
MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis ("MD&A") is intended to provide a summary of the operational and financial results of Karnalyte Resources Inc. ("Karnalyte" or the "Company") for the years ended December 31, 2010 and 2009. This MD&A should be read in conjunction with the audited financial statements of the Company and the related notes thereto. This commentary is dated March 8, 2011. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). These documents, including the Annual Information Form, and additional information about the Company are available on SEDAR at www.sedar.com. Some of the statements made herein contain "forward-looking information" and accordingly please refer to the "Forward-Looking Statements" section at the end of the MD&A.

OVERVIEW

Karnalyte was incorporated under the ABCA on November 16, 2007 and is an Alberta headquartered company focused on exploration and development of potash in Saskatchewan. The Company holds subsurface mineral Permit KP 360A comprising 68,301 acres as well as a lease comprising 16,825 acres near Wynyard, Saskatchewan. To date, the Company has drilled two exploration drill holes and has conducted advanced exploration on approximately 6,300 acres, or 7.5% of the permit area. In the Preliminary Resource Assessment Study ("PRAS"), it was estimated that the Karnalyte property has recoverable indicated mineral resources and inferred mineral resources of approximately 56.2 million tonnes of KCl (13% - 17% grade range) and 186.3 million tonnes of KCl (13% - 19% grade range), respectively. The Company recently completed two additional wells for assessing rock mechanical work in conjunction with a feasibility study. 3D seismic surveys have also been completed on approximately one-third of the permit area to further confirm the resource.

Karnalyte is proposing to explore and develop a carnallite/sylvite mineral resource to produce high quality agricultural and industrial potash and potentially magnesium compounds, at low cost, with a minor environmental footprint using a proven solution mining process. The manufacturing plant is planned to have an initial production capacity of 500,000 tonnes per year of potash and expanding to 2 million tonnes per year.

Karnalyte plans to use solution mining to extract a brine rich in potash (KCl), magnesium chloride (MgCl₂) and sodium chloride (NaCl) which can then be processed into marketable products. The first phase of the Wynyard Carnallite Project (the "Project") will concentrate on the production of high quality potash products with a brine rich in magnesium chloride and sodium chloride treated as waste and disposed of back underground into the spent caverns. In a subsequent phase of the Project these waste streams are planned to be treated to produce marketable sodium chloride and magnesium-products. The products in the current phase are expected to be a granulated potash pellets for the agricultural market and industrial grade for the industrial market.

The Company successfully completed its Initial Public Offering ("IPO") at the end of 2010, culminating in an initial TSX listing on December 14, 2010. A total of \$59,985,000 was raised in the base IPO consisting of 6,975,000 shares at \$8.60 per share. Subsequently, on January 13, 2011, the Company completed the over-allotment option granted in connection with the IPO. The underwriters purchased an additional 470,000 shares at a price of \$8.60 for total gross proceeds of \$4,042,000. As a result, total gross proceeds of \$64,027,000 were raised through the IPO. These funds will be used to continue further delineation of the ore body as well as to complete a feasibility study that is required prior to making the decision on building the processing plant. Prior to the IPO, the Company has been financed through

various private placements. On July 31, 2009 the Company closed the first tranche of the 2009 private placement by issuing 260,800 flow-through units for total proceeds of \$1,499,600. An additional 487,000 flow-through units and 2,037,600 common shares were issued on August 12, 2009 pursuant to the closing of the second tranche of the 2009 private placement for total proceeds of \$12,988,250. Each flow-through unit consists of one common share of the Company and one flow-through warrant. Funds raised were used by the Company for general corporate purposes to advance the Company's potash project towards commerciality. In November 2010 the Company issued 278,540 common shares for no consideration to comply with the terms of the liquidity penalty granted to subscribers of the 2009 private placement. Upon the completion of the IPO, the liquidity penalty granted to subscribers of the 2009 private placement terminated.

SELECTED ANNUAL INFORMATION

The information has been summarised from the Company's audited financial statements. Although the Company was incorporated on November 16, 2007, only minimal activity occurred prior to May of 2008. In addition due to the development stage of operations, the focus of the Company has been continually changing resulting in difficulties in comparing different fiscal periods.

During the year ended December 31, 2010, the Company expanded its senior management team, launched operation of its cavern brine test facility, finalized the PRAS and completed its transition to a public company by finalizing its IPO. This is in comparison to the year ended December 31, 2009 where the Company built staffing levels to commence exploration and pre-development activities which included completing National Instruments 43-101 compliant technical reports and launching the PRAS. In addition, resources were focused during 2009 on preparing the cavern brine test facility in Wynyard, Saskatchewan and on obtaining new financing to advance the Project. In the year ended December 31, 2008, the Company did not conduct any significant operations prior to May and from that period was focused on building the appropriate corporate structure including hiring necessary staff.

The Company is planning to develop a solution mine and construct processing facilities to produce high-quality potash products. At this point in time the Company considers itself to be in the exploration and development stage and has completed the preliminary exploration and development functions necessary to continue to move the Project forward. The next phase of this development will be additional work focused on attaining a feasibility study that is expected to confirm the feasibility of the Project. Expenditures to date were focused on setting the stage for this feasibility study which, in turn, is expected to then lead into the actual construction phase. Plant construction is expected to take approximately 18 - 24 months following the receipt of satisfactory results of the feasibility study, and completion of additional financing and preparation of the brine field is planned to take approximately 24 - 30 months which is expected to be completed concurrently with plant construction. Management plans to start ramping up production upon completion of plant construction while it continues with brine field preparation. Within a 10 month period following the completion of the plant the Company expects production to be ramped up to a full run rate of 500,000 tonnes per year. The next phase representing the feasibility study, exploration and drilling program and other planned activities for 2011 will require capital of approximately \$30 million. Subsequent phases of the Project, including the construction phase will form the vast majority of the total expected project cost of approximately \$409 million.

Selected Annual Results

	Year ended December 31		
	2010	2009	2008
Total revenue	\$ -	\$ -	\$ -
Interest and other income	38,750	48,729	41,237
Net and comprehensive loss	(2,100,879)	(1,815,332)	(1,071,843)
Basic and diluted per share	(0.16)	(0.17)	(0.15)
Total current assets	59,481,598	9,134,814	2,438,910
Total assets	70,610,459	16,398,771	4,204,262
Total current liabilities	2,295,027	680,795	176,848
Total liabilities	2,339,060	680,795	176,848
Total shareholders' equity	68,271,399	15,717,976	4,027,414

RESULTS OF OPERATIONS

Interest and other income for the year ended December 31, 2010 amounted to \$38,750 compared to \$48,729 for the comparative 2009 period. Rental income was generated in the year ended December 31, 2010 by renting out purchased land for farming while it was not being used. No such income was generated in the prior year. However, this increase was more than offset by reduced interest income as the excess funds available for investment were down from 2009 as more funds were used for operational requirements. This was compounded by a significant decrease in interest rates over the periods. The economic downturn resulted in governments reducing interest rates that caused a reduction in interest related revenue for the Company. The reduction in interest rates was further compounded by the Company deciding to invest excess funds in safer Government of Canada treasury bills subsequent to July 2009 compared to investing in higher interest bonds until July 2009. Throughout 2010, as the treasury bills came due, the funds were then invested in money market funds with slightly higher interest.

Net loss for the year ended December 31, 2010 totalled \$2,100,879 compared to \$1,815,332 in the comparative 2009 period. The Company is in the exploration and development stage and does not currently have any revenue other than interest and rental income and therefore is in a net loss position. The losses resulted from general and administrative (“G&A”) related expenses incurred in establishing the Company and building the business. Another significant component of the loss incurred for the year ended December 31, 2010 relates to non-cash stock-based compensation expense of \$318,672 that was compared to nil in the 2009 year related to issuance of stock options.

