

CONSOLIDATED CINOLA MINES 1985 ANNUAL REPORT

887904

REPORT TO SHAREHOLDERS

The Company has made excellent progress this past year. The Board is pleased to announce a major metallurgical breakthrough in the treatment of Cinola ore. Preliminary analysis indicates a commercially viable operation of 3,000 tonnes per day with an initial capital investment of approximately C\$50 million. Operating costs are forecast to be in the area of C\$22.00 per tonne or US\$ 207 per ounce.

■ The next phase of development involves the drilling of a 30 tonne bulk sample representative of the first two to three years of milling for further metallurgical testing. This work is scheduled to begin in late spring, leading to the completion of a bankable feasibility study in the fall of 1986. Upon completion of the feasibility study, and after arranging appropriate financing, the Company estimates production of gold could begin in 1988 on the Cinola deposit. ■ On behalf of the Board of Directors, I would like to take this opportunity to thank the shareholders for their continued support and confidence.

Reno J. Calabrigo
PRESIDENT & CHIEF EXECUTIVE OFFICER



Angelo Tosi
CHAIRMAN



OPERATIONS REVIEW

THE GRAHAM ISLAND GOLD DEPOSIT

QUEEN CHARLOTTE ISLANDS

- Graham Island
- Cinola gold deposit
- Sandspit fault

- Upper Cenozoic sediments
- Lower Cenozoic sediments
- Cenozoic-Mesozoic intrusives
- Mesozoic sediments/volcanics
- Cenozoic volcanics
- Gold

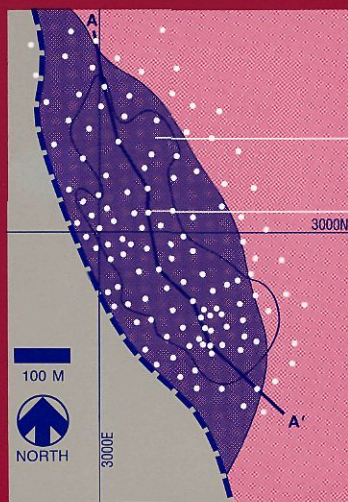
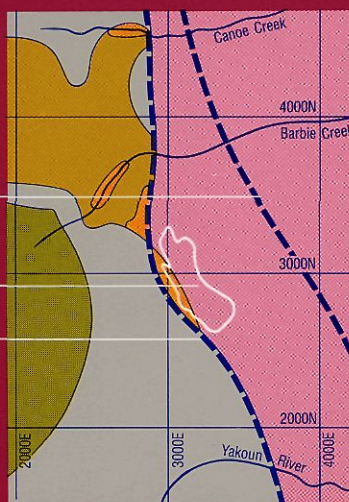


Drill Hole #	Width (feet)	Gold oz./ton
78-6	78	0.860
78-7	20	0.400
78-8	6.5	0.101
79-1	59	0.177
79-2	65	0.263
79-3	33	0.184
79-7(10)	19	0.197
79-8	55	0.209
79-9	6.5	0.092
79-11	13	1.122
79-12	538.1	0.082

DRILL HOLE INTERSECTIONS

- Sandspit fault
- Main mineralization
- Cinola fault

- Rhyolite
- Skonum formation
- Haida formation
- Masset volcanics



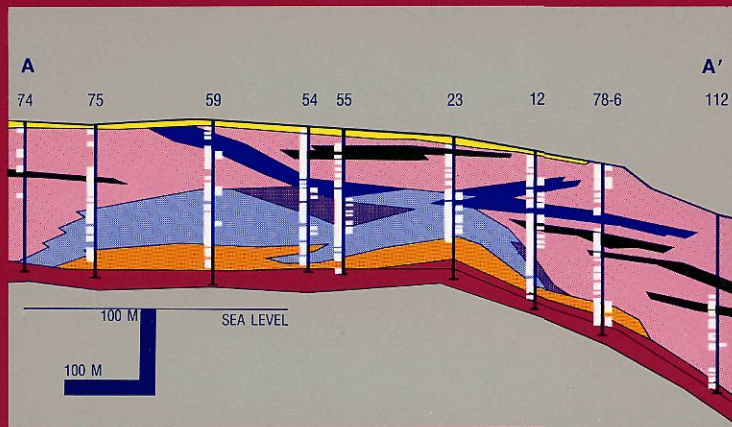
Main mineralization

DDH #55

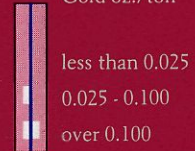
- Strong silicification
- Argillic alteration
- Drill holes

