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**Financial Statements**

**Avalon Rare Metals Inc.**  
**(formerly Avalon Ventures Ltd.)**

**For the years ended August 31, 2009 and 2008**

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## **MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING**

The financial statements and other financial information for this annual report were prepared by the management of Avalon Rare Metals Inc. (formerly Avalon Ventures Ltd.), reviewed by the Audit Committee of the Board of Directors, and approved by the Board of Directors.

Management is responsible for the preparation of the financial statements and believes that they fairly represent the Company's financial position and the results of operations in accordance with Canadian generally accepted accounting principles. Management has included amounts in the Company's financial statements based on estimates, judgements, and policies that it believes reasonable in the circumstances.

To discharge its responsibilities for financial reporting and for the safeguarding of assets, management believes that it has established appropriate systems of internal accounting control which provide reasonable assurance that the assets are maintained and accounted for in accordance with its policies and that transactions are recorded accurately in the Company's books and records.

Sievert & Sawrantschuk LLP, Chartered Accountants were appointed as auditors by the Board of Directors of the Company.

“Donald S. Bubar”

*President and CEO*

“R. J. (Jim) Andersen”

*CFO and Vice President Finance*

Toronto, Ontario  
October 5, 2009

**SIEVERT & SAWRANTSCHUK LLP  
CHARTERED ACCOUNTANTS**

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**AUDITORS' REPORT**

To the Shareholders of:  
**Avalon Rare Metals Inc. (formerly Avalon Ventures Ltd.)**

We have audited the balance sheets of Avalon Rare Metals Inc. (formerly Avalon Ventures Ltd.) as at August 31, 2009 and 2008 and the statements of operations and deficit, comprehensive loss and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at August 31, 2009 and 2008 and the results of its operations and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Toronto, Canada  
October 5, 2009

Sievert & Sawrantschuk LLP  
Chartered Accountants, Licensed Public Accountants

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Balance Sheets  
As at August 31

	2009	2008
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 6,003,782	\$ 10,738,700
Receivables	598,468	152,165
Prepaid expenses	118,037	130,226
	<u>6,720,287</u>	<u>11,021,091</u>
<b>Investments Available for Sale</b> (note 3)	2,657	3,943
<b>Resource Properties</b> (note 4)	19,677,856	13,188,626
<b>Property, Plant and Equipment</b> (note 5)	<u>120,464</u>	<u>170,930</u>
	<u>\$ 26,521,264</u>	<u>\$ 24,384,590</u>
<b>Liabilities</b>		
<b>Current Liabilities</b>		
Accounts payable (note 11)	<u>\$ 1,429,712</u>	<u>\$ 892,806</u>
<b>Shareholders' Equity</b>		
<b>Share Capital</b> (note 6)	44,828,738	40,032,502
<b>Contributed Surplus</b> (note 7)	3,054,653	3,294,916
<b>Deficit</b>	(22,782,353)	(19,827,434)
<b>Accumulated Other Comprehensive Loss</b> (note 8)	<u>(9,486)</u>	<u>(8,200)</u>
	<u>25,091,552</u>	<u>23,491,784</u>
	<u>\$ 26,521,264</u>	<u>\$ 24,384,590</u>

## Commitments (note 14, 15)

The accompanying notes form an integral part of these financial statements.

Approved on behalf of the Board of Directors:

"Donald S. Bubar", Director

"Brian MacEachen", Director

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Statements of Operations and Deficit

For the Years Ended August 31

	2009	2008
<b>Revenue</b>		
Interest	\$ 159,982	\$ 357,539
<b>Expenses</b>		
Amortization	50,466	40,806
Consulting fees (note 11)	45,788	88,504
Directors' fees	38,000	42,000
Insurance	63,359	43,727
Interest and financing costs (note 6b))	19,826	81,274
Office and general	31,418	36,722
Professional fees (note 11)	179,736	172,962
Public and investor relations	593,728	526,291
Rent and utilities	111,978	108,237
Salaries and benefits	522,294	655,765
Shareholders' information	27,311	32,069
Stock-based compensation (note 7b))	1,016,933	641,458
Transfer and filing fees	67,969	203,858
Travel	152,536	230,580
	<u>2,921,342</u>	<u>2,904,253</u>
<b>Loss before the Undernoted Items</b>	(2,761,360)	(2,546,714)
<b>Write-down of Resource Properties</b> (note 4f))	(598,559)	(228,367)
<b>Recoveries of Resource Properties</b> (note 10)	<u>-</u>	<u>10,000</u>
<b>Loss before Income Taxes</b>	(3,359,919)	(2,765,081)
<b>Future Income Tax Recoveries</b> (note 12g))	<u>405,000</u>	<u>1,373,500</u>
<b>Net Loss for the Year</b>	(2,954,919)	(1,391,581)
<b>Deficit – Beginning of Year</b>	<u>(19,827,434)</u>	<u>(18,435,853)</u>
<b>Deficit - End of Year</b>	<u>\$ (22,782,353)</u>	<u>\$ (19,827,434)</u>
<b>Loss per Share, Basic and Fully Diluted</b>	<u>\$ (0.04)</u>	<u>\$ (0.02)</u>
<b>Weighted Average Number of Common Shares Outstanding, Basic and Fully Diluted</b>	<u>67,603,514</u>	<u>61,658,223</u>

The accompanying notes form an integral part of these financial statements.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Statements of Comprehensive Loss

For the Years Ended August 31

	2009	2008
<b>Net Loss for the Year</b>	\$ (2,954,919)	\$ (1,391,581)
<b>Other Comprehensive Income (Loss)</b>		
Unrealized gains (losses) on available-for-sale financial assets arising during the year	<u>(1,286)</u>	<u>899</u>
<b>Comprehensive Loss for the Year</b>	<u>\$ (2,956,205)</u>	<u>\$ (1,390,682)</u>

The accompanying notes form an integral part of these financial statements.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Cash Flow Statements

For the Years Ended August 31

	2009	2008
<b>Cash Flows from Operating Activities</b>		
Cash paid to suppliers and employees	\$ (1,954,458)	\$ (2,136,448)
Interest received	159,982	357,539
Interest paid	(72,969)	(45,273)
	<u>(1,867,445)</u>	<u>(1,824,182)</u>
<b>Cash Flows from Financing Activities</b>		
Share capital – private placement(s) (note 6b))	1,400,625	15,527,155
Share capital – exercise of warrants (note 6b))	903,040	1,317,769
Share capital – exercise of options (note 6b))	516,625	265,500
Share capital – exercise of agents’ compensation options (note 6b))	<u>1,123,750</u>	<u>-</u>
	<u>3,944,040</u>	<u>17,110,424</u>
<b>Cash Flows from Investing Activities</b>		
Resource property expenditures	(6,811,513)	(5,979,571)
Recoveries of abandoned resource properties	-	10,000
Purchase of property, plant and equipment	<u>-</u>	<u>(140,073)</u>
	<u>(6,811,513)</u>	<u>(6,109,644)</u>
<b>Change in Cash and Cash Equivalents</b>	<b>(4,734,918)</b>	<b>9,176,598</b>
<b>Cash and Cash Equivalents - Beginning of Year</b>	<b><u>10,738,700</u></b>	<b><u>1,562,102</u></b>
<b>Cash and Cash Equivalents - End of Year</b>	<b><u>\$ 6,003,782</u></b>	<b><u>\$ 10,738,700</u></b>

The accompanying notes form an integral part of these financial statements.