Total assets for the year ended December 31, 2010 amounted to \$70,610,459, compared to \$16,398,771 in the comparative 2009 period. The large increase in assets for the year ended December 31, 2010 compared to the 2009 comparative period resulted from gross funds of \$59,985,000 raised in the IPO. The funds raised will be used to continue delineation of the Company’s property and preparation of feasibility, environmental and NI 43-101 resource update reports. As of the date of this MD&A the majority of the IPO proceeds are in cash. The combination of increased capitalized costs on Karnalyte’s property combined with excess funds invested to generate interest income accounted for the large increase in total assets.

Total liabilities have increased significantly from \$680,795 in 2009 to \$2,339,060 for the year ended December 31, 2010. The increase in liabilities is a result of the drilling project that was underway at the current year end. A large portion of the expenses were incurred but not yet paid prior to December 31,

2010. There was also a significant amount of expenditures relating to the IPO that were outstanding at the 2010 year end.

Shareholders' equity at December 31, 2010 was \$68,271,399 compared to \$15,717,976 in the comparative 2009 period. The increase in 2010 is a result of the funds raised through the IPO. There were a total of 6,975,000 shares issued at \$8.60 for total capital raised of \$59,985,000. The share issue expenses incurred were netted off this amount in share capital.

General and administrative expenses (G&A)

G&A costs for the year ended December 31, 2010 amounted to \$2,840,196, an increase of \$1,034,344 from the comparative 2009 amount of \$1,805,852. During the year ended December 31, 2010, the Company focused on enhancing the corporate infrastructure as it continued to work on the Project. Additional executives were hired to expand the management team and prepare for the transition to a public company and to prepare for the feasibility study and related work. As mentioned at the outset of this MD&A, it is difficult to compare the year ended December 31, 2010 to the comparative periods due to activity levels increasing significantly and the Company being required to address the needs to support the operations. During 2009 the Company focused on completion of third party reports required to progress the Project leading to increased G&A activities.

The key components of the G&A costs are as follows:

G&A Expenditures		
	Year ended December 31	
	2010	2009
Salaries, wages and benefits	\$ 1,782,031	\$ -
Management and consulting	239,792	1,405,898
Accounting and legal	338,187	93,043
Business development	103,492	82,731
Rent	105,088	103,180
Other	271,606	121,000
Total general and administrative	\$ 2,840,196	\$ 1,805,852

Salaries, wages and benefits for the year ended December 31, 2010 was \$1,782,031 compared to nil in the 2009 comparative period. Prior to January 1, 2010, all personnel working on the Project were classified as consultants, however, effective January 1, 2010 all these personnel were transferred to full time salaried employees. This caused a shift from management and consulting to salaries, wages and benefits. In addition, during the year ended December 31, 2010, the Company increased the size of its senior management team by adding resources focused on finance, corporate development and engineering to continue building the corporate structure. The decrease in management consulting fees is the direct result of this change from consulting arrangements to employee status. During the year ended December 31, 2010, the Company continued to utilize certain consultants focused on engineering, environmental, marketing and other activities where specific skill sets were required outside of the Company.

Management and consulting expenses for the year ended December 31, 2010 amounted to \$239,792 compared to \$1,405,898 for the year ended December 31, 2009. The transfer of Company executives from consultants to employees in 2010 significantly reduced the consultant expenses from 2009 to 2010.

Consulting fees in 2009 related to adding resources to establish the engineering, corporate development, financing and R&D activities.

Accounting and legal expenses for the year ended December 31, 2010 amounted to \$338,187 compared to \$93,043 for the comparative year in 2009 representing an increase \$245,144. Accounting fees increased in the year end December 31, 2010 as quarterly reviews were completed that were not done in the comparative year. In addition, accounting and tax fees relating to the flow-through shares were incurred along with higher audit fees from higher corporate activity. Legal fees increased in the year ended December 31, 2010 due to granting of stock options in 2010 where none were granted in the comparative years. In addition, legal fees were incurred in establishing the Board of Director mandates, shareholder meeting planning, establishing employment contracts and consulting on benefit plans among other legal matters.

Business development and investor relation expenses for the year ended December 31, 2010 amounted to \$103,492 increasing \$20,761 from \$82,731 for the year ended December 31, 2009. Business development and investor relation activities in the year ended December 31, 2010 were up compared to the prior year as the Company focused on finalizing its revised technical reports, PRAS and other third party engagements aimed at preparing for the IPO.

Rent expense for the year ended December 31, 2010 amounted to \$105,088 compared to \$103,180 for the year ended December 31, 2009. The rent has remained consistent over the comparative periods as the lease rates remained stable.

Other expenses for the year ended December 31, 2010 amounted to \$271,606 compared to \$121,000 for the comparative 2009 year representing an increase of \$150,606. This increase resulted from a variety of other G&A costs with the primary increases in 2010 relating to small electronics required due to the increases in staffing levels (up \$25,476) and director fees (up \$46,698) as directors were not compensated in 2009. In addition, other employee related G&A costs including but not limited to office supplies, motor vehicle expenses, computer supplies and telephone expenses increased \$53,725 over the year ended December 31, 2009 due to increased staff and higher activity levels. Finally general corporate costs (such as insurance, property taxes and repairs and maintenance) were \$24,707 higher for the year ended December 31, 2010 compared to the prior year due to higher activity levels on various aspects of the Project. This activity included supporting the additional staff quarters in Wynard and costs incurred to support the additional activities and staff levels.

Other expenses

Realized and unrealized investment loss incurred in the year ended December 31, 2010 amounted to \$277 loss as compared to \$4,844 in 2009.

Foreign exchange losses were incurred for the year ended December 31, 2010 amounted to \$3,076 compared to \$32,747 in the comparative 2009 year. This loss was a result of exchange rate fluctuations in an environment where in general the Canadian dollar increased in value compared to the United States dollar. The Company currently maintains U.S. account balances sufficient to fulfill current contract amounts in order to hedge against exchange rate fluctuations.

Stock-based compensation expense incurred in the year ended December 31, 2010 amounted to \$318,672 compared to nil in the comparative 2009 period. A total of 1,828,000 options were granted in the twelve

months ended December 31, 2010 compared to none being granted in 2009. A total of 1,300,000 options were granted in the year ended December 31, 2010 prior to the Company completing its' IPO. These options had a weighted average life of 2.39 years and vested immediately. The remaining 528,000 granted in the year ended December 31, 2010 were granted subsequent to the Company completing its' IPO. These have a five year expiration and vest over two years. All options were valued using the Black-Scholes option-pricing model.

Depreciation and accretion for the year ended December 31, 2010 amounted to \$52,371 compared to \$20,618 for the comparative 2009 year representing an increase of \$31,753. The increased depreciation expense was as a result of the increase in assets throughout the year. Renovations conducted in 2009 to a building in Wynyard, Saskatchewan that was originally purchased in 2008 and subsequently finalized in the first two quarters of 2010 resulted in increased depreciation throughout the 2010 period. The building is used for living accommodations and office space for employees or consultants who travel to the property for continued exploration and business development efforts. In addition, the increased staffing levels required leasehold renovations to the Okotoks head office where a second floor renovation was completed and corresponding furniture, fixtures and equipment were purchased in early 2010 and are now being depreciated.