The gold deposit — discovered in 1971, was under continuous purchase option agreements with major Canadian mining companies until its purchase by Cinola in 1977. ■ Low gold prices in that period slowed the development of the property. However, Cinola's purchase price in 1977 coincided with the start of an up-trending price cycle. ■ The property was purchased outright in January 1979, after Cinola had pulled a series of spectacular diamond drill hole intersections. What was thought to be a low grade deposit clearly contained higher grade zones within the deposit. ■ In August 1979 a joint venture agreement was initiated between Cinola and Energy Reserves Canada which gave Energy Reserves the right to earn a 50 percent interest in the property by spending C\$5 million on exploration over five years. By the end of 1980 the required \$5 million had been spent and Energy Reserves had earned its 50 percent interest. ■ At the close of

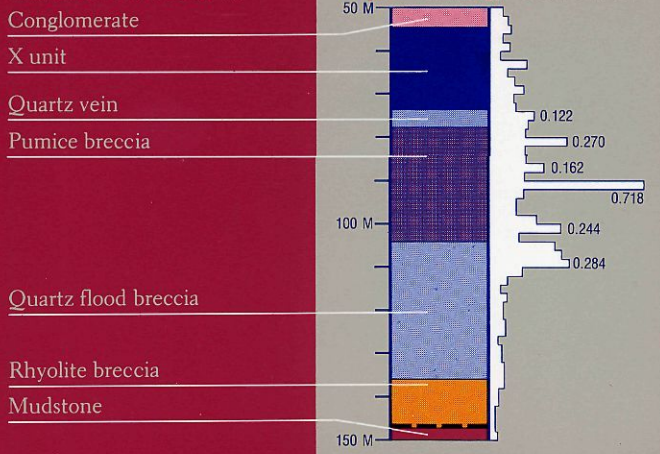
LONGITUDINAL SECTION A-A'



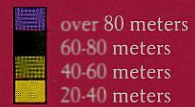
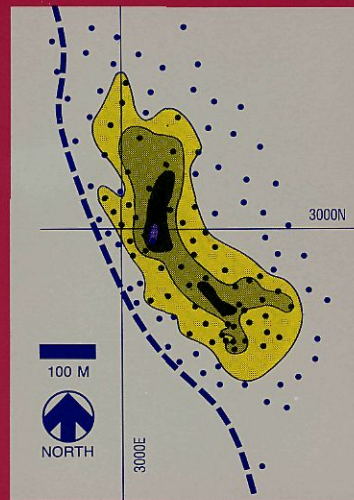
DRILL CORE SAMPLES
Gold oz./ton



