-	1,622,000
Additional loss relating to redemption and modification of senior secured note agreement under U.S. GAAP (f)	3,831,931	-
Net loss – U.S. GAAP	\$(3,597,227)	\$(49,752,062)
Other comprehensive (loss) gain		
Unrealized (loss) gain on translating financial statements to U.S. reporting currency	487,574	716,555
Foreign exchange on difference in mineral properties expensed under U.S. GAAP	-	(1,622,000)
Foreign exchange on difference in senior secured notes under U.S. GAAP	-	-
Comprehensive loss for the year	\$(3,106,653)	\$(50,657,507)
Basic and diluted loss per share – U.S. GAAP	\$(0.04)	\$(0.53)

<b>Mineral Properties</b>	<b>May 31, 2010</b>	<b>May 31, 2009</b>
Mineral properties – Canadian GAAP	\$ 58,788,272	\$ 60,843,501
Amortization (i)	(2,465,492)	(640,425)
Revenue recognized under U.S. GAAP (i)	28,602,416	653,941
Cost of goods sold (i)	(25,536,104)	(1,260,127)
Depletion of mineral properties under Canadian GAAP (i)	3,619,733	-
Amortization of ball mills included in mineral properties under U.S. GAAP (i)	(419,345)	-
Inventory write-down (i)	-	(2,404,695)
Reclassification of work-in-progress and finished goods to current assets	-	(2,868,999)
Mineral properties expensed under U.S. GAAP (b)	(60,036,692)	(51,350,063)
Mineral properties – U.S. GAAP	\$ 2,552,788	\$ 2,973,133

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**ACCOUNTING PRINCIPLES (continued)**

<b>Balance Sheets</b>	<b>May 31 2010</b>	<b>May 31 2009</b>
Total assets – Canadian GAAP	\$ 80,262,195	\$ 81,543,823
Depletion of mineral properties added to ending inventory (i)	(281,617)	-
Mineral properties expensed or charged to cost of sales and revenue under U.S. GAAP (b)(i)	(56,235,484)	(55,001,369)
Total assets – U.S. GAAP	\$ 23,745,094	\$ 26,542,454
Liabilities – Canadian GAAP	\$101,615,310	\$ 90,464,111
Derivative liability – warrants (j)	4,965,589	6,292,830
Equity component of convertible debt treated as a liability under U.S. GAAP (g)	177,778	495,121
Liabilities – U.S. GAAP	\$106,758,677	\$ 97,252,062
Shareholders' equity (deficit) - Canadian GAAP	\$(21,353,115)	\$(8,920,288)
Mineral properties expensed or charged to cost of sales and revenue under U.S. GAAP (b)(i)	(56,235,484)	(55,001,369)
Exercise of warrants denominated in Canadian dollars under U.S. GAAP (j)	272,000	-
Depletion added to ending inventory	(281,617)	-
(Decrease) increase in retained earnings due to translation of prior year mineral property expenses and senior secured notes	(4,564,949)	(4,564,949)
Difference in accumulated other comprehensive income	4,564,949	4,564,949
Increase in net income due to the change in fair value of warrants denominated in Canadian dollars under U.S. GAAP (j)	22,883,272	22,871,582
Decrease in warrants due to fair value of warrants denominated in Canadian dollars under U.S. GAAP (j)	(28,120,861)	(29,164,412)
Additional loss relating to redemption and modification of senior secured note agreement under U.S. GAAP (f)	(14,591,713)	(14,903,816)
Allocation of fair value of senior secured notes under U.S. GAAP (f)	14,591,713	14,903,816
Equity component of convertible debenture treated as a liability under U.S. GAAP (g)	(177,778)	(495,121)
Shareholders' equity (deficit) – U.S. GAAP	\$(83,013,583)	\$(70,709,608)

<b>Statement of Cash Flows</b>	<b>Year ended May 31, 2010</b>	<b>Year ended May 31, 2009</b>
Cash provided by (used in) operating activities – Canadian GAAP	\$ 500,846	\$ (16,010,085)
Revenues and expenses charged to mineral properties under Canadian GAAP	3,672,498	-
Expenditures on mineral properties	(3,411,935)	(27,201,810)
Cash provided by (used in) operating activities – U.S. GAAP	\$ 761,409	\$(43,211,895)
Cash provided by (used in) financing activities – Canadian GAAP	\$ 6,354,018	\$ (1,260,198)
Cash provided by (used in) financing activities – U.S. GAAP	\$ 6,354,018	\$ (1,260,198)
Cash from (used in) investing activities – Canadian GAAP	\$ (5,804,679)	\$ 8,164,377
Revenues and expenses charged to mineral properties under Canadian GAAP	(3,672,498)	-
Expenditures on mineral properties	3,411,935	27,201,810
Cash from (used in) investing activities – U.S. GAAP	\$ (6,065,242)	\$ 35,366,187
Cash and cash equivalents, end of period – Canadian GAAP	\$ 4,625,649	\$ 3,575,168
Cash and cash equivalents, end of period – U.S. GAAP	\$ 4,625,649	\$ 3,575,168