Previously disclosed use of proceeds

Analysis of Prospectus Use of Proceeds				
	Current Expectation	Prospectus	Variance	Notes
Geological Analysis	\$ 3,000,000	\$ 3,000,000	\$ -	
Feasibility Study Costs	9,000,000	17,000,000	(8,000,000)	a
Additional Exploration Seismic and Drilling	16,000,000	10,000,000	6,000,000	b
Environmental Impact Assessment	2,000,000	2,000,000	-	
Infrastructure Preparation and Equipment Deposits	9,400,000	9,400,000	-	
Contingencies	11,000,000	9,000,000	2,000,000	c
General, Administrative and Corporate Purposes	5,046,300	5,046,300	-	
Total	\$ 55,446,300	\$ 55,446,300	\$ -	

Notes

- a) Feasibility Study Costs estimated in the Prospectus, dated December 6, 2010 (the "Prospectus"), were based on expectations of at least four additional drill cores being required to fully understand the rock mechanical properties and geological structure related to constructing the processing facility and preparing the solution mine area. Upon further review of existing information and considering the results of the two drill hole Geological Analysis drilling program conducted, the co-authors of the feasibility study that is currently being prepared determined the additional drill holes would not be required. The Company included an estimate of approximately \$6 million for these holes in the \$17 million Feasibility Study Costs. In addition, the Company had included \$2 million in additional contingencies for the surface facility and other portions of the feasibility study that are not required based on the proposals received and accepted.
- b) The Company decided subsequent to the Prospectus to increase the drilling and exploration program planned for 2011. No additional 3D seismic activity was planned in the Prospectus but has since been determined to be important to gaining a better understanding of up to one-half the

total permit area under control, estimated at \$2.5 million. In addition, the Company had planned on additional drill holes being required in the feasibility study that were subsequently removed as described above. As a result, the Company decided to add two additional drill targets to the exploration plan at a cost of up to \$3.5 million.

- c) The Company believes other sensitivities could arise in 2011 related to the key initiatives highlighted in the Prospectus and has therefore increased the expected contingencies by \$2 million to arrive at the same total as projected in the Prospectus

The amounts above exclude gross proceeds of \$4,042,000 (\$3,799,480 net of commissions) related to the closing of the over-allotment option on January 13, 2011. These proceeds will be allocated to general, administrative and corporate purposes

QUARTERLY INFORMATION

The following table provides selected financial information of the Company for each of the last eight quarters ended at December 31, 2010:

Selected Quarterly Results								
	2010				2009			
	Dec 31	Sep 30	Jun 30	Mar 31	Dec 31	Sep 30	Jun 30	Mar 31
Total revenue	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Interest and other income	10,258	7,239	9,517	11,736	4,786	1,010	10,431	32,502
Net and comprehensive loss	(817,564)	(663,779)	(952,523)	332,987	(482,500)	(501,203)	(440,626)	(391,003)
Basic and fully diluted per share	(0.06)	(0.05)	(0.08)	0.03	(0.03)	(0.05)	(0.05)	(0.04)
Total current assets	59,481,598	4,909,484	5,624,365	7,215,379	9,134,814	13,412,854	9,814,225	1,557,426
Total assets	70,610,459	14,402,008	14,666,176	15,372,345	16,398,771	16,198,707	3,193,442	3,624,773
Total liabilities	2,239,060	458,522	338,911	250,187	680,795	748	15,389	1,532
Total shareholders equity	68,271,399	13,943,486	14,327,265	15,122,158	15,717,976	16,197,959	3,178,053	3,623,241

As discussed in other sections of this MD&A, the development of the Company from a start up operation in 2008 continuing to grow the business throughout the years ended December 31, 2010 and 2009 will make comparability between quarters very difficult. However, general trends can be summarized as follows:

Interest income was generated from excess funds being invested in various financial instruments. Spending on major projects in 2009 reduced the funds available for investment. Offsetting the increased funds available from the 2009 private placement was a significant decrease in interest rates available on investments. This decrease in interest rates continued into the year ended December 31, 2010 as governments' continued to foster an environment where they continued to stimulate a fragile economy.

Net loss was driven primarily by G&A expenses incurred in the continued build up of the Company. The net loss has increased from \$391,003 for the quarter ended March 31, 2009 to \$817,564 for the quarter ended December 31, 2010. The increase results from increased activity in establishing operations, growing staff levels, increase in staff support costs and other G&A costs associated with continuing to grow the business. Net income recognized in the quarter ended March 31, 2010 related to a future income tax reduction from the renouncement of the flow-through shares (\$1,074,963) that was partially offset by higher personnel costs as additional staff were hired along with \$134,658 in stock-based compensation. The loss in the quarter ended June 30, 2010 increased due to the senior management team being larger

along with stock-based compensation expenses of \$116,830 from stock options issued in the quarter. The loss for the quarter ended December 31, 2010 includes stock-based compensation expenses of \$67,183.

Current assets trends principally activity in the cash account. This account comprises the vast majority of current assets with relatively minor balances in prepaid expenses and some miscellaneous receivables. The quarterly trends illustrated throughout the first two quarters of 2009 reflect relatively consistent spend of cash on the Project. This trend accelerated through the third and fourth quarters of 2009 when spending began to increase on National Instrument 43-101 technical reports, 3D seismic and drilling activity and other third party consulting on the Project. Current assets fell below \$1 million for the quarter ended June 30, 2009 but was replenished by proceeds from the 2009 private placement. Starting with the quarter ended December 31, 2009 and through the first two quarters of 2010, spending has increased (and by default, current assets have decreased to fund the expenditures) as the Project activity increased from completing third party reports as the Company moved into the next phase of its Project. The quarter ended December 31, 2010, reflects a large increase in current assets as a result of the Company successfully completing an IPO on December 14, 2010. The IPO raised \$59,985,000 from the offering with underwriting fees and related share issue costs resulting in net proceeds of \$55,014,993.

Total assets on a quarterly basis reflect two main components, cash from financings still available to the Company and capitalized expenditures on moving the Project forward. Total assets remained relatively constant for the majority of the periods above. The quarterly fluctuations generally reflect cash expended on G&A expenses. The significant spike for the quarter ended September 30, 2009 reflects the 2009 private placement which generated net proceeds of over \$14 million.

Total liabilities for the quarterly periods illustrated relate primarily to accounts payable and accrued liabilities. These balances vary in the analysis due to timing of payments that are required on the various work performed on bringing the Project to the current level.

General and administrative expenses for the periods shown reflect the Company continuing to add staff and related staff support costs which increased G&A expenses. In addition, increased legal, accounting, taxation and other professional fees related to support a growing operation also increased the G&A costs.

FINANCING

2009

During 2009, the 2009 private placement was completed in two stages with 260,800 flow-through units issued on July 31, 2009 at \$5.75 per unit for total proceeds of \$1,499,600. This was followed by an additional closing on August 12, 2009 of 487,000 flow-through units at \$5.75 per unit for total proceeds of \$2,800,250 and 2,037,600 common shares issued for \$5.00 per share for proceeds of \$10,188,000. Total proceeds from the 2009 private placement amounted to \$14,487,850 and were used for the following purposes:

- Launch PRAS and other independent engineering studies;
- Additional 3D seismic analysis on approximately 24 square miles of permit area;
- Further drilling conducted that included three drill holes for exploration, testing and water;
- Key land for the initial phase of the Project was purchased;
- Leasehold improvements for Okotoks head office and office space at the field location in Saskatchewan; and
- General corporate purposes.