RESULTS FROM DDH #55



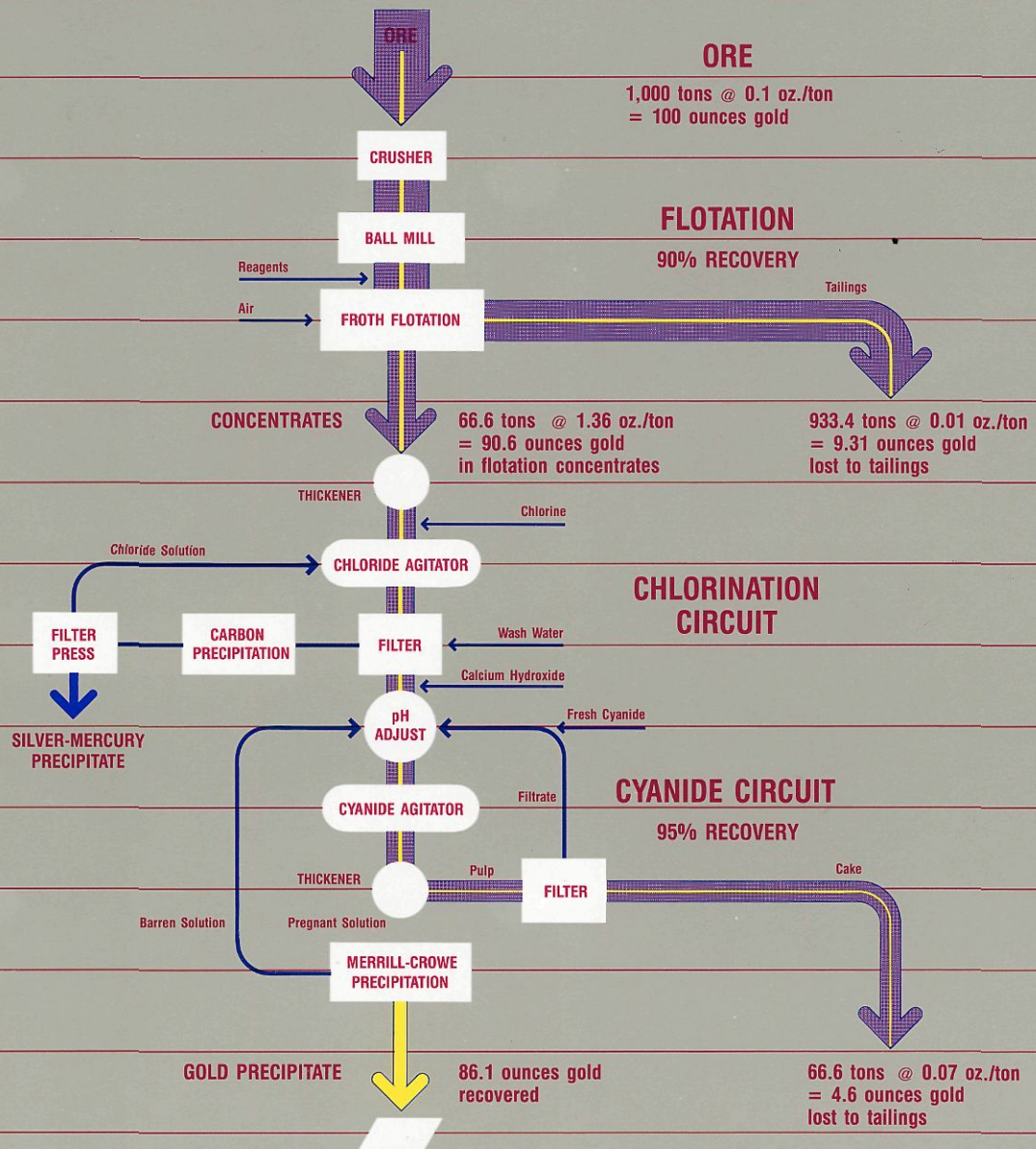
CUMULATIVE THICKNESS
OF MINERALIZATION
Gold over 0.05 oz./ton



1982 Energy Reserves had spent approximately \$18 million on property development leading to the completion of a feasibility study. The results proved up 41 million tonnes of ore grading 0.067 oz. gold per tonne, which translated into roughly 2.4 million ounces of gold. ■ Through a series of transactions, Cinola purchased Energy Reserves' 50 percent property interest in the Cinola-Queen Charlotte gold deposit for C\$5 million plus a royalty package based on a sliding scale tied to the gold price. To date Cinola has paid \$2.5 million to Energy Reserves with the balance payable in December 1986. ■ The Company is in the process of arranging for the appropriate funds to complete both the final feasibility study and the buy-out of Energy Reserves' 50 percent property interest. Management anticipates a successful outcome in both endeavours.