# **Avalon Rare Metals Inc.**

**(formerly Avalon Ventures Ltd.)**

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

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## **1. Nature of Operations**

The Company is in the process of exploring its mineral resource properties. To date, the Company has not earned significant revenues and is considered to be in the development stage.

The realization of amounts shown for resource properties is dependent upon the discovery of economically recoverable reserves, the ability of the Company to obtain the necessary financing to develop these properties, and future profitable production or proceeds of disposition from these properties.

The Company operates in one geographic area, Canada, and in one industry segment, mining exploration.

## **2. Summary of Significant Accounting Policies**

These financial statements are prepared in accordance with accounting principles generally accepted in Canada, and reflect the following significant accounting policies:

### **a) New Accounting Policy**

On September 1, 2008, the Company adopted three new accounting standards issued by the CICA: Handbook Section 1535, "Capital Disclosures", Handbook Section 3862, "Financial Instruments – Disclosures", and Handbook Section 3863, "Financial Instruments – Presentation". The Company has applied these new standards on a prospective basis.

#### Capital Disclosures

Handbook Section 1535 requires disclosure of an entity's objectives, policies and process for managing capital, quantitative data about what the entity regards as capital and whether the entity has complied with any capital requirements and, if it has not complied, the consequences of such non-compliance. The Company has included disclosures recommended by this new Handbook section in note 9.

#### Financial Instruments – Disclosures

Handbook Section 3862 requires an entity to provide disclosures to enable users to evaluate the significance of financial instruments for an entity's financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about the nature and extent of risks arising from financial instruments, including specified minimum disclosures about liquidity risk and market risk. The quantitative disclosures must also include a sensitivity analysis for each type of market risk to which an entity is exposed, showing how net income and other comprehensive income would have been affected by reasonably possible changes in the relevant risk variable. The Company has included disclosures recommended by this new Handbook section in note 13.

#### Financial Instruments – Presentation

Handbook Section 3863 replaces the existing requirements on presentation of financial instruments which have been carried forward unchanged to this new section. The adoption of this standard did not have any impact on the presentation of the Company's financial statements.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

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## 2. Summary of Significant Accounting Policies (Continued)

### b) Use of Estimates

The preparation of the financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of operations during the reporting period. Significant estimates and assumptions include those related to the recoverability of resource properties, stock-based compensation and the fair value of warrants issued in conjunction with the issuance of the Company's common shares. While management believes that the estimates and assumptions are reasonable, actual results could differ from those estimates.

### c) Financial Instruments

Financial instruments are initially recognized at fair value and are subsequently re-measured based on their classification as: held-for-trading, available-for-sale, held-to-maturity, loans and receivables or other liabilities. Financial assets and liabilities held-for-trading are measured at fair value with the change in the fair value recognized in net income. Available-for-sale instruments are measured at fair value with any unrealized gains or losses recognized in other comprehensive income. Financial assets held-to-maturity, loans and receivables and financial liabilities other than those held-for-trading are measured at amortized cost, using the effective interest method.

The Company has classified its financial instruments as follows:

<u>Financial Instrument</u>	<u>Classification</u>	<u>Accounting Treatment</u>
Cash and cash equivalents	Held-for-trading	Fair value
Receivables	Loans and receivables	Amortized cost
Investments available for sale	Available-for-sale	Fair value
Accounts payable	Other liabilities	Amortized cost

### d) Cash and Cash Equivalents

Cash and cash equivalents include bank deposits and highly liquid short-term money market investments such as bankers acceptance notes, treasury bills and guaranteed investment certificates.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

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## 2. Summary of Significant Accounting Policies (Continued)

### e) Resource Properties

Acquisition costs of resource properties together with direct exploration and development expenditures thereon are deferred in the accounts. When production is attained, these costs will be amortized on a unit-of-production basis. If the properties are abandoned, sold or considered to be impaired in value, the costs of the properties and related deferred expenses will be written down at that time. When deferred expenditures on individual producing properties exceed the estimated net realizable value of undiscounted proven reserves, the properties are written down to the estimated fair value.

The Company is in the process of exploring and developing its mineral properties and has not yet determined the amount of reserves available. Senior management regularly reviews the carrying amount of mineral properties and deferred exploration and development costs to assess whether there has been any impairment in value.

### f) Property, Plant and Equipment

Property, plant and equipment are carried at cost less accumulated amortization. Amortization is provided over the estimated useful lives of the Company's assets on the following basis and rates per annum:

Computer equipment	-	30% on a declining balance basis
Computer software	-	33 1/3% on a declining balance basis
Equipment	-	30% on a declining balance basis
Office furniture	-	25% on a declining balance basis
Leasehold improvements	-	straight line basis over the term of the lease

Additions during the year are amortized using the half-year rule.

### g) Asset Retirement Obligations

The Company recognizes the legal liability for obligations relating to the retirement of property, plant and equipment, and arising from the acquisition, construction, development, or normal operation of those assets. Such asset retirement costs are recognized at fair value, when a reasonable estimate of fair value can be estimated, in the period in which it is incurred, added to the carrying value of the related asset, and amortized into income on a systematic basis over the related asset's useful life. The liability is adjusted for changes in the expected amounts and timing of cash flows required to discharge the liability and accreted to full value over time through periodic charges to net income.

As at August 31, 2009, no asset retirement obligations have been recognized as none of the Company's properties are estimated to require any remediation or other expenditures upon their retirement.

### h) Research and Development

Research and development costs related to a specific property are deferred as part of the costs of that property in accordance with the Company's policy on exploration and development expenditures. General research and development costs are expensed as incurred.

# **Avalon Rare Metals Inc.**

**(formerly Avalon Ventures Ltd.)**

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

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## **2. Summary of Significant Accounting Policies (Continued)**

### **i) Flow-through Shares**

A portion of the Company's exploration activities are financed by flow-through share arrangements. Under the terms of flow-through share agreements, the tax deductions of the related Canadian exploration expenses ("CEE") are renounced in favor of the investors. Accordingly, share capital issued through flow-through arrangements is recorded at net proceeds less the tax effect relating to the renunciation of the Company's CEE to investors.