As of December 31, 2009 the Company had incurred all of the eligible expenditures required under the flow-through unit agreements. In conjunction with this financing, the Company granted 167,124 non-transferable broker warrants to the agents with an exercise price of \$5.00 per warrant that expire 12 months after the Company completed its IPO.

During the year ended December 31, 2009 a total of 140,000 stock options were exercised by employees, directors and consultants for gross proceeds to the Company of \$140,000.

2010

The IPO was completed on December 14, 2010 where 6,975,000 common shares were issued at a price of \$8.60 per share for total gross proceeds of \$59,985,000. Share issue costs related to this offering were \$4,970,007. The proceeds from the IPO will be used for the following purposes:

- Feasibility study costs;
- Infrastructure preparation and equipment deposits;
- Environmental impact assessment;
- Geological analysis;
- Additional exploration, seismic and drilling;
- General administrative and corporate purposes; and
- Contingencies.

In conjunction with the IPO, the Company granted 418,500 non-transferable broker warrants to the agents with an exercise price of \$8.60 per warrant that will expire on or about on June 14, 2012.

On November 12, 2010 the Company issued 278,540 common shares for no consideration to comply with the terms of the liquidity penalty granted to subscribers of the 2009 private placement.

During the year ended December 31, 2010 a total of 176,400 stock options were exercised by employees, directors and consultants for gross proceeds to the Company of \$395,600.

INVESTING

The Company capitalizes costs incurred on projects that are determined to provide future benefit and charges other costs to operations including administrative salaries, support and office costs, community relations programs and other administrative related expenditures. Costs directly related to capital assets are capitalized to appropriate categories and depreciated over their useful lives. Costs of personnel related entirely to preparation of mineral properties on the Company's permit areas and for the future construction of facilities are capitalized as part of the mineral properties or of the processing facilities.

Mineral properties

During the year ended December 31, 2010, the Company capitalized \$3,780,655 to mineral properties for work done on the permit area compared to \$5,324,994 in the comparative 2009 fiscal year end in the following areas:

Mineral Properties		
	Year ended December 31	
	2010	2009
Surface land	\$ 751,750	\$ 331,750
Permits	130,906	79,582
Geophysics	3,282,474	2,926,175
Drilling	5,354,843	3,076,277
Engineering	794,871	193,755
Environmental	257,615	184,265
Balance, end of year	\$ 10,572,459	\$ 6,791,804

A comparison of the periods is very difficult due to the changing focus and the acceleration of development activities being done on the Project. The mineral property expenditures in 2010 and 2009 relate to capital spent to delineate the ore body contained within permit KP 360A through 3D seismic geophysical analysis and drilling activity. This additional work was required for the Company to proceed with the PRAS that led to increased indicated and inferred resources in the completed National Instrument 43-101 report. Surface land expenditures relate to land purchased outright where the Company anticipates placing the processing plant and mines. The Company will continue adding to land holdings as it deems necessary to continue to progress the Project. Permit expenditures relate to the annual costs of renewing the Company's overall permit holdings. Geophysics expenditures include work done on 3D seismic analysis and completion of the two National Instrument 43-101 compliant reports. The first report was finalized in May 2009 and the updated report was finalized in April 2010. Drilling costs related to the additional drill cores conducted by the Company to prove up the existing areas and enhance the indicated and inferred resources. Engineering costs relate to the work done on the permit area and includes the development of the pilot test facility to test the characteristics of the mineral deposits. The environmental expenditures relate to the work done during the year ended December 31, 2009 on the environmental assessment that is critical to moving the Project forward. The environmental work was continued in 2010 to address initial government comments.

Capital assets

During the year ended December 31, 2010, the Company capitalized \$99,787 to buildings, leasehold improvements, equipment and furniture for additional work space required to accommodate additional personnel compared to \$129,718 for the comparative 2009 period. Expenditures were capitalized to the following areas:

Capital Assets		
	Year ended December 31	
	2010	2009
Buildings	\$ 238,320	\$ 239,599
Land	124,656	124,656
Leasehold improvements	44,013	22,199
Equipment under capital lease	12,658	-
Furniture and equipment	39,729	10,484
Balance, end of year	\$ 459,376	\$ 396,938

Buildings increased by \$9,100 during the year ended December 31, 2010 compared to \$110,362 for the comparative year of 2009. These expenditures relate to the purchase and subsequent renovations of a building in Wynard, Saskatchewan to be used for staff accommodations during the development stage of the Company's Project. The size and infrastructure of the local area creates challenges relating to sufficient accommodations for staff when on site to develop the Project. As a result, the Company decided to purchase an unused building and renovate it into staff accommodations. Expenditures of \$110,362 in the year ended December 31, 2009 related to improvements and renovations to this building. Expenditures made in 2010 related to completing the final alterations to the building. The Company expects to obtain savings over the long term by controlling its' own staff accommodation staging area. The building is being depreciated on a straight-line basis over a 25 year estimated life resulting in depreciation charges of \$10,379 for the twelve-months ended December 31, 2010 and \$7,963 for the year ended December 31, 2009.

Land was not acquired in the year ended December 31, 2010 compared to \$4,250 during 2009 year for legal fees that were related to purchasing the land.

Leasehold improvements increased by \$34,518 in the year ended December 31, 2010 compared to \$6,902 in the year ended December 31, 2009. The \$6,902 in expenditures made during the year ended December 31, 2009 relate to expansion of the head office building in Okotoks, Alberta to accommodate the increased staff and management team. During the year ended December 31, 2010 \$34,518 was spent on renovating the building to accommodate a second floor for the additional staff and to allow for space for consultants and future additional personnel. These leaseholds are being amortized on a straight line basis over the term of the lease with \$12,704 amortized in the year ended December 31, 2010 compared to \$4,958 in the year ended December 31, 2009.

Furniture and equipment increased by \$35,457 during the year ended December 31, 2010 compared \$8,204 in the year ended December 31, 2009. The majority of expenditures capitalized relate to furniture and equipment for the head office as a result of additional staff and required space. During the year ended December 31, 2009, expenditures were required in finalizing the original office set up.

Intangible assets

During the year ended December 31, 2010, the Company capitalized \$35,524 to intangible assets.

Intangible Assets		
	Year ended December 31	
	2010	2009
Process patent	\$ 56,428	\$ 37,744
Computer software	40,598	37,471
Balance, end of year	\$ 97,026	\$ 75,215

Process patents that were originally filed in August 2008, increased by \$21,396 during the year ended December 31, 2010 compared to \$24,083 for the year ended December 31, 2009. Costs incurred in the year ended December 31, 2009 related to filing in the United States, related legal costs and additional filings. Expenditures were capitalized in the year ended December 31, 2010 on related legal costs to maintain the patents.

Computer software increased by \$14,128 in the year ended December 31, 2010 compared to \$40,428 for the year ended December 31, 2009. The expenditures capitalized relate to the installation of the Great Plains accounting software. The system was installed late in the year ended December 31, 2009 and finalized in the beginning of 2010.

Asset retirement obligations

The Company's asset retirement obligations are based on the Company's net ownership in wells and facilities. Management estimates the costs to abandon and reclaim the wells and the facilities and the estimated time period during which these costs will be incurred in the future. The majority of these costs are expected to be incurred over the next 30 years. The undiscounted amount of estimated costs required to settle the retirement obligations at December 31, 2010 is \$148,000 (December 31, 2009 – \$nil). The estimated costs have been inflated at 2 percent and discounted at a credit-adjusted risk free rate of 10 percent for 2010.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2010, the Company had net working capital of \$57,186,571 compared to \$8,454,019 at December 31, 2009 including \$59,000,457 and \$2,490,823, respectively, in cash. Net working capital also contained \$nil and \$6,147,759 in short term investments for the years ending December 31, 2010 and 2009, respectively. For the year ended December 31, 2010, the Company also had \$125,000 in short-term restricted cash that was set up as a requirement from the Government of Saskatchewan in order to operate the pilot test plant in Saskatchewan. This requirement did not exist in the prior year. The Company maintains cash in bank accounts for day to day operations and invests the excess in short-term financial instruments including but not limited to Guaranteed Investment Certificates and Money Market Funds that are very liquid. No investments are made in commercial paper instruments.