To obtain maximum recoveries of gold and silver from any ore it is necessary to fully understand the mineralogy of the ore. All minerals in the ore must be identified and their inter-relationships established. ■ The mineralogy of the Cinola ore is relatively simple in that there are only two major metallic minerals. About 25 percent of the gold in the Cinola ore occurs in a complex structure within one of these. Until now it has been difficult to free gold from the marcasite component of the ore. Marcasite has the same chemical composition as common pyrite, which is the other major metallic mineral in the Cinola ore. ■ This complex of marcasite, gold, silver, and minor amounts of mercury has been responsible for the moderate gold recoveries from the ore. However, this complex can be destroyed by exposing it to ferric chloride which is an inexpensive iron reagent containing chlorine. ■ The chlorine is the active ingredient with a strong natural chemical attraction to silver and mercury. The attraction breaks the marcasite, gold, silver and mercury complex, and liberates gold and silver for final extraction using standard cyaniding procedure. ■ The mercury component is converted to a mercury chloride that can be accounted for, controlled and recovered. This will alleviate any environmental concerns over the mercury content of the Cinola ore. ■ The addition of natural chlorine will maintain the workability of the process, which is basically an adaption of an old process which has been in use in the mineral industry since the last century. The use of this method to process the Cinola ore will give gold recoveries greater than 85 percent.

SIMPLIFIED GOLD RECOVERY PROCESS



CONSOLIDATED BALANCE SHEET

AS AT DECEMBER 31, 1985

	1985	1984
ASSETS		
CASH AND SHORT-TERM DEPOSITS	\$ 118	\$ 133,112
ACCOUNTS RECEIVABLE	9,615	7,605
PREPAIDS	2,483	6,873
INVESTMENTS (Note 3)	1,856	116,853
QUEEN CHARLOTTE GOLD PROPERTY (Note 4)	8,695,204	8,355,660
FIXED ASSETS (Note 5)	24,689	31,245
	<u>\$8,733,965</u>	<u>\$8,651,348</u>
LIABILITIES		
ACCOUNTS PAYABLE AND ACCRUED LIABILITIES	\$ 114,679	\$ 128,226
ADVANCES PAYABLE (Note 7)	2,500,000	2,500,000
CAPITAL LEASE (Note 6)	3,856	6,214
	<u>2,618,535</u>	<u>2,634,440</u>
SHAREHOLDERS' EQUITY		
CAPITAL STOCK (Note 8)	10,095,748	9,547,809
DEFICIT	(3,980,318)	(3,530,901)
	<u>6,115,430</u>	<u>6,016,908</u>
	<u>\$8,733,965</u>	<u>\$8,651,348</u>

NATURE AND CONTINUANCE OF OPERATIONS
AND CONTINGENCY (Notes 1 and 7)

Approved by the Directors



Director



Director

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

FOR THE YEAR ENDED DECEMBER 31, 1985

	1985	1984
SOURCE OF CASH		
Proceeds from issue of capital stock	\$547,939	\$ 122,120
Disposal of investments	48,136	32,603
Issue of shares for takeover of Misty Gold Inc.	—	5,250,000
Capital lease	—	6,214
Net decrease in receivables, prepaids and payables	—	50,941
	596,075	5,461,878
USE OF CASH		
Administrative costs	382,556	365,210
Deduct: Item not affecting cash — Depreciation	(6,556)	(7,897)
	376,000	357,313
Capital lease payments	2,358	—
Compensation to former employee	—	50,000
Acquisition of telephone system	—	8,355
Consideration for amending agreement with ERM	200,000	—
Exploration and development costs	139,544	376,520
Additions to mineral properties	—	4,745,880
Legal fees re debt settlement	—	25,000
Net increase in receivables, prepaids and payables	11,167	—
	729,069	5,563,068
DECREASE IN CASH	(132,994)	(101,190)
CASH — BEGINNING OF YEAR	133,112	234,302
CASH — END OF YEAR	\$ 118	\$ 133,112

AUDITORS' REPORT TO THE SHAREHOLDERS

We have examined the consolidated balance sheet of Consolidated Cinola Mines Ltd. as at December 31, 1985 and the consolidated statements of deficit and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Company as at December 31, 1985 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Vancouver, B.C.
January 31, 1986
(March 7, 1986 as to Note 12)

COOPERS & LYBRAND
Chartered Accountants

CONSOLIDATED STATEMENT OF DEFICIT

FOR THE YEAR ENDED DECEMBER 31, 1985

	1985	1984
BALANCE — BEGINNING OF YEAR	\$3,530,901	\$3,088,632
Compensation to former employee	—	50,000
Administrative costs — see Schedule	382,556	365,210
Write-down of investment	98,033	19,411
Gain on disposal of investment	(31,172)	(17,352)
Legal fees re debt settlement	—	25,000
BALANCE — END OF YEAR	\$3,980,318	\$3,530,901