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**ACCOUNTING PRINCIPLES (continued)**

<b>Statement of Cash Flows</b>	<b>One month ended May 31, 2008</b>	<b>Year ended April 30, 2008</b>
Cash (used in) provided by operating activities – Canadian GAAP	\$ (10,134,316)	\$ (6,667,860)
Expenditures on mineral properties	(1,884,160)	(21,058,970)
Cash used in operating activities – U.S. GAAP	<u>\$(12,018,476)</u>	<u>\$(27,726,830)</u>
Cash from (used in) financing activities – Canadian GAAP	\$ 23,380,108	\$ 30,654,125
Cash from (used in) financing activities – U.S. GAAP	<u>\$ 23,380,108</u>	<u>\$ 30,654,125</u>
Cash from (used in) investing activities – Canadian GAAP	\$ (1,289,902)	\$(19,977,584)
Expenditures on mineral properties	1,884,160	21,058,970
Cash from investing activities – U.S. GAAP	<u>\$ 594,258</u>	<u>\$ 1,081,386</u>
Cash and cash equivalents, end of period – Canadian GAAP	\$ 12,850,137	\$ 1,766,256
Cash and cash equivalents, end of period – U.S. GAAP	<u>\$ 12,850,137</u>	<u>\$ 1,766,256</u>

## a) Equity investment in Petaquilla Copper Ltd.

Under U.S. GAAP, changes in the parent company's proportionate share of equity resulting from the additional equity raised by an entity subject to significant influence in the development stage are accounted for as an equity transaction on consolidation. Under Canadian GAAP, these gains have been credited to income.

## b) Mineral properties and deferred costs

Mineral property costs and related exploration expenditures are accounted for in accordance with Canadian GAAP as disclosed in Note 2. For U.S. GAAP purposes, the Company expenses, as incurred, the exploration costs related to unproven mineral properties. When proven and probable reserves are determined for a property and a feasibility study is prepared, then subsequent exploration and development costs of the property would be capitalized. The capitalized costs of such properties are measured periodically for recoverability of carrying values.

## c) Development stage company

Pursuant to U.S. GAAP, the Company would be subject to the disclosure requirements applicable to a development stage enterprise as the Company is devoting its efforts to establishing commercially viable mineral properties. However, the identification of the Company as such for accounting purposes does not impact the measurement principles applied to these consolidated financial statements.

## d) Income taxes

Under Canadian GAAP, future tax assets and liabilities are recorded at substantively enacted tax rates. Under U.S. GAAP, deferred tax assets and liabilities are recorded at enacted rates. There were no significant differences between enacted and substantively enacted rates for the periods presented.

## e) Accounting for uncertainty in income taxes

U.S. GAAP provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and prescribes a recognition threshold and measurement of a tax position taken or expected to be taken in a tax return.

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**27. DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (continued)**

Effective May 1, 2007 the Company adopted the U.S. GAAP guidance in accounting for uncertainty in income taxes. The adoption did not result in any adjustment to opening retained earnings under U.S. GAAP. As a result of the implementation of this guidance, the Company did not recognize any liabilities for unrecognized tax benefits. In the event that the Company recognizes accrued interest related to unrecognized tax benefits, it will be recorded in interest expense. Any penalties will be recorded in general and administrative expenses.