Cash, restricted cash and short-term investments at December 31, 2010 amounted to \$59,125,457 compared to \$8,638,582 at December 31, 2009. The funds available at December 31, 2009 reflect cash remaining from the 2009 private placement with the majority of significant capital expenditures having been funded prior to the end of the year. The significant funds available at the year ended December 31, 2010 are a result of the proceeds generated from the IPO completed on December 14, 2010.

The Company has sufficient cash to meet its short-term corporate costs and existing current capital plans and has sufficient funds to finance exploration and ongoing corporate functions. There is no certainty, however, that the Company will be able to raise additional funds to obtain the necessary capital to move the Project forward to the production stage.

CONTRACTUAL OBLIGATIONS

Mineral lease obligations were revised on February 28, 2011 when the Company received approval to transfer 16,825 acres from a permit to a lease with the remaining 68,301 acres continuing to be held as a permit. The Company is required to pay annual rent of \$0.50 per acre on its permit held for a term of five years ending on March 12, 2013 for a total cost of \$34,150 per year. Extension of the term of the permit is \$10,000 for the first extension period, \$20,000 for the second five-year extension and \$40,000 for the third extension period. The Company is required to spend \$40,000 in each of the second and third years of the term, and \$80,000 in the fourth and fifth years of the term on work for the purpose of exploring for, developing or mining subsurface minerals. To date, the Company has met and expects to meet all of these related commitments.

The Company is required to pay an annual lease of \$2.00 per acre on any area held under lease for a term of twenty-one years for a total cost of \$33,650 per year. The Company is required to expend not less than \$3,000,000 for work during the first three years of the term of the lease. In case of any deficiency in the amount of expenditures for work required to be made pursuant to this requirement, the lessee may upon application obtain twelve month extensions of time for making the required expenditures with a maximum of three such extensions, provided that for each twelve month extension the lease holder makes a cash payment equivalent to three per cent of the difference between \$3,000,000 and the amount of accumulated expenditures made to the date of application. Upon application the lessee may, after the third extension, obtain further extensions of time for making the expenditures required to be made by deposit of \$90,000 for each twelve month extension or portion thereof. If a lease is surrendered by the lessee or cancelled by the minister, the requirement of expenditures to be made is terminated. If the lessee makes the expenditures and furnishes proof thereof in accordance with “The Subsurface Mineral Regulations, 1960”, the deposit will be refunded to the lessee.

An operating lease exists for the office space in Okotoks, AB. The Company entered into a lease agreement for building space for the corporate head office location that runs through to April 30, 2013 with monthly lease payments of \$18,325. This is an increase of approximately \$9,000 over prior years as a result of the Company obtaining extra office space in its current building to accommodate additional staff that have been hired.

Professional services contracts are in place for various technical, geological, environmental, engineering and consulting services representing total committed costs of approximately \$0.4 million as at December 31, 2010. These contracts relate to update the National Instrument 43-101 technical report, environmental studies, process test work and related matters.

Subsequent to the year ended December 31, 2010, the Company entered into a contract with Foster Wheeler AG who will prepare the feasibility study and coordinate preparation of the overall Environmental Impact Statement. GeoEngineers Inc. will perform environmental and geotechnical engineering services for the study. ERCOSPLAN Ingenieuresellschaft Geotechnik und Bergbau mbH of Erfurt Germany will perform mining engineering services for the underground mining portion of the study. The total amount of the contract is approximately \$6.4 million and the work is expected to be completed by the end of December 31, 2011.

Consultants are utilized by the Company as required to progress its Project towards commercial development. As at December 31, 2010, minimal commitments were in place related to assistance on environmental assessment reviews and engineering reviews on relatively short term contracts ending in 2011.

A capital lease was entered into for computer hardware that is classified as capital leases with a 36 month term that runs from January 1, 2010 to December 31, 2012 carrying monthly lease payments of \$1,023 per month.

The following table summarizes the commitments of the Company as at December 31, 2010:

Contractual Obligations					
	Payments due by period				
	Total	Less than 1 year	1-3 years	4-5 years	More than 5 years
Mineral lease	\$ 786,678	\$ 70,990	\$ 109,988	\$ 67,300	\$ 538,400
Operating lease	513,100	219,900	293,200	-	-
Professional services contracts ¹	384,298	384,298	-	-	-
Consultants	13,365	13,365	-	-	-
Capital lease	13,808	6,904	6,904	-	-
Total	\$ 1,711,249	\$ 695,457	\$ 410,092	\$ 67,300	\$ 538,400

¹ Excludes the \$6.4 million contracts relating to the feasibility study signed in January, 2011.

INCOME TAXES

Significant components of future income tax assets (liabilities) are as follows:

	Income Taxes	
	Year ended December 31	
	2010	2009
Mineral property, capital and intangible assets	\$ (1,082,730)	\$ 6,581
Share issue costs	1,166,060	230,039
Non-capital losses	1,781,761	776,635
Asset retirement obligations	9,282	-
Valuation allowance	(1,874,373)	(1,013,255)
	\$ -	\$ -

The Company has Canadian non-capital losses, for which no benefit has been recognized in the financial statements of approximately \$7,100,000, which commence expiry in 2026. The Company did not consider it more than likely that it would be able to realize a future tax benefit on continuing operations and as a result, a valuation allowance is provided against the future tax assets.

In the first quarter of 2010, the Company recognized a future income tax reduction of \$1.1 million relating to the recognition of the income tax effect on the \$4.2 million renounced in January 2010 pursuant to the 2009 flow-through share issuance.

TRANSACTIONS WITH RELATED PARTIES

During the year ended December 31, 2010, the Company incurred \$23,883 (2009 - \$25,783) in costs from a law firm in which a director of the Company is a partner. The Company did not incur consulting fees for management services for the year ended December 31, 2010. However in the prior year non-independent directors were working under contract arrangements resulting in \$562,744 fees for the year ended December 31, 2009. During the year ended December 31, 2010 there was \$46,698 (2009 - \$nil) in costs paid to directors.

These transactions are in the normal course of business and have been recorded at exchange amount under G&A costs.

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amount of assets, liabilities and expenses. The Company evaluates the estimates periodically. In making judgments about the carrying values, the Company uses estimates based on historical experience and various assumptions that are considered reasonable in the circumstances. Actual results may differ from those reported. The Company reviews significant areas subject to estimation with the Audit Committee and its independent auditors. Significant areas requiring estimate include the determination of capitalization and impairment of assets, mineral properties and capital assets, the related amortization based on depletion and depreciation and the calculation of stock-based compensation expense.

Stage of development

The Company is in the early development stage of its history and at this stage of the Company's growth, it is subject to the risks associated with early stage companies, including uncertainty of future revenues, developing acceptable markets and growth into established markets, profitability and the need to raise additional financing to continue to progress its Project.

Continued exploration and development of the Property, as well as the Company's ability to continue as a going concern are dependent on Karnalyte's ability to obtain necessary financing. As the Company is not currently producing from its property, it will be necessary for the Company to seek additional equity to finance its programs.