CONSOLIDATED SCHEDULE OF ADMINISTRATIVE COSTS

FOR THE YEAR ENDED DECEMBER 31, 1985

	1985	1984
Advertising	\$ 387	\$ 2,087
Automobile	3,561	4,983
Corporation capital tax	30,400	20,977
Depreciation	6,556	7,897
Donations, dues and subscriptions	5,486	2,247
Equipment rental	8,886	9,618
Interest	(791)	(9,249)
Lease financing costs	1,801	743
Legal, accounting and audit	78,309	31,532
Office supplies, postage and delivery	15,305	8,230
Printing and stationery	22,954	17,059
Public relations, travel and promotion	28,749	27,780
Rent and taxes	42,497	36,517
Salaries and benefits	88,101	148,681
Sundry	1,970	11,584
Telephone and telegraph	17,028	17,805
Transfer agent fees	31,060	25,193
Professional fees	297	1,526
	\$382,556	\$365,210

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED DECEMBER 31, 1985

NOTE 1. NATURE AND CONTINUANCE OF OPERATIONS

The Company is in the process of developing its Queen Charlotte gold property (Note 4) and is of the opinion that these properties contain economically recoverable ore reserves. During the year ended December 31, 1984, the Company entered into agreements to restructure the ownership of the property (Notes 4 and 7). Pursuant to these agreements, the Company has an obligation in the amount of \$2,500,000, upon satisfaction of which it will have a 100% interest in the Queen Charlotte gold property. The Company is currently attempting to arrange the necessary financing to satisfy this obligation.

The recoverability of the amounts shown for mineral properties and deferred costs is dependent upon the ability of the Company to obtain the necessary financing to satisfy the obligation of \$2,500,000 and to complete the development, and upon future profitable production.

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES

(a) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Misty Gold Inc., consolidated from November 21, 1984, the date of purchase.

(b) Deferred Costs

Each group of permits or licences in a designated exploration or development area is accounted for as a separate area of interest. All exploration costs and administration costs are written off in the year incurred. If it is determined that an area of interest contains economically recoverable reserves, all development costs, including interest, relating directly to that area are deferred. These deferred development costs, together with property acquisition costs, will be amortized against related revenues by the unit-of-production method upon commencement of commercial production.

(c) Fixed Assets

Fixed assets are carried at cost less accumulated depreciation. Annual depreciation is provided as follows:

Asset	Method	Rate
Office furniture	Declining-balance	20%
Automobile	Declining-balance	25%
Telephone system	Declining-balance	20%

(d) Loss per Share

Basic loss per share has not been calculated as it is not considered meaningful at this stage in the Company's operations.

NOTE 3. INVESTMENTS

	1985	1984
Kennedy Resources Inc. — at nominal value		
185,500 shares (1984 — 227,000 shares)	\$1,855	\$ 56,750
Ark La Tex Industries Ltd. — at cost		
32,943 shares	—	6,588
Westland Syndicate — at nominal value		
30 units	1	53,515
	\$1,856	\$116,853

All the Company's investments are involved in exploration and development of natural resources. At December 31, 1985, there were no quoted values for these investments.

NOTE 4. QUEEN CHARLOTTE GOLD PROPERTY

	1985	1984
Deferred development costs	\$6,956,701	\$6,817,157
Deferred interest charges	3,883,102	3,883,102
Mineral properties	3,142,415	3,142,415
Excess acquisition cost of Misty Gold Inc.	2,245,880	2,245,880
Consideration for amending terms of the agreement with ERM	200,000	—
	16,428,098	16,088,554
Less: Intercompany debt eliminated on consolidation (Note 7)	(7,732,894)	(7,732,894)
	\$8,695,204	\$8,355,660

The Company's mineral properties are situated in the Queen Charlotte Islands, in the Skeena Mining Division, British Columbia. The Company is of the opinion that these properties contain economically recoverable ore reserves. These properties were acquired for \$450,000 cash and 300,000 shares of the Company. Energy Reserves Canada, Ltd. (ERC) earned a 50% interest in these properties, having contributed the initial required \$5,000,000 to their development.