The Company is subject to taxation in Canada and various other foreign jurisdictions. The Company is currently open to audit under the statute of limitations by the Canada Revenue Agency for years ended January 31, 2006 through May 31, 2010.

f) Senior secured notes

Under Canadian GAAP, compound financial instruments can be accounted for using the residual method when allocating between the liability and the equity component of the instrument. Under U.S. GAAP, compound financial instruments are accounted for using the fair value method when allocating between the liability and the equity component. On the modification of the senior secured note agreement on March 25, 2009, the senior secured notes were required to be marked- to-market and the Company recognized additional losses relating to redemption and inception losses in the amount of \$14,903,816. This resulted in harmonizing both Canadian GAAP and U.S. GAAP with no differences going forward. In the current year, a portion of the warrants were exercised and this amount decreased to \$14,591,173.

g) Convertible senior secured notes

Under U.S. GAAP, convertible debt instruments are classified as debt until converted to equity, whereas under Canadian GAAP, the proceeds of the convertible debt instrument are allocated to both debt and equity components, with the debt component being accreted over time to its face value and accretion charged to earnings. Under U.S. GAAP, a value is assigned to the conversion feature only if the effective conversion rate is less than the market price of the common stock at the commitment date. No value would be assigned under U.S. GAAP to the conversion feature and thus, the entire value of the convertible notes is classified as debt. This difference resulted in liabilities being increased by \$177,778 and shareholders' equity being decreased by \$177,778.

h) Deferred financing costs

U.S. GAAP requires that debt issuance costs be reported in the balance sheet as deferred charges and amortized over the term of the debt. Upon issuance, the Company reduced the carrying value of the senior secured notes by debt issuance costs. On modification of the senior secured note agreement as stated above in (g), an inception loss wrote off all deferred financing costs. No differences exist for the period ended May 31, 2010.

i) Commencement of production

Under Canadian GAAP, the Company uses specific criteria to assess the point at which an operation commences commercial production (Note 2). Under U.S. GAAP, commercial production is considered to have commenced when saleable minerals are extracted (produced) from an ore body, regardless of the level of production. However, commercial production does not commence with the removal of de minimus saleable mineral material that occurs in conjunction with the removal of overburden or waste material for the purpose of obtaining access to an ore body. For the year ended May 31, 2010, there was one Canadian/U.S. GAAP difference with respect to the determination of commercial production.

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**27. DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (continued)**

Under Canadian GAAP, up until January 7, 2010, the Molejon gold mine was at a pre-commercial production phase whereas for U.S. GAAP purposes, commercial production commenced on the date on which revenue was earned from the sale of gold. For U.S. GAAP purposes, the impact of this difference was to increase revenues, cost of sales and amortization and decrease depletion for the year ended May 31, 2010 by \$27,948,475, \$24,275,977, \$1,825,067 and \$3,338,116 respectively, and increase mineral properties and net earnings for the year ended May 31, 2010 by \$8,054,546, and \$5,185,547, respectfully.

j) Warrants

Under Canadian GAAP share purchase warrants are accounted for as equity. Under US GAAP, as required by the Financial Accounting Standards Board ("FASB") issued ASC Topic 815 (formerly, SFAS 133 "Accounting for Derivative Instruments and Hedging Activities"), as amended, and EITF 07-5 "Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock", share purchase warrants denominated in a currency that is not the functional currency of the Company are accounted for as a liability, with the change in fair value recorded in the statement of operations.

For the year ended May 31, 2010, under U.S. GAAP, other income was increased by \$1,751,114 arising from a decrease in fair value of the warrants granted in which the exercise price denominated currency is different from the Company's functional currency. As of May 31, 2010, the liability relating to warrants granted for which the exercise price denominated currency is different from the Company's functional currency was \$4,965,589 and the warrant account was reduced by \$28,120,861 as a result of the reclassification of the warrants to liabilities pursuant to U.S. GAAP.

k) Under Canadian GAAP, the financial position and results of operations of a variable interest entity are consolidated with those of the Company designated as the primary beneficiary of the entity even though the Company may not hold the controlling interest in the entity. Under ASC 810, non-controlling interests are classified as a separate component of shareholders' equity. Under ASC 810, accumulated losses attributable to non-controlling interests are not limited to the original carrying amount, and therefore non-controlling interests could have a negative carrying amount.

l) Adoption of new accounting policies

During the first quarter of fiscal 2010, the Company adopted the FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles in accordance with FASB ASC Topic 105, "Generally Accepted Accounting Principles" (the Codification). The Codification has become the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. Effective with the Company's adoption on July 1, 2009, the Codification has superseded all prior non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the Codification has become non-authoritative. As the adoption of the Codification only affected how specific references to GAAP literature have been disclosed in the notes to our condensed consolidated financial statements, it did not result in any impact on the Company's results of operations, financial condition, or cash flows.