Mineral properties and deferred exploration costs

The Company's expenditures relating to the acquisition of leases, permits and the exploration and development thereon are recorded at cost and include direct and indirect acquisition and exploration costs associated with specific mineral properties. These costs are capitalized on the basis of the potential realization from the underlying asset. Amortization of these amounts will be recognized using the unit-of-production method over shorter of estimates of reserves or service life following the commencement of production or written off, if the properties are sold or abandoned.

The Company reviews capitalized amounts for impairment conditions quarterly or whenever events or changes in circumstances indicate its carrying amount may not be recoverable. The carrying value of assets is assessed for indications that the carrying amounts recorded may not be recoverable from estimated current and future cash flows. Estimating future cash flows requires assumptions about future business conditions and other developments. Significant, unanticipated changes to these assumptions could require a provision for impairment in the future.

Upon indication that impairment may exist, carrying values of assets would be adjusted. Impairment conditions may result from any of the following items, but not limited to: cessation of exploration activities; exploration results are not promising such that exploration will not be planned for the foreseeable future; permit or lease ownership rights expire; sufficient funding is not expected to be available to complete the exploration program; an exploration property is deemed to have no material economic value to the Company's business plan or future development of the property becomes uneconomical.

Capital and intangible assets

Buildings equipment, furniture and leasehold improvements, software and patents are recorded at cost, less accumulated depreciation and amortization. Capital and intangible assets are depreciated using the straight-line method at rates of 5% to 30% per annum. Leasehold improvements are amortized on a straight line basis over the terms of the respective leases.

Stock-based compensation

The Company has stock-based expenses for stock option awards to employee, directors, officers and consultants, as explained in the Company’s financial statements. Canadian GAAP requires that all stock-based awards to employees and non-employees be accounted for using the fair value method. Under this method, the fair value computation requires estimates of the expected life of the option, stock volatility and the risk-free interest rate expected over the life of the option. A change in these assumptions could materially change the amount of stock-based expenses recorded.

Income taxes

The Company accounts for income taxes in accordance with the asset and liability method. Under this method, future income tax assets and liabilities are recognized for 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 substantively enacted income 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 income tax assets and liabilities of a change in income tax rates is recognized in the period that includes the date of substantive enactment. A future income tax asset is recognized only when it is more likely than not that the income tax asset will be realized.

Warrants

The Black-Scholes option pricing model was used to determine the fair value of the warrants issued as part of the private placements and the IPO. The Company has made certain assumptions relating to the share price at date of issue / extension, expected volatility, expected dividends and risk free interest rate in determining their fair values. Any changes in these assumptions could materially affect the value of the recorded warrants.

Financial Instruments

All financial instruments have been classified into one of the following five categories: (i) held-for-trading assets or liabilities, (ii) held-to-maturity investments, (iii) loans and receivables, (iv) available-for-sale financial assets, or (v) other financial liabilities. Held-for-trading financial instruments are measured at fair value and all gains and losses are included in net income in the period in which they arise. Loans and receivables, held-to maturity investments and other financial liabilities are measured at amortized cost using the effective interest method.

The Company has made the following classifications:

Financial Instrument Classification	
Cash	Held-for-trading
Restricted cash	Held-for-trading
Investments	Held-for-trading
Accounts receivable	Loan and receivables
Accounts payable and accrued liabilities	Other financial liabilities

The carrying amounts of cash, restricted cash, investments, accounts receivable and accounts payable and accrued liabilities approximate their fair value due to their short term to maturity. The Company's risk exposures and the impact on the Company's financial instruments are set out below.

FINANCIAL RISK FACTORS

Credit risk

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its commercial obligations. The Company has no significant concentration of credit risk arising from operations. The Company's cash and cash equivalents are held with large Canadian financial institutions and management believes the risk of loss to be remote. Investments consisted of treasury bills which are readily convertible into a known amount of cash. As at December 31, 2010 and 2009, the Company had GST receivables from the Canadian Government and other immaterial receivables such that management believes that the credit risk with respect to receivables is low.

Liquidity risk

The Company manages liquidity risk by maintaining sufficient cash and cash equivalents and investment balances to meet liabilities when due. As at December 31, 2010, the Company had cash totalling \$59,000,457 to settle current liabilities of \$2,295,027. As at December 31, 2010 and 2009 the Company's accounts receivable were all considered current and are subject to normal trade terms.

Market risk

Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all instruments traded in the market. The Company will be exposed to price risk with respect to North American and international potash prices. A significant decrease in the price of potash could cause the continued exploration and future development of the Company's properties to be uneconomical.

Currency risk

The Company's functional currency is the Canadian dollar with the majority of transactions denominated in Canadian dollars. The Company has engaged third party experts to perform various reports on the future potential of its mineral properties where such contracts are denominated in United States dollars and Euros. Management believes the foreign exchange risk derived from currency conversions is not significant and therefore does not hedge its foreign exchange risk.

As at December 31, 2010, the Company's cash included a cash balance of \$46,083 denominated in United States dollars. As such, the Company believes that a change in the Canadian dollar and United States dollar foreign exchange rate would not be material to the financial position of the Company.

Interest rate risk

The Company's accounts payable and accrued liabilities are non-interest bearing and have contractual maturities of less than 45 days. As at December 31, 2010, the Company's only interest bearing asset is cash in money market funds with low exposure. Cash earns interest at prevailing short-term interest rates. During the year ended December 31, 2010 the Company earned interest income of \$26,630 from its cash and investments. For the year ended December 31, 2009, the Company earned interest income of \$44,109 from its investments in cash and Government of Canada treasury bills and bonds. As such, the Company

believes that a plus or minus 1% change in interest rates would not be material to the financial position of the Company.

RECENT ACCOUNTING PRONOUNCEMENTS

International Financial Reporting Standards

The Canadian Accounting Standards Board has confirmed January 1, 2011 as the changeover date for Canadian publicly accountable enterprises to start using International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”). The new standards are applicable to enterprises for interim and annual financial statements effective for fiscal years beginning on or after January 1, 2011, including comparatives for 2010. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences in recognition, measurement and disclosures.

The transition from Canadian GAAP to IFRS is a significant undertaking that may materially affect the reported financial position. The Company continues to monitor standards development as issued by IASB and the Accounting Standards Board, as well as regulatory developments as issued by the Canadian Securities Administrators (“CSA”), which may affect the timing, nature or disclosure of the adoption of IFRS.

IFRS Conversion Plan

The Company has finalized a plan to convert its financial statements to IFRS. The plan included development of a cross-functional IFRS team sponsored and managed by the Chief Financial Officer and including representatives from various areas within the Company including financial personnel, information technology, and other senior management as deemed necessary. External contracting resources have been utilized to provide technical accounting advice and guidance on project management of the conversion to IFRS. Updates regarding the progress of the conversion plan have been provided to the Company’s Audit Committee on a quarterly basis.

The Company’s implementation plan consists of three main phases:

Phase 1: Preliminary Scoping and Diagnostic

This phase included performing a high-level impact assessment that was aimed at identifying key areas that are impacted upon adoption of IFRS. Deliverables from this phase have been prioritized in areas that have been evaluated in the second phase of the project plan. Information obtained in the first phase has been used to develop a detailed plan of implementation.