Under an agreement dated November 21, 1979, the Company and ERC entered into an unincorporated joint venture to explore, develop, mine, process and sell gold and other minerals from the Queen Charlotte gold property. The venturers had equal interests in the assets and liabilities, net earnings or losses of the joint venture. ERC subsequently assigned its interests in the properties and in the joint venture to Energy Reserves Canada (Metals) Ltd. (ERM).

Upon an agreement dated August 2, 1984, Misty Gold Inc. (Misty) agreed to acquire the interest of ERM in the joint venture for cash consideration of \$2,500,000, of which \$1,250,000 had been paid at December 31, 1984 and \$1,250,000 was payable on or before April 6, 1985 (see below and Note 7). The agreement is subject to a net smelter returns royalty ranging from .5% to 5% unless, subject to certain conditions, Misty elects to satisfy such royalty interest by a lump sum payment in cash. Under an agreement dated March 15, 1985, the payment of \$1,250,000 to ERM has been delayed one year to April 6, 1986 in consideration of \$200,000 cash and the deletion of the buy-out clause of the royalty interest of ERM (see Note 7).

Under an agreement dated August 8, 1984, the Company and Misty entered into an unincorporated joint venture to own, explore, and develop the Queen Charlotte property. On November 21, 1984, the Company acquired 100% of the shares of Misty and, therefore, effectively is acquiring a 100% interest in the property.

In the year ended December 31, 1985, the Company expended \$139,544 on exploration of the property.

NOTE 5. FIXED ASSETS

	1985			1984
	Cost	Accumulated depreciation	Net	Net
Office furniture	\$46,401	\$32,562	\$13,839	\$17,299
Automobile	16,848	12,238	4,610	6,146
Telephone system (Note 6)	8,355	2,115	6,240	7,800
	\$71,604	\$46,915	\$24,689	\$31,245

NOTE 6. CAPITAL LEASE

The Company has acquired a telephone system by a lease agreement commencing September 1984 for 43 months at \$293 per month. The lease payments over the next three fiscal years are as follows:

1986	\$3,514
1987	3,514
1988	880
Total lease payments	<u>\$7,908</u>

NOTE 7. ADVANCES PAYABLE AND CONTINGENCY

	1985	1984
Due to ERC and ERM	\$2,500,000	\$2,500,000

ERC and ERM had commenced an action in the Courts with respect to funds expended on the Queen Charlotte gold property on the Company's behalf. This action was settled out of court by Misty under an agreement dated August 2, 1984 whereby Misty agreed to purchase the claim against the Company from ERC and ERM for consideration of \$2,500,000, of which \$1,250,000 was paid on the execution of the agreement with the balance of \$1,250,000 due on April 6, 1985, subsequently amended to April 6, 1986 (Note 4) (see also below). The Company subsequently acquired 100% of the shares of Misty. A credit of \$7,732,894 arising from the elimination of the intercompany debt on consolidation has been deducted from the deferred exploration and development costs of the joint venture (Note 4). This amount is determined as follows:

Contribution to joint venture by ERC and ERM on behalf of the Company	\$6,349,792
Accrued interest in dispute	3,883,102
ERC and ERM's claim against the Company	10,232,894
Cost of acquisition of above claim by Misty	2,500,000
Elimination of intercompany debt on consolidation (Note 4)	<u>\$7,732,894</u>

Under the same agreement (Note 4), Misty acquired ERM's 50% interest in the Queen Charlotte gold property for a sum of \$2,500,000, out of which \$1,250,000 was paid on the execution of the agreement with the balance of \$1,250,000 due on April 6, 1985, subsequently amended to April 6, 1986.

The due date of the aggregate \$2,500,000 obligation has subsequently been extended to December 31, 1986 (see Note 12).

Should Misty be unable to satisfy this \$2,500,000 obligation, the August 2, 1984 agreement would be in breach, and the Company would have an obligation at December 31, 1985 of an amount in the range of \$10 million to \$13 million with respect to advances to the joint venture by ERC and ERM on its behalf, and accrued interest thereon.