### **j) Income Taxes**

Future tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Future tax assets are recorded only to the extent that, based on available evidence, it is more likely than not that they will be realized.

### **k) Stock Option Compensation**

The Company has one stock option plan that is described in note 6d). The Company has adopted CICA Handbook Section 3870 "Stock-Based Compensation and Other Stock-Based Payments", which recommends the fair value-based method of accounting for stock-based transactions.

### **l) Foreign Currency Transactions**

Transactions denominated in foreign currencies are recorded at the rate of exchange prevailing at the transaction date. Monetary assets and liabilities denominated in foreign currency are translated into Canadian dollars at the rate of exchange prevailing at the balance sheet date. Unrealized gains and losses on translation of monetary assets and liabilities are included in the determination of earnings for the year.

### **m) Related Party Transactions**

All transactions with related parties are in the normal course of business and are measured at the exchange amount.

### **n) Share Issuance Costs**

Costs incurred in connection with the issuance of share capital are netted against the proceeds received.

### **o) Basic and Diluted Loss per Share**

The basic loss per share is computed based on the weighted average number of common shares outstanding during the year. The diluted loss per share is calculated using the treasury method, and is equal to the basic loss per share due to the anti-dilutive effect of share purchase options and warrants.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

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## 2. Summary of Significant Accounting Policies (Continued)

### p) Comparative Figures

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

## 3. Investments Available for Sale

Investments available for sale ("investments") consist of shares received as consideration for resource property interests. All investments are in publicly traded companies.

Investments are carried at fair value, any unrealized gains or losses are recognized as Other comprehensive income until the investment is disposed of, at which time any Cumulative unrealized gain or loss previously recognized in Accumulated other comprehensive income is transferred and recognized as Net income for the period.

	2009		2008	
	Number	Amount	Number	Amount
Alto Ventures Inc.	28,571	\$ 857	28,571	\$ 2,143
Tiomin Resources Inc. <sup>(1)</sup>	45,000	1,800	-	-
Radiant Resources Inc.	-	-	45,000	1,800
		<u>\$ 2,657</u>		<u>\$ 3,943</u>

<sup>(1)</sup> Received in exchange for 45,000 shares of Radiant Resources Inc. as a result of the acquisition of Radiant Resources Inc. by Tiomin Resources Inc.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

## 4. Resource Properties

August 31, 2009

	August 31, 2009						Total
	Separation Rapids Lithium- Tantalum Project	Warren Township Anorthosite Project	Thor Lake Rare Metals Project	Red Hill Copper- Zinc-Silver Project	East Kemptonville Rare Metals Project	Other	
note	4(a)	4(b)	4(c)	4(d)	4(e)	4(f,g)	
Acquisition costs	\$ -	\$ -	\$ 590	\$ -	\$ -	\$ -	\$ 590
Community consultation	-	3,325	204,462	-	-	-	207,787
Diamond drilling	-	-	3,317,271 <sup>(1)</sup>	-	-	-	3,317,271
Environmental studies/permitting	70,302	996	1,125,276	-	-	-	1,196,574
Feasibility/engineering studies	3,120	67	504,770	-	159,019	-	666,976
Geochemical	-	-	-	-	32,348	-	32,348
Geology	-	-	397,565	295	105,973	-	503,833
Geophysical	-	-	87,121	-	-	-	87,121
Metallurgical/market studies	60,387	4,125	903,214	-	76,586	-	1,044,312
Other	9,479	300	21,198	-	-	-	30,977
Current expenditures	143,288	8,813	6,561,467	295	373,926	-	7,087,789
Balance - beginning of year	3,713,949	1,185,805	7,281,767	598,264	408,841	-	13,188,626
Write-down of resource properties	-	-	-	(598,559)	-	-	(598,559)
Balance - end of year	\$ 3,857,237	\$ 1,194,618	\$ 13,843,234	\$ -	\$ 782,767	\$ -	\$ 19,677,856

<sup>(1)</sup> Net of \$48,548 contributions recoverable from the Mine Training Society of the Northwest Territories ("MTS") under the Driller Training Program Contribution Agreement between the Company and MTS.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

## 4. Resource Properties (Continued)

	August 31, 2008						
	Separation Rapids Lithium- Tantalum Project	Warren Township Anorthosite Project	Thor Lake Rare Metals Project	Red Hill Copper- Zinc-Silver Project	East Kemptonville Rare Metals Project	Other	Total
note	4(a)	4(b)	4(c)	4(d)	4(e)	4(f,g)	
Acquisition costs	\$ 1,154	\$ -	\$ -	\$ -	\$ 991	\$ -	\$ 2,145
Community consultation	2,974	5,323	36,352	-	2,423	-	47,072
Diamond drilling	-	-	4,677,581	-	-	-	4,677,581
Environmental studies/permitting	-	1,679	82,496	-	-	-	84,175
Feasibility/engineering studies	5,443	1,482	32,517	-	52,945	-	92,387
Geochemical	-	-	-	-	7,972	-	7,972
Geology	4,451	1,359	367,954	10,021	172,850	7,272	563,907
Geophysical	-	-	11,078	1,813	15,550	-	28,441
Metallurgical/market studies	217,473	95,518	239,383	-	56,466	-	608,840
Other	12,840	1,800	24,991	-	9,400	-	49,031
Current expenditures	244,335	107,161	5,472,352	11,834	318,597	7,272	6,161,551
Balance - beginning of year	3,469,614	1,078,644	1,809,415	586,430	90,244	221,095	7,255,442
Write-down of resource properties	-	-	-	-	-	(228,367)	(228,367)
Balance - end of year	\$ 3,713,949	\$ 1,185,805	\$ 7,281,767	\$ 598,264	\$ 408,841	\$ -	\$ 13,188,626

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

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## 4. Resource Properties (Continued)

### a) Separation Rapids Rare Metals Project, Ontario

The Company owns a 100% interest (subject to a 2.0% net smelter returns royalty (“NSR”), half of which can be bought back for \$1.0 million) in certain claims in the Paterson Lake area of Ontario.

### b) Warren Township Anorthosite Project, Ontario

The Company owns a 100% interest in certain claims located near Foleyet, Ontario, which were staked by the Company during the year ended August 31, 2003.

### c) Thor Lake Rare Metals Project, Northwest Territories

During the year ended August 31, 2005 the Company acquired a 100% interest (subject to a 5.5% NSR, of which 2.5% can be bought back at the principal amount of \$150,000 compounded annually at the average Canadian prime rate from May 2, 1982 to the buyback date (as at August 31, 2009, this amounted to approximately \$1.2 million)) in five mining leases covering the Thor Lake rare metals deposit located in the Mackenzie Mining District of the Northwest Territories.