The preliminary assessment of the impacts of adopting IFRS based on the current standards has been completed and the following areas will have the most significant potential impact to the financial statements. Based on the analysis, the major differences between Canadian GAAP and IFRS that will impact the Company include, but are not limited to:

- (a) IFRS 1 – First-Time Adoption of International Financial Accounting Standards - provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions, in certain areas, to the general requirement of full retrospective application of IFRS. Most adjustments required on transition to IFRS will be made retrospectively in the first comparative balance sheet.
- (b) IFRS 6 – Exploration and evaluation of mineral resources (“E&E”) – IFRS 6 is the only specific standard that applies to extractive industries. This standard refers to a very clear and definitive segregation of capital expenditures into three main categories – pre-exploration, exploration and

evaluation (“E&E”), and post-exploration or development and production expenditures. Under IFRS, all pre-license costs are expensed, while under Canadian GAAP, these costs may be capitalized. Karnalyte did not incur any costs associated to pre-licensing. E&E costs under IFRS may either be expensed or capitalized. The Company has determined that it will capitalize E&E expenditures. Under IFRS, the E&E expenditures must be assessed for impairment when the facts suggest that the carrying amount of an asset exceeds its recoverable amount. Furthermore, when an E&E asset is transferred to development assets an impairment test must be conducted.

- (c) IFRS 16 – Property, Plant and Equipment – IAS 16 requires componentization of assets where each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. Componentization of assets may impact depreciation recognized and the carrying value of an asset. IAS 16 provides an accounting policy choice, subsequent to the initial recognition of the asset, using either a cost model or revaluation model. After initial recognition of assets, the use of the revaluation model will result in increases or decreases in the asset being revalued and corresponding increases and decreases in the revaluation surplus account (component of equity).
- (d) IFRS 36 – Impairment of Assets – IAS 36 uses a one step approach for both testing and measurement of impairment, with assets’ carrying values compared directly with the higher of fair value less costs to sell or value in use (which uses discounted cash flows). The Company will be required to assess impairment indicators at the end of each reporting period. Where an impairment indicator is present, management must determine the recoverable amount of the individual asset or cash generating unit. A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Intangible assets and capital assets must be tested for impairment annually.
- (e) IAS 37 – Provisions, Contingent Liabilities and Contingent Assets – IAS 37 requires a provision to be recognized when there is a present obligation as a result of a past transaction or event; it is probable that an outflow of resources will be required to settle the obligation; and a reliable estimate can be made of the obligations. The threshold for recognition of a provision under Canadian GAAP is higher than under IFRS (70% vs. 50%). Therefore, it is possible that some contingent liabilities not recognized under Canadian GAAP may meet the recognition criteria under IFRS. Furthermore, IFRS requires the use of best estimates, mid-points, or probabilistic weighted averages as the measurement method. Under Canadian GAAP, the discount rate used in determining the value of asset retirement obligations is the credit adjusted risk-free rate applicable to the Company. Under IFRS, the discount rate used reflect the risks specific to the obligation or liability. Finally, unwinding of the discount under IFRS is interest expense (finance costs), as opposed to accretion expense (operating expense). The Company expects the asset retirement obligations recorded at December 31, 2010 to increase by less than \$0.1 million as a result of changing the discount rate.
- (f) IAS 12 – Income Taxes – IAS 12 prescribes that an entity account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Therefore, where transactions and other events are recognized in earnings, the

recognition of deferred tax assets or liabilities which arise from those transactions should also be recorded in earnings. For transactions that are recognized outside of the statement of earnings, either in other comprehensive income or directly in equity, any related tax effects should also be recognized outside the statement of earnings. The Company expects to reclassify approximately \$0.6 million of its share capital to deferred income taxes as a result of the flow-through share issuance in 2009, on its opening balance sheet.

- (g) IFRS 2 – Share-based payments - Under IFRS 2, Share-Based Payment awards will continue to be measured at fair value, with compensation expense under our plans recognized over the service period. For the Company’s plan which is equity-settled, the Company will continue to recognize a corresponding increase in equity. Unlike Canadian GAAP, the service period under IFRS may commence prior to the date of grant and end on the vesting date. This represents a difference in timing and ultimately does not impact the overall expense. The Company is still analyzing the quantification of differences related to this standard.
- (h) Disclosures – IFRS requires significant disclosures for accounting policies, use of IFRS 1 mandatory exemptions, and use of IFRS 1 elective exemptions. The Company expects the IFRS disclosures will be substantial, as the basis of substance over form reflected in IFRS will require much more detailed disclosures than Canadian GAAP requires.

Phase 2: Detailed Evaluation and Design

In this phase further evaluation of the financial statement areas impacted by IFRS has been conducted and involved a very detailed, systematic gap analysis of accounting and disclosure differences between Canadian GAAP and IFRS. This analysis has facilitated final decisions about accounting policies and the direction of the overall conversion strategy. Output from this stage highlighted required changes to current business processes and also highlighted any information technology system upgrades or changes required to facilitate the conversion and meet reporting requirements under IFRS. In this phase, the Company:

- Completed an analysis of all financial statement areas impacted by IFRS and performed a systematic gap analysis of each area;
- Evaluated the accounting policy options and developed IFRS compliant accounting policies;
- Is in the process of quantifying differences in key accounts and prepared an opening IFRS compliant balance sheet as at January 1, 2010;
- Is in the process of quantifying differences in key accounts for the 2010 comparative year;
- Developed comprehensive training programs for staff, senior management and directors; and
- Is analyzing information technology impacts on a continual basis.

Phase 3: Implementation

This is the last phase and includes execution of changes to business processes impacted by the Company’s transition to IFRS and formal approval of recommended accounting policy changes. In addition, delivery of training to Karnalyte’s staff, senior management and directors is occurring in this phase. This phase will culminate with the collection of financial information necessary to compile IFRS compliant financial statements and Audit Committee approval of IFRS financial statements commencing in 2011. This phase has begun and will continue until the end of the first quarter of 2011.

Training and Communication

The Company has utilized a professional accountant to assist in providing technical accounting advice and project management guidance. Key members of the Company have either completed or will obtain the required training in IFRS and will then continue to complete, IFRS specific training courses to maintain up to date knowledge of best practices and changes in standards. The Company will establish a plan to train internal personnel who will be impacted by the conversion to IFRS in their daily activities throughout implementation. Training has begun in early 2011 and is expected to continue throughout the year.

Financial Statement Preparation and Internal Controls

Karnalyte has assessed the impact of the adoption of IFRS on its results of operations, financial position and financial statement disclosures. In addition, the Company has assessed the impact of the conversion on internal controls over financial reporting and disclosure controls and procedures. The Company will commit the resources required to ensure adequate training and resources throughout the transition period.

Management has determined that there are three main areas of impact on the opening balance sheet numbers for the comparative periods ending December 31, 2010. These areas are in relation to calculations for asset retirement obligations, stock-based compensation and deferred taxes that resulted from the sale of flow-through shares. The opening IFRS comparative balance sheet will reflect these changes are detailed in Phase 2 above.

Business Activities

The effects of IFRS conversion on the Company's activities have been reviewed in detail and it is not expected that the conversion to IFRS will significantly impact these activities or requirements. The expected timing of key activities identified above may change due to changes in regulation, economic conditions or other factors and the issuance of new accounting standards or amendments to existing accounting standards including, and in addition to, those noted above.

Overall, management is confident the conversion to IFRS will be finalized in time for preparation of the March 31, 2011 interim financial statements. Since Karnalyte is a development stage Company, historical records and established policies and procedures are relatively easy to manage as the Project progresses compared to companies with well established procedures requiring significant change.