NOTE 8. CAPITAL STOCK

	1985	1984
Authorized —		
10,000,000 shares without par value		
Issued and fully paid —		
4,086,488 (1984 — 3,842,788) shares for cash	\$ 4,526,823	\$3,978,884
690,438 shares for mineral properties	318,925	318,925
1,500,000 shares for the acquisition of Misty Gold Inc.	5,250,000	5,250,000
6,276,926	<u>\$10,095,748</u>	<u>\$9,547,809</u>

(a) During the year ended December 31, 1985, the Company issued 112,600 shares for a cash consideration of \$247,720 relating to options exercised. At December 31, 1985 options were outstanding to directors and employees to purchase 144,000 shares of the Company at \$3.15 per share prior to November 27, 1986, 132,300 shares at \$2.20 per share prior to January 25, 1987, 88,000 shares at \$2.20 per share prior to February 26, 1987, and 50,000 shares at \$2.50 per share prior to September 12, 1990.

Subsequent to December 31, 1985, the Company issued 4,500 shares for cash consideration of \$9,900 on the exercise of directors' stock options.

(b) During the year the Company issued, by way of a private placement, 131,100 shares, with one warrant attached to each share, for aggregate cash consideration of \$300,219. These shares must be held unconditionally for a period of twelve months. The holder of each warrant has the right to purchase one share at \$2.54 on or before March 18, 1986.

NOTE 9. INCOME TAXES

No income taxes are payable for the year. At December 31, 1985, the Company had approximately \$12.7 million of exploration and development expenditures which are available to reduce taxable income in future years. No future tax benefit has been recognized in the accounts.

NOTE 10. COMMITMENTS

The Company is committed to make minimum payments under the terms of the lease agreements as follows:

Year ending December 31, 1986	\$26,278
1987	26,278
1988	26,278
1989	17,517

The Company has five-year employment contracts with one director and one officer of the Company commencing January 1981 with options to renew them for an additional five years at the discretion of the individuals. During the year these contracts were renewed for an additional term. In addition the Company has a five-year employment contract with a director of the Company commencing June 1984 with an option to renew for an additional five years at the discretion of the individual. The contracts provide for minimum yearly increments in remuneration at a rate which is 5% higher than the cost of living index. At December 31, 1985 the annual salaries under these contracts totalled \$59,000 (1984 — \$116,943).

NOTE 11. RELATED PARTY TRANSACTIONS

Related party transactions undertaken by the Company during the year are disclosed elsewhere in the notes to the financial statements.

NOTE 12. SUBSEQUENT EVENT

By agreement dated March 7, 1986, the payment of \$2,500,000 to ERC and ERM has been delayed to December 31, 1986, in consideration of \$200,000 cash.

CORPORATE DIRECTORY

OFFICERS AND DIRECTORS

Angelo Tosi
Chairman and Director
Reno J. Calabrigo, M.B.A.
President, Chief Executive Officer
and Director
Kenneth G. Sanders, P.Eng.
Secretary and Director
Sam Parks
Director
Lyll J. Lichty
Director
Reno A. Calabrigo
Vice President

CINOLA OPERATING COMPANY LTD.

Kenneth G. Sanders, P.Eng.
Chairman

SOLICITORS

Shrum Liddle & Heberton
1300 - 999 West Hastings Street
Vancouver, B.C. V6C 2W5
Milgrim, Thomajan, Jacobs & Lee
405 Lexington Avenue
New York, N.Y. 10017

BANK

Toronto Dominion Bank
839 West Hastings Street
Vancouver, B.C.

REGISTRAR AND TRANSFER AGENT

Central Trust Company
700 - 750 West Pender Street
Vancouver, B.C. V6C 2B2
320 Bay Street
Toronto, Ontario

INVESTMENT BANKERS

Drexel Burnham Lambert
60 Broad Street
New York, N.Y.

EXCHANGE LISTING

Vancouver Stock Exchange
Symbol CSZ
Over-the-counter
NASDAQ symbol CCIMF

HEAD OFFICE

440 - 625 Howe Street
Vancouver, B.C. V6C 2T6

REGISTERED OFFICE

1300 - 999 West Hastings Street
Vancouver, B.C. V6C 2W5

CAPITALIZATION

Authorized: 10,000,000 Common shares
Issued: 6,276,926 Common shares

DIRECT INQUIRIES TO

Reno J. Calabrigo
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