### d) Red Hill Copper-Zinc-Silver Project, British Columbia

During the year ended August 31, 2005 the Company entered into an option agreement with Teck Cominco Limited to acquire a 100% interest (subject to a 2.0% NSR and certain back-in-rights) in Teck Cominco’s Red Hill Copper-Zinc-Silver property located in the Kamloops Mining Division of British Columbia.

During the year ended August 31, 2009 the Company decided not to fund any further expenditures on the project, and the total costs incurred to date of \$598,559 have been written off.

### e) East Kemptville Rare Metals Project, Nova Scotia

During the year ended August 31, 2007 the Company was granted a special exploration licence to search and prospect for all minerals except for coal, salt, potash and uranium within four claims totalling approximately 880 acres in the East Kemptville area of Yarmouth, Nova Scotia. In order to keep the licence in good standing, the Company must incur \$2,250,000 in exploration expenditures by August 1, 2011, of which \$601,575 had been incurred by August 31, 2009.

As at August 31, 2009 the Company also has twelve regular exploration licences for 401 additional claims totalling approximately 16,000 acres in the same proximity to the claims covered under the special exploration licence.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

## 4. Resource Properties (Continued)

- f) Resource properties written down during the years ended August 31, 2009 and 2008 consist of the following:

	<u>2009</u>	<u>2008</u>
Red Hill Copper-Zinc-Silver Project	\$ 598,559	\$ -
U6 Savant Gold Project	-	220,774
General Exploration	-	7,593
	<u>\$ 598,559</u>	<u>\$ 228,367</u>

- g) Other Resource Properties

The Company has a 100% interest in several mining claims in the Lilypad Lakes Tantalum Property, a 2.0% NSR interest in certain mining claims of the East Cedartree Gold Property located near Kenora, Ontario, and a 0.4% NSR interest in the Wolf Mountain Platinum-Palladium Project.

## 5. Property, Plant and Equipment

	<u>2009</u>			<u>2008</u>		
	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net</u>	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Computer equipment	\$ 25,520	\$ 17,708	\$ 7,812	\$ 25,520	\$ 14,360	\$ 11,160
Computer software	7,395	4,656	2,739	7,395	3,287	4,108
Exploration equipment	183,590	94,569	89,021	183,590	56,417	127,173
Office furniture and equipment	18,866	7,455	11,411	18,866	3,651	15,215
Leasehold improvements	18,963	9,482	9,481	18,963	5,689	13,274
	<u>\$ 254,334</u>	<u>\$ 133,870</u>	<u>\$ 120,464</u>	<u>\$ 254,334</u>	<u>\$ 83,404</u>	<u>\$ 170,930</u>

## 6. Share Capital

### a) Authorized

The Company is presently authorized to issue an unlimited number of common shares without par value. The Company is also authorized to issue up to 25,000,000 preferred shares without par value, of which none have been issued.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

## 6. Share Capital (Continued)

### b) Common Shares Issued and Outstanding:

	2009		2008	
	Number	Amount	Number	Amount
Balance - beginning of year	64,649,748	\$ 40,032,502	52,128,123	\$ 25,645,316
Issued pursuant to:				
private placement(s)	3,000,000	1,500,000	10,360,000	15,248,752
exercise of warrants	1,302,200	1,394,755	1,414,125	1,640,312
exercise of options	1,127,500	892,578	747,500	480,820
exercise of agents' compensation options	725,000	1,549,470	-	-
Finder's fees - paid cash	-	(99,375)	-	-
Finder's fees - compensation warrants issued	-	(36,192)	-	-
Commission and advisory fees paid	-	-	-	(1,013,076)
Commission - agents' compensation options issued	-	-	-	(384,597)
Issuance costs paid	-	-	-	(211,525)
Tax effect on issuance of flow-through shares	-	(405,000)	-	(1,373,500)
Balance - end of year	<u>70,804,448</u>	<u>\$ 44,828,738</u>	<u>64,649,748</u>	<u>\$ 40,032,502</u>

During the year ended August 31, 2009 the Company:

- i) completed a private placement and issued 3,000,000 flow-through common shares at a price of \$0.50 per share for gross proceeds of \$1,500,000.

In connection with this private placement, the Company paid finders' fees of \$99,375 in cash and granted 198,750 non-transferable finders' warrants to the finders. Each warrant entitles the holder to purchase one non-flow-through common share at a price of \$0.50 per share, exercisable until December 15, 2010. The estimated fair value of the warrants totalled \$36,192.

- ii) issued 1,302,200 non-flow-through common shares pursuant to the exercise of an equivalent number of common share purchase warrants for cash proceeds of \$903,040. The estimated fair value at issuance of these options was \$491,715, and this amount has been added to the recorded value of the issued shares.
- iii) issued 1,127,500 non-flow-through common shares pursuant to the exercise of an equivalent number of stock options for cash proceeds of \$516,625. The estimated fair value at issuance of these options was \$375,953, and this amount has been added to the recorded value of the issued shares.
- iv) issued 725,000 non-flow-through common shares pursuant to the exercise of an equivalent number of agents' compensation options for cash proceeds of \$1,123,750. The estimated fair value at issuance of these compensation options was \$425,720, and this amount has been added to the recorded value of the issued shares.

# Avalon Rare Metals Inc.

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Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

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## 6. Share Capital (Continued)

During the year ended August 31, 2008 the Company:

- i) completed a private placement (the "Offering") comprised of the issuance of 7,610,000 units (the "Units") at a price of \$1.55 per Unit and 2,750,000 flow-through common shares at a price of \$1.85 per share (of which 75,000 flow-through common shares were issued to directors and officers of the Company) for gross proceeds of \$16,883,000. Each Unit consisted of one common share and one-half of one common share purchase warrant. Each whole warrant entitled the holder to purchase one common share at an exercise price of \$2.00 per share until May 22, 2009.

The estimated fair value of the warrants totalled \$1,634,248 and this amount has been allocated to the warrant component of the Units.

In consideration for the services of the agents of the Offering, the Company paid commissions and advisory fees of \$1,121,650 in cash and granted compensation options to the agents to acquire up to 725,000 Units (the "Agents' Compensation Options") at a price of \$1.55 per Unit, exercisable until November 22, 2009. Any warrants issued pursuant to the exercise of the Agent's Compensation Options will expire on May 22, 2009. No warrants will be issued upon any exercise of the Agent's Compensation Options after May 22, 2009.