In February 2010, FASB issued ASU 2010-09 Subsequent Event (Topic 855) Amendments to Certain Recognition and Disclosure Requirements. ASU 2010-09 removes the requirement for an SEC filer to disclose a date in both issued and revised financial statements. Revised financial statements include financial statements revised as a result of either correction of an error or retrospective application of GAAP. All of the amendments in ASU 2010-09 are effective upon issuance of the final ASU, except for the use of the issued date for conduit debt obligors. That amendment is effective for interim or

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**27. DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (continued)**

annual periods ending after June 15, 2010. The Company adopted ASU 2010-09 in February 2010 and did not disclose the date the financial statements are available to be issued.

In December 2007, the FASB issued authoritative guidance related to non-controlling interests in consolidated financial statements, which was an amendment of ARB No. 51. This guidance is set forth in ASC 810, *Consolidation*. ASC 810 establishes accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. This accounting standard is effective for fiscal years beginning on or after December 15, 2008, which for the Company was the fiscal year beginning June 1, 2009. The Company adopted ASC 810 at June 1, 2009 and the adoption did not have any impact on the consolidated financial statements.

In April 2009, the FASB issued ASC 820-10-65 formerly FASB Staff Position FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" ("FSP 157-4"). This provides significant guidance for determining when a market has become inactive as well as guidance for determining whether transactions are not orderly. It also provides guidance on the use of valuation techniques and the use of broker quotes and pricing services. It reiterates that fair value is based on an exit price and also that fair value is market-driven and not entity-specific. The accounting standard of codification applies to all assets and liabilities within the scope of ASC 820 and is effective for all interim and annual periods ending after June 15, 2009. The adoption of ASC 820-10-65 did not have a material effect on the Company's results of operations, financial position, and cash flows.

In June 2008, the FASB Task Force reached a consensus on EITF Issue No. 07-05, "Determining Whether an Instrument (or Embedded Feature) is Indexed to an Equity's Own Stock" ("EITF 07-5"). The standard provides that an equity linked financial instrument (or embedded derivative) would not be considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency. EITF 07-5 is effective for periods beginning on or after December 15, 2008. The adoption of this standard did not have any impact on the Company's consolidated financial statements.

In December 2007, the FASB issued a revised standard on accounting for business combinations ("SFAS-141R"). The statement is effective for periods beginning on or after December 15, 2008. SFAS-141R requires fair value measurement for all business acquisitions including pre-acquisition contingencies. The standard also expands the existing definition of a business and removes certain acquisition related costs from the purchase price consideration. The adoption of this standard had no impact on the Company's consolidated financial statements.

m) Recent Account Pronouncements

On January 21, 2010, the FASB issued ASU 2010-06, which amends ASC 820 to add new requirements for disclosures about transfers into and out of Levels 1 and 2 and separate disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements. The ASU also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure fair value. Further, the ASU amends guidance on employers' disclosures about postretirement benefit plan assets under ASC 715 to require that disclosures be provided by classes of assets instead of by major categories of assets. The ASU is effective for the first reporting period (including interim periods) beginning after December 15, 2009, except for the requirement to provide the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis, which will be effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The Company does not expect the adoption of ASU 2009-06 to have a material impact on the financial statements.

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**27. DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (continued)**

In June 2009, the FASB issued ASU 2009-17. This Accounting Standards Update amends the FASB Accounting Standards Codification for the issuance of FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R). The amendments in this Accounting Standards Update replace the quantitative-based risks and rewards calculation for determining which reporting entity, if any, has a controlling financial interest in a variable interest entity with an approach focused on identifying which reporting entity has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (1) the obligation to absorb losses of the entity or (2) the right to receive benefits from the entity. An approach that is expected to be primarily qualitative will be more effective for identifying which reporting entity has a controlling financial interest in a variable interest entity. The amendments in this Update also require additional disclosures about a reporting entity's involvement in variable interest entities, which will enhance the information provided to users of financial statements. The standard will be effective for the years beginning after November 19, 2009 and for interim periods within those fiscal years. The Company does not expect the adoption of ASU 2009-17 to have a material impact on the financial statements.

In September 2009, the FASB issued authoritative guidance regarding multiple-deliverable revenue arrangements. This guidance addresses how to separate deliverables and how to measure and allocate consideration to one or more units of accounting. Specifically, the guidance requires that consideration be allocated among multiple deliverables based on relative selling prices. The guidance establishes a selling price hierarchy of (1) vendor-specific objective evidence, (2) third-party evidence and (3) estimated selling price. This guidance is effective for annual periods beginning after June 15, 2010 but may be early adopted as of the beginning of an annual period. The Company is currently evaluating the effect that this guidance will have on consolidated financial position and results of operations.