DISCLOSURE CONTROLS & PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING

Disclosure Controls and Procedures

The Company has established disclosure controls and procedures for the timely and accurate preparation of financial and other reports. Such disclosure controls and procedures are designed to provide reasonable assurance that material information required to be disclosed is recorded, processed, summarized and reported within the periods specified by applicable securities regulations. In addition, the disclosure controls ensure that information required to be disclosed is accumulated and communicated to the appropriate members of management and properly reflected in the Company's continuous disclosure filings. As with most small or developing Company's and consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these disclosure controls and procedures should not exceed their expected benefits. As a result, the Company's disclosure controls and procedures can only provide reasonable assurance, and not absolute assurance, that the objectives of such controls and procedures are met. The Chief Executive Officer and Chief Financial Officer are responsible

to oversee this evaluation process. They have concluded that the design and operation of these disclosure controls and procedures were effective, with the exception of the weaknesses on the internal controls over financial reporting noted in the following section, to provide reasonable assurance that material information related to the Company is made known to them by others within the Company.

Internal Controls over Financial Reporting (ICFR)

The Chief Executive Officer and Chief Financial Officer of the Company are responsible for designing and ensuring the operating effectiveness of internal controls over financial reporting. They are also responsible for causing them to be designed and operated effectively under their supervision. They are intended to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. The Company's management has assessed the design and operating effectiveness of internal controls over financial reporting. There were no changes in the Company's ICFR in the period ended December 31, 2010 that have materially affected, or are reasonably likely to affect, the Company's ICFR. While the Company's Chief Executive Officer and Chief Financial Officer believe the Company's internal controls and procedures provide a reasonable level of assurance that they are reliable, an internal control system cannot prevent all errors and fraud. It is management's belief that any control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

During the design and operating effectiveness assessment certain material weaknesses in internal controls over financial reporting were identified, as follows:

- Management is aware that there is a lack of segregation of duties due to the small number of employees dealing with general and administrative and financial matters. However, management believes that at this time the potential benefits of adding employees to clearly segregate duties do not justify the costs associated with such increase;
- Many of the Company's information systems are subject to general control deficiencies as are common with many small or developing organizations. These include a lack of effective controls over spreadsheets, access and documentation. The Company expects that some deficiencies will continue into the future; and
- The Company does not have full-time in-house personnel to address all complex financial and non-routine tax issues that may arise. It is not deemed as economically feasible at this time to have such personnel. When faced with unusual or non-routine issues, the Company relies on external experts for review and advice. Such circumstances may involve complicated financial issues and for tax planning, tax provision and compilation of corporate tax returns.

These weaknesses in internal controls over financial reporting result in a more than remote likelihood that a material misstatement would not be prevented or detected. Management and the board of directors work to mitigate the risk of material misstatement but they do not have reasonable assurance that this risk can be reduced to a remote likelihood of a material misstatement.

OFF BALANCE SHEET ARRANGEMENTS

The Company has no off balance sheet arrangements at the time of this MD&A.

OUTSTANDING SHARES

As of the date of this MD&A, the Company has 20,597,242 common shares, 552,122 warrants and 1,773,200 stock options issued and outstanding.

OUTLOOK

General Market Trends

Short-Term Outlook

The economic climate during the year ended December 31, 2010 saw significant market fluctuation as the global recession from the latter half of 2008 and early 2009 faded out and the economy continued to improve. Although the overall economy continued to improve the improvement was gradual and subject to significant variability as investor sentiment fluctuates with the general market. Access to capital markets was seen as choppy at best and continues to be challenging. Even in this uncertain capital market environment, the Company was able to close its IPO on December 14, 2010. Although the economy seems to be improving, and the Company has experienced success in the capital markets of late, it is uncertain how the markets will progress and what the new market standards will be.

Long-Term Outlook

The long-term economic outlook is more stable. World-wide demand for potash has seen an increase over the recent past and the Company expects this trend to continue. Global macroeconomic pressures brought on by continued population increases in North America and more so in the developing world is resulting in a substantial increase in demand for high-quality agricultural products. Global fertilizer demand is expected to continue to increase due to the expectations from this growing population base with the need to supplement soils to produce ever expanding demand. Potash prices are expected to see continual steady growth in the long-term as companies attempt to meet the demands. This long-term trend is positive for new companies attempting to establish themselves as a producer in the potash market.

Company Outlook

Karnalyte is in the early development stage and therefore access to capital markets is critical to continue to progress. The Company is confident it will continue to have adequate access to capital to meet its short and medium term business plan of continuing to develop its Project towards commercialization. Independent third parties have confirmed they believe the current business plan is achievable and provided the capital markets and the global economy can continue to improve the outlook for the Company is positive.

Over the short term, the Company will continue to focus on the following key initiatives;

- Continue to pursue independent third party reports including the feasibility study;
- Analyze the potential to enhance its resource base through additional drilling of high-potential targets;
- Continue to delineate its mineral holdings through additional 3D seismic analysis;
- Continue to gain understanding of the current target area through operation of its pilot test facility to confirm whether the process achieves the desired results and provide independent assays of the product samples recovered; and
- Continue working with the machinery and equipment suppliers to optimize product results.

FORWARD-LOOKING INFORMATION

Certain statements in this MD&A may constitute "forward-looking" statements which involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Forward-looking statements may include, but are not limited to, statements regarding:

- future extraction and exploitation of mineral deposits;
- capital expenditure requirements;
- expectations regarding prices and costs;
- development of mineral resources and mineral extraction processes;
- the Company spending the funds available to it as stated in this MD&A;
- expectations regarding the Company's ability to subsequently raise capital;
- expenditures to be made by the Company to meet certain work commitments;
- work plans to be conducted by the Company;
- reclamation and rehabilitation obligations and liabilities;

In certain cases, forward-looking statements can be identified by the use of such words as "may", "would", "could", "will", "intend", "expect", "believe", "plan", "anticipate", "estimate" and other similar terminology. These statements reflect the Company's current expectations regarding future events and operating performance and speak only as of the date of this MD&A.

Forward-looking statements in this MD&A include statements regarding:

- the Company's ability to commence and ramp up production from 500,000 to 2 million tonnes per year;
- the Company's plans to carry out mineral deposit analysis, complete a feasibility study and advance the EIS;
- further seismic exploration and drilling;
- time to completion of plant construction of 18 to 24 months following receipt of satisfactory results of a feasibility study;
- brine field preparation taking between 24 and 30 months;
- production run rates achieving 500,000 tonnes per year within 10 months following the completion of the processing plant;
- total capital expenditure for a 500,000 tonne mine of \$408.9 million;
- anticipated results of development and extraction activities and estimated future development;
- the Company's ability to obtain additional financing on satisfactory terms;

Such forward-looking statements are based on a number of material factors and assumptions, including, that:

- the Company executes its project development plans in a manner consistent with its budgets and planning;
- feasibility and other studies support the Company's current development plans;
- the Company obtains additional financing in the future;

Forward-looking statements involve significant risks and uncertainties, should not be read as guarantees of future performance or results, and will not necessarily be accurate indications of whether or not such results will be achieved. A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements, including, but not limited to, the factors discussed immediately under "Financial Risk Factors" elsewhere in this MD&A and under "Risk Factors" in the Company's Annual Information Form. Although the forward-looking statements contained in this MD&A are based upon what management of the Company believes are reasonable assumptions, the Company cannot assure investors that actual results will be consistent with these forward-looking statements. These forward-looking statements are made as of the date of this MD&A and are expressly qualified in their entirety by this cautionary statement. Subject to applicable securities laws, the Company assumes no obligation to update or revise them to reflect new events or circumstances.