The estimated fair value of the Agents' Compensation Options totalled \$425,720. The fair values of the Agents' Compensation Options were estimated using the Black-Scholes pricing model, with the following assumptions: expected dividend yield of Nil; risk free interest rate of 3.70%; expected life of 2.0 years; and expected volatility of 65%.

The Company also paid other cash issuance costs of \$234,195 in connection with the Offering.

The total transaction costs of \$1,781,565 (including cash commissions and advisory fees, the estimated fair value of the Agents' Compensation Options and other cash issuance costs) has been allocated to the common shares and the warrants on a pro rata basis based on the fair values of the common shares and the warrants.

- ii) issued 1,414,125 non-flow-through common shares pursuant to the exercise of an equivalent number of common share purchase warrants for cash proceeds of \$1,317,769. The estimated fair value at issuance of these warrants was \$322,543, and this amount has been added to the recorded value of the issued shares.
- iii) issued 747,500 non-flow-through common shares pursuant to the exercise of an equivalent number of stock options for cash proceeds of \$265,500. The estimated fair value at issuance of these options was \$215,320, and this amount has been added to the recorded value of the issued shares.

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## 6. Share Capital (Continued)

The fair values of the warrants were estimated on the issuance date using the Black-Scholes pricing model, with the following weighted average assumptions:

	<u>2009</u>	<u>2008</u>
Expected dividend yield	Nil	Nil
Risk-free interest rate	1.49%	3.63%
Expected life	2.0 years	1.5 year
Expected volatility	96%	62%

Warrant pricing models require the input of highly subjective assumptions including the expected price volatility. Changes in the subjective input assumptions can materially affect the fair value estimate, and therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company's warrants.

The Company incurred Part XII.6 interest expense of \$7,190 (2008 - \$83,041) on the monthly unspent portions of the proceeds from its flow-through financings. This amount has been included in the interest and financing costs.

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Notes to the Financial Statements

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## 7. Contributed Surplus

	2009		2008	
	Number	Amount	Number	Amount
<b>Warrants</b>				
Balance - beginning of year	3,805,000	\$ 1,461,881	1,489,125	\$ 338,342
Issued pursuant to				
private placement(s)	-	-	3,805,000	1,634,248
Issued for finders' fees	198,750	36,192	-	-
Exercised	(1,302,200)	(491,715)	(1,414,125)	(322,543)
Cancelled/Expired	(2,545,300)	(977,905)	(75,000)	(15,799)
Commission and advisory fees paid	-	-	-	(108,574)
Commission – agents' compensation options issued	-	-	-	(41,123)
Issuance costs paid	-	-	-	(22,670)
Balance - end of year	<u>156,250</u>	<u>28,453</u>	<u>3,805,000</u>	<u>1,461,881</u>
<b>Stock Options</b>				
Balance - beginning of year	4,327,500	1,353,140	3,900,000	927,002
Granted	1,907,000	503,904	1,175,000	153,441
Exercised	(1,127,500)	(375,953)	(747,500)	(215,320)
Cancelled/Expired	(807,000)	(328,678)	-	-
Fair value of options recognized relating to previous option grants	-	513,029	-	488,017
Balance - end of year	<u>4,300,000</u>	<u>1,665,442</u>	<u>4,327,500</u>	<u>1,353,140</u>
<b>Agents' Compensation Options</b>				
Balance - beginning of year	725,000	425,720	-	-
Granted to agents	-	-	725,000	425,720
Exercised	(725,000)	(425,720)	-	-
Balance - end of year	<u>-</u>	<u>-</u>	<u>725,000</u>	<u>425,720</u>
<b>Cancelled/Expired Warrants and Options</b>				
Balance - beginning of year		54,175		38,376
Expired warrants		977,905		15,799
Cancelled/expired options		<u>328,678</u>		<u>-</u>
Balance - end of year		<u>1,360,758</u>		<u>54,175</u>
		<u>\$ 3,054,653</u>		<u>\$ 3,294,916</u>

### a) Warrants

During the year ended August 31, 2009 the Company amended the exercise price of 3,805,000 share purchase warrants that were expiring on May 22, 2009 from \$2.00 to \$0.70. 1,259,700 of these warrants were exercised and the balance of 2,545,300 expired unexercised.

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For the Years Ended August 31, 2009 and 2008

## 7. Contributed Surplus (Continued)

During the years ended August 31, 2009 and 2008, warrants were issued, exercised and expired/cancelled as follows:

	2009		2008	
	Number of Warrants	Weighted Average Exercise	Number of Warrants	Weighted Average Exercise
Balance - beginning of year	3,805,000	\$ 2.00	1,489,125	\$ 0.94
Issued	198,750	0.50	3,805,000	2.00
Exercised	(1,302,200)	0.69	(1,414,125)	0.93
Expired/Cancelled	(2,545,300)	0.70	(75,000)	1.08
Balance - end of year	156,250	\$ 0.50	3,805,000	\$ 2.00

### b) Stock Option Plan

The shareholders have approved a Stock Option Plan (the "Plan") that provides for the issue of up to 10% of the number of issued and outstanding common shares of the Company to eligible employees, directors and service providers of the Company.

The Plan authorizes the granting of options to purchase common shares of the Company at a price equal to or greater than the closing price of the shares on either the trading day prior to the grant or the day of the grant. The options generally vest over a period of one to four years, and generally have a term of two to five years (but can have a maximum term of 10 years).

During the years ended August 31, 2009 and 2008, stock options were granted, exercised and expired/cancelled as follows:

	2009		2008	
	Number of Options	Weighted Average Exercise	Number of Options	Weighted Average Exercise
Balance - beginning of year	4,327,500	\$ 1.13	3,900,000	\$ 0.91
Granted	1,907,000	1.00	1,175,000	1.35
Exercised	(1,127,500)	0.46	(747,500)	0.36
Expired/Cancelled	(807,000)	1.54	-	-
Balance - end of year	4,300,000	\$ 1.17	4,327,500	\$ 1.13
Vested options included in end of year balance above	1,581,250	\$ 1.15	2,133,750	\$ 0.87

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Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

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## 7. Contributed Surplus (Continued)

During the year ended August 31, 2009, the Company granted:

- i) 32,000 stock options to a consultant of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$1.86 per share until September 1, 2010. These options vest at the rate of 25% every three months following September 1, 2008. These options were cancelled during the year, including 16,000 of these options that had been earned prior to their cancellation, with an estimated fair value of \$2,063 which had been recorded as stock-based compensation expense;
- ii) 200,000 stock options to a consultant of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$0.50 per share until December 31, 2010. These options vest at the rate of 25% every three months following December 31, 2008. As at August 31, 2009, 133,333 options had been earned. The estimated fair value of these options totalled \$158,292 and this amount had been recorded as stock-based compensation expense;
- iii) an aggregate of 200,000 stock options to three consultants of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$0.70 per share until January 13, 2011. These options vest at the rate of 25% every three months following January 13, 2009. As at August 31, 2009, 125,000 options had been earned. The estimated fair value of these options totalled \$121,940 and this amount had been recorded as stock-based compensation expense;
- iv) 50,000 stock options to a consultant of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$0.63 per share until January 27, 2011. These options vest at the rate of 25% every three months following January 27, 2009. As at August 31, 2009, 29,160 options had been earned. The estimated fair value of these options totalled \$35,130 and this amount had been recorded as stock-based compensation expense;
- v) 100,000 stock options to a new officer of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$0.63 per share until January 27, 2014. These options vest at the rate of 25% every twelve months following January 27, 2009. The estimated fair value of these options totalled \$53,850 and this amount is being amortized and expensed as stock-based compensation over the vesting terms. As August 31, 2009, \$7,854 had been recognized and recorded as stock-based compensation expense;
- vi) an aggregate of 400,000 stock options to the Company's directors and officers. Each option entitles the holder to purchase one common share of the Company at a price of \$0.75 per share until February 13, 2014. These options vest at the rate of 25% every twelve months following February 13, 2009. The estimated fair value of these options totalled \$222,120 and this amount is being amortized and expensed as stock-based compensation over the vesting terms. As August 31, 2009, \$30,079 had been recognized and recorded as stock-based compensation expense;
- vii) an aggregate of 150,000 stock options to three consultants of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$0.75 per share until February 13, 2011. These options vest at the rate of 25% every three months following February 13, 2009. As at August 31, 2009, 81,240 options had been earned. The estimated fair value of these options totalled \$75,690, and this amount had been recorded as stock-based compensation expense;

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## 7. Contributed Surplus (Continued)

- viii) 100,000 stock options to an employee of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$0.55 per share until April 7, 2014. These options vest at the rate of 25% every twelve months following April 7, 2009. The estimated fair value of these options totalled \$40,210 and this amount is being amortized and expensed as stock-based compensation over the vesting terms. As August 31, 2009, \$3,351 had been recognized and recorded as stock-based compensation expense;
- ix) granted an aggregate of 200,000 stock options to two of the Company's officers. Each option entitles the holder to purchase one common share of the Company at a price of \$1.41 per share until June 2, 2014. These options vest at the rate of 25% every twelve months following June 2, 2009. The estimated fair value of these options totalled \$255,180 and this amount is being amortized and expensed as stock-based compensation over the vesting terms. As August 31, 2009, \$15,949 had been recognized and recorded as stock-based compensation expense;
- x) granted an aggregate of 225,000 stock options to three of the Company's directors. Each option entitles the holder to purchase one common share of the Company at a price of \$1.54 per share until July 14, 2014. These options vest at the rate of 25% every twelve months following July 14, 2009. The estimated fair value of these options totalled \$279,698 and this amount is being amortized and expensed as stock-based compensation over the vesting terms. As August 31, 2009, \$8,741 had been recognized and recorded as stock-based compensation expense;
- xi) granted an aggregate of 200,000 stock options to four consultants of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$1.54 per share until July 14, 2011. These options vest at the rate of 25% every three months following July 14, 2009. As at August 31, 2009, 25,000 options had been earned. The estimated fair value of these options totalled \$44,815, and this amount had been recorded as stock-based compensation expense; and
- xii) granted 50,000 stock options to a new employee of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$2.35 per share until August 28, 2014. These options vest at the rate of 25% every twelve months following August 28, 2009. The estimated fair value of these options totalled \$87,475 and this amount is being amortized and expensed as stock-based compensation over the vesting terms.

During the year ended August 31, 2009, the Company also recorded stock-based compensation expense of \$513,029 related to stock options with graded vesting schedules which were earned during the year ended August 31, 2009.

The fair value of stock options to employees, officers and directors was estimated at the grant date and the options to service providers were estimated at the service completion date based on the Black-Scholes pricing model, using the following weighted average assumptions:

	<u>2009</u>	<u>2008</u>
Expected dividend yield	Nil	Nil
Risk-free interest rate	1.92%	3.34%
Expected life	3.9 years	3.9 years
Expected volatility	103%	77%

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## 7. Contributed Surplus (Continued)

Option pricing models require the input of highly subjective assumptions including the expected price volatility. Changes in the subjective input assumptions can materially affect the fair value estimate and, therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company's stock options.

As at August 31, 2009, the following options were vested and outstanding:

Option Price	Number of Options		Weighted Average Remaining Contractual Life
	Unvested	Vested	
\$ 2.35	50,000	-	5.0 years
\$ 1.82	168,750	56,250	3.2 years
\$ 1.80	25,000	75,000	1.9 years
\$ 1.61	250,000	250,000	2.8 years
\$ 1.54	425,000	-	3.5 years
\$ 1.41	200,000	-	4.8 years
\$ 1.20	500,000	400,000	2.8 years
\$ 1.08	-	150,000	1.8 years
\$ 0.98	200,000	200,000	2.4 years
\$ 0.80	-	300,000	2.1 years
\$ 0.75	475,000	75,000	3.6 years
\$ 0.70	100,000	50,000	1.4 years
\$ 0.63	125,000	25,000	3.4 years
\$ 0.55	100,000	-	4.6 years
\$ 0.50	<u>100,000</u>	<u>-</u>	1.3 years
	<u>2,718,750</u>	<u>1,581,250</u>	

### c) Special Warrants and Special Flow-through Warrants

As at August 31, 2009 the Company had entered into an agreement (the "Offering Agreement") with a syndicate of underwriters led by CIBC pursuant to which the Underwriters had agreed to purchase and offer for resale on a private placement basis (the "Offering") approximately \$12.5 million of a combination of special warrants ("Special Warrants") and flow-through special warrants ("FT Special Warrants"). The Special Warrants were to be issued at a price of \$2.30 per Special Warrant and the FT Special Warrants were to be issued at a price of \$2.65 per FT Special Warrant. The Company had also granted the Underwriters an option to purchase up to an additional 2,174,000 Special Warrants, for additional gross proceeds of up to approximately \$5.0 million. The Offering was completed subsequent to the year ended August 31, 2009 as described in note 17(c).

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For the Years Ended August 31, 2009 and 2008

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## 8. Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss consists of the unrealized losses on the Company's investments available for sale. The changes during the years ended August 31, 2009 and 2008 are summarized below:

	<u>2009</u>	<u>2008</u>
Balance - beginning of year	\$ (8,200)	\$ (9,099)
Change in unrealized gains (losses) on investments available for sale	<u>(1,286)</u>	<u>899</u>
Balance - end of year	<u>\$ (9,486)</u>	<u>\$ (8,200)</u>

## 9. Capital Disclosures

Capital of the Company consists of the components of shareholders' equity.

The Company's objectives when managing capital are as follows:

- (i) to safeguard the Company's ability to continue as a going concern;
- (ii) to raise sufficient capital to finance its exploration and development activities on its Thor Lake Project; and
- (iii) to raise sufficient capital to meet its general and administrative expenditures, and to explore and develop its other resource properties.

The Company manages its capital structure and makes adjustments to it, based on the funds available to the Company in light of changes in general economic conditions, the Company's short term working capital requirements, and its planned exploration and development program expenditure requirements.

As the Company is in the development stage, its principal source of capital is from the issuance of common shares. In order to achieve its objectives, the Company expects to spend its existing working capital and raise additional funds as required.

The Company does not have any externally imposed capital requirements and there were no changes to the Company's approach to capital management during the year ended August 31, 2009.

## 10. Recoveries of Resource Properties

During the year ended August 31, 2008, the Company sold the technical data files related to one of its abandoned properties to a third party for cash proceeds of \$10,000.

## 11. Related Party Transactions

- a) During the year ended August 31, 2009 the Company incurred consulting fees of \$Nil (2008 - \$9,750) with an officer and director, which were deferred as resource property costs.
- b) During the year ended August 31, 2009 the Company incurred accounting fees of \$57,000 (2008 - \$72,000) with an accounting firm in which an officer is the principal. As at August 31, 2009 accounts payable included \$14,000 (2008 - \$27,133) payable to this accounting firm.

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## 11. Related Party Transactions (Continued)

- c) During the year ended August 31, 2009 the Company incurred consulting fees of \$154,525 (2008 - \$125,300) with a company owned by an officer of the Company, which were deferred as resource property costs. As at August 31, 2009 accounts payable included \$7,875 payable to this company (2008 - \$16,170).
- d) During the year ended August 31, 2009 the Company incurred consulting fees of \$67,100 (2008 - \$Nil) with an officer of the Company, of which \$41,800 were deferred as resource property costs. As at August 31, 2009 accounts payable included \$5,775 payable to this officer (2008 - \$Nil).

Additional related party transactions are described separately in note 6(a).

## 12. Income Taxes

- a) Future Income Tax Assets

The tax effects of temporary differences that give rise to significant portions of the future income tax assets and liabilities at August 31, 2009 and 2008 are as follows:

	<u>2009</u>	<u>2008</u>
Difference in resource properties	\$ 480,782	\$ 510,378
Difference in investments available for sale	33,972	33,624
Difference in property, plant and equipment	39,110	25,484
Non-capital loss carry forwards	597,254	354,552
Capital loss carry forwards	240,345	240,345
Non-refundable investment tax credit carry forwards	800,065	441,074
	<u>2,191,528</u>	<u>1,605,457</u>
Less: valuation allowance	<u>(2,191,528)</u>	<u>(1,605,457)</u>
Net future income tax assets	<u>\$ -</u>	<u>\$ -</u>

A valuation allowance has been applied against all of the above future income tax assets.

- b) Non-Capital Losses

The Company has non-capital losses carried forward of approximately \$2,212,000 (2008 - \$1,313,000) available to reduce future years' taxable income. These losses will expire as follows:

2010	\$19,000
2014	40,000
2015	4,000
2026	156,000
2027	232,000
2028	847,000
2029	914,000

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## 12. Income Taxes (Continued)

### c) Capital Losses

The Company has capital losses carried forward of approximately \$1,800,000 (2008 - \$1,800,000) available to reduce future years' capital gains.

### d) Canadian Exploration and Development Expenses

The Company has cumulative Canadian development expenses of \$3,179,000 (2008 - \$3,179,000) and cumulative Canadian exploration expenses of \$15,621,000 (2008 - \$10,913,000) available to reduce future years' taxable income.

### e) Scientific Research and Experimental Expenditures ("SR&ED")

The Company has SR&ED expenditures carry forward of \$2,635,000 (2008 - \$964,000) available to reduce future years' taxable income.

### f) Non-refundable Investment Tax Credits

The Company has non-refundable investment tax credits of \$800,035 (2008 - \$441,074) available to reduce future years' federal income tax payable. These credits will expire as follows:

2018	\$ 43,866
2019	72,006
2020	14,159
2024	23,855
2025	19,486
2026	62,818
2027	133,198
2028	71,686
2029	358,961

### g) Future Income Tax Recoveries

During year ended August 31, 2009 the Company renounced CEE of \$1,500,000 (2008 - \$5,087,500) to the investors in the flow-through private placement completed in December, 2008. This renunciation resulted in a reduction of the Company's future income tax assets of \$405,000 (2008 - \$1,373,500) and a corresponding reduction in share capital. However, as the Company has not recognized its future income tax assets, the \$405,000 (2008 - \$1,373,500) is recorded as a future income tax recovery on the statement of operations.

## 13. Financial Instruments

### Fair Values

Except as disclosed elsewhere in these financial statements, the carrying amounts for the Company's financial instruments approximate their fair values because of the short-term nature of these items.

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## 13. Financial Instruments (Continued)

The Company's risk exposures and the impact on the Company's financial instruments are summarized below:

### Credit risk

The Company is not exposed to any significant credit risk as at August 31, 2009. The Company's cash and cash equivalents are either on deposit with a highly rated banking group in Canada or invested in bankers acceptance notes or guaranteed investment certificates issued by two highly rated Canadian banking groups.

### Liquidity risk

Liquidity risk is the risk that an entity will not be able to meet its financial obligations as they come due. The Company has sufficient funds to cover its short term working capital requirements and with the financing completed subsequent to August 31, 2009 as disclosed in note 17, the Company has sufficient funds to cover its working capital requirements for at least the next eighteen months.

### Market risk

#### (i) Interest rate risk

The Company has significant cash and cash equivalents balances and it has no interest-bearing debt. The Company's current policy is to invest its excess cash in highly liquid money market investments such as bankers acceptance notes, treasury bills and guaranteed investment certificates. These short term money market investments are subject to interest rate fluctuations.

#### (ii) Foreign currency risk

The Company's functional currency is primarily the Canadian dollar. The majority of the Company's purchases are transacted in Canadian dollars. As at August 31, 2009, the Company had US\$35,385 in cash and accounts payable of US\$18,645.

#### (iii) Price risk

The prices of metals and minerals fluctuate widely and are affected by many factors outside of the Company's control. The prices of metals and minerals and future expectation of such prices have a significant impact on the market sentiment for investment in mining and mineral exploration companies. This in turn may impact the Company's ability to raise equity financing for its long term working capital requirements.

In addition, the values of the Company's Investments are subject to market price fluctuations.

### Sensitivity analysis

Based on management's knowledge and experiences of the financial markets, the Company's management believes the following movements are "reasonably possible" over a three month period.

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## 13. Financial Instruments (Continued)

As at August 31, 2009, approximately 50% of the Company's cash and cash equivalents are at fixed interest rates within the next three months. Sensitivity to a plus or minus 25 basis points change in rates would not have any significant effect on the Company's net loss over a three month period.

The Company had US\$34,214 in cash and accounts payable of US\$18,645 as at August 31, 2009 and its quarterly average expenditures transacted in US dollars is approximately US\$35,000. If the Canadian Dollar weakens or strengthens 10% against the United States Dollar with other variables held constant, the Company's net loss would not change significantly over a three month period.

A plus or minus 10% change in the market price of the Company's Investments would not have any significant effect on the Company's net loss.

## 14. Commitments

The Company has a standby letter of credit of \$76,580 for its closure plan at Separation Rapids related to the Company's advanced exploration permit, which is secured by a guaranteed investment certificate for the same amount.

Pursuant to an advisory agreement, the Company has engaged a company in the United States to act on behalf of the Company as its exclusive OTCQX advisor for a period of twelve months until July 31, 2009 for an annual fee of US\$100,000, of which US\$25,000 has been paid as at August 31, 2009.

## 15. Lease Commitments

The Company has an operating lease for its office premises, the minimum lease commitments under this lease are as follows:

2010	\$ 88,858
2011	88,858
2012	29,619

## 16. Recent Accounting Pronouncements

Recent accounting pronouncements issued and not yet effective:

### Business combinations

In January 2009, the CICA published Section 1582, "Business Combinations" to replace Section 1581. The new standard requires the acquiring entity in a business combination to recognize most of the assets acquired and liabilities assumed in the transaction at fair value including contingent assets and liabilities, and recognize and measure the goodwill acquired in the business combination or a gain from a bargain purchase. Acquisition-related costs are to be expensed. This standard becomes effective January 1, 2011. This new standard only have an impact on the financial statements for future acquisitions that will be made in periods subsequent to the of date adoption.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

Notes to the Financial Statements

For the Years Ended August 31, 2009 and 2008

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## 16. Recent Accounting Pronouncements (Continued)

### Consolidated financial statements and non-controlling interests

In January 2009, the CICA published Section 1601, "Consolidated Financial Statements", and Section 1602, "Non-controlling Interests" replacing Section 1600. Section 1601 carries forward guidance from Section 1600 with the exception of non-controlling interests, which are addressed in a separate section. This standard requires the Company to report non-controlling interests within equity, separately from the equity of the owners of the parent, and transactions between an entity and non-controlling interests as equity transactions. These standards become effective January 1, 2011. The Company currently does not have any significant equity investment in other entities and therefore the application of this new standard is not expected to have any impact on the financial statements of the Company.

### International Financial Reporting Standards ("IFRS")

The CICA plans to incorporate IFRS into the CICA Handbook as a replacement for current Canadian Generally Accepted Accounting Principles for most publicly accountable enterprises effectively for fiscal years beginning on or after January 1, 2011. The transition date of September 1, 2011 for the Company will require restatement for comparative purposes of amounts reported by the Company for the year ended August 31, 2011. While the Company has begun assessing the adoption of IFRS for 2011, the financial reporting impact of the transition to IFRS has not been determined at this time.

## 17. Subsequent Events

Subsequent to the year ended August 31, 2009 the Company:

- a) issued 100,000 non-flow-through common shares pursuant to the exercise of an equivalent number of stock options for cash proceeds of \$85,000;
- b) granted 175,000 stock options to a new director of the Company. Each option entitles the holder to purchase one common share of the Company at a price of \$2.80 per share until September 4, 2014. These options vest at the rate of 25% every twelve months following September 4, 2009. The estimated fair value of these options totalled \$466,130 and this amount will be amortized and expensed as stock-based compensation over the vesting terms. The fair values of these options were estimated using the Black-Scholes pricing model, with the following assumptions: expected dividend yield of Nil; risk free interest rate of 2.61%; expected life of 5.0 years; and expected volatility of 96%;
- c) completed the "Offering" consisting of 6,745,000 Special Warrants at a price of \$2.30 per Special Warrant and 755,000 FT Special Warrants at price \$2.65 per FT Special Warrant for total gross proceeds of \$17,514,250.

Each Special Warrant is exercisable into one unit (the "Unit") of the Company without further payment. Each Unit will be comprised of one common share (a "Common Share") and one-half of a common share purchase warrant. Each whole warrant (a "Warrant") will entitle the holder to purchase one additional common share of the Company, at a price of \$3.00 per Common Share, for a period of 24 months following September 17, 2009.

Each FT Special Warrant is exercisable into one flow-through share of the Company without further payment.

# Avalon Rare Metals Inc.

(formerly Avalon Ventures Ltd.)

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## 17. Subsequent Events (Continued)

The Company will use its best efforts to obtain a receipt for a final prospectus by November 16, 2009 which will qualify for sale the Common Shares and Warrants underlying the Special Warrants and the flow-through common shares underlying the FT Special Warrants issued pursuant to the Offering.

In the event that such date is not met by the Company, each Special Warrant will thereafter entitle the holder thereof to receive one Unit and an additional 0.1 Common Shares without further payment on the part of the holder. No adjustment will be made for holders of FT Special Warrants.

Of the Special Warrant price of \$2.30, \$1.7914 was allocated to the Common Share component of the Unit and the balance of \$0.5086 was allocated to the Warrant component of the Unit. These values were calculated on a pro rata basis based on the closing trading price of the Company's common shares on the date of the Offering Agreement which was \$2.58, and the estimated fair value of a whole Warrant of \$1.4649 (which was estimated using the Black-Scholes pricing model, with the following assumptions: expected dividend yield of Nil; risk free interest rate of 1.28%; expected life of 2.0 years; and expected volatility of 117%).

In connection with the Offering, the Company paid cash commissions totalling \$1,050,855 and issued 450,000 warrants ("Broker Warrants") to the underwriters of the Offering. Each Broker Warrant entitles the holder to purchase one Unit for a period of 24 months following September 17, 2009 at the exercise price of \$2.43 per Unit.

The estimated fair value of the Broker Warrants totalled \$608,040. The fair values of the Broker Warrants were estimated using the Black-Scholes pricing model, with the following assumptions: expected dividend yield of Nil; risk free interest rate of 1.28%; expected life of 2.0 years; and expected volatility of 117%.