

RARE ELEMENT RESOURCES LTD.
CONSOLIDATED FINANCIAL STATEMENTS
For the six months ended December 31, 2008
(UNAUDITED)

**NOTICE OF NO AUDITOR REVIEW OF
INTERIM FINANCIAL STATEMENTS**

Under National Instrument 51-102, Part 4, subsection 4.3 (3) (a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited interim financial statements of the Company have been prepared by, and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

RARE ELEMENT RESOURCES LTD.
CONSOLIDATED BALANCE SHEETS

(Expressed in US Dollars)

	December 31, 2008	June 30, 2008
	(Unaudited)	(Audited)
ASSETS		
CURRENT		
Cash and cash equivalents	\$ 1,362,892	\$ 2,271,917
Accounts receivable	6,622	46,726
Prepaid expenses	10,798	26,883
	1,380,312	2,345,526
Equipment (Note 4)	2,703	4,267
Investment (Note 5)	15,083	15,083
Mineral properties and deferred exploration costs (Note 3)	1,418,171	1,019,349
Reclamation bond (Note 6)	10,000	10,000
	\$ 2,826,269	\$ 3,394,225
	\$ 2,826,269	\$ 3,394,225
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	\$ 46,077	\$ 48,594
Due to related parties (Note 8)	16,899	15,257
	62,976	63,851
	62,976	63,851
SHAREHOLDERS' EQUITY		
SHARE CAPITAL (Note 7)	6,574,447	6,574,447
WARRANTS (Note 7e)	337,114	337,114
CONTRIBUTED SURPLUS (Note 7d)	681,585	542,188
DEFICIT	(4,829,853)	(4,123,375)
	2,763,293	3,330,374
	\$ 2,826,269	\$ 3,394,225
NATURE OF OPERATIONS (Note 1)		
COMMITMENTS AND CONTINGENCIES (Note 9)		

APPROVED BY THE BOARD OF DIRECTORS:

"Donald E. Ranta"

Donald E. Ranta

"Mark T. Brown"

Mark T. Brown

See accompanying notes to consolidated financial statements

RARE ELEMENT RESOURCES LTD.
CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
(Expressed in US Dollars)
(Unaudited)

	For the three months ended December 31		For the six months ended December 31	
	2008	2007	2008	2007
EXPENSES				
Audit and legal	\$ 1,055	\$ 4,174	\$ 1,631	\$ 6,491
Accounting and administrative fees (Note 8)	29,008	22,214	50,416	48,784
Amortization	759	-	1,564	83
Bank charges	608	677	1,234	823
Foreign exchange loss (gain)	256,055	39,669	309,455	(152,581)
Investor relations and shareholder communication	45,430	58,805	97,210	78,723
Management fees (Note 8)	26,579	53,320	52,260	73,391
Office and miscellaneous	10,292	11,619	18,015	18,827
Rent (Note 8)	1,898	2,298	3,582	4,448
Stock-based compensation	57,580	65,369	139,397	155,698
Transfer and listing fees	10,018	17,180	10,976	19,303
Travel	16,721	14,712	36,676	16,856
	<u>(456,003)</u>	<u>(290,037)</u>	<u>(722,416)</u>	<u>(270,846)</u>
OTHER ITEM				
Interest income	7,041	7,413	15,938	7,413
NET LOSS FOR THE PERIOD	(448,962)	(282,624)	(706,478)	(263,433)
DEFICIT, BEGINNING OF PERIOD	(4,380,891)	(3,250,318)	(4,123,375)	(3,269,509)
DEFICIT, END OF PERIOD	<u>\$ (4,829,853)</u>	<u>\$ (3,532,942)</u>	<u>\$ (4,829,853)</u>	<u>\$ (3,532,942)</u>
LOSS PER SHARE – BASIC AND DILUTED	<u>\$ (0.02)</u>	<u>\$ (0.01)</u>	<u>\$ (0.03)</u>	<u>\$ (0.01)</u>
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	<u>23,866,736</u>	<u>22,746,328</u>	<u>23,866,736</u>	<u>22,356,156</u>

See accompanying notes to consolidated financial statements

RARE ELEMENT RESOURCES LTD.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Expressed in US Dollars)

(Unaudited)

	For the three months ended		For the six months ended	
	2008	December 31 2007	2008	December 31 2007
CASH PROVIDED BY (USED IN) OPERATIONS				
Net loss for the period	\$ (448,962)	\$ (282,624)	\$ (706,478)	\$ (263,433)
Items not involving cash:				
Amortization	759	-	1,564	83
Stock-based compensation	57,580	65,369	139,397	155,698
	(390,623)	(217,255)	(565,517)	(107,652)
Changes in non-cash working-capital items:				
Accounts receivable	33,758	11,846	40,104	24,481
Prepaid expenses	47,455	27,966	16,085	19,113
Accounts payable and accrued liabilities	(54,393)	(30,653)	(2,517)	(3,264)
Due to related parties	(85)	14,886	1,642	7,596
	(363,888)	(193,210)	(510,203)	(59,726)
INVESTING ACTIVITIES				
Deferred exploration costs	(153,132)	(162,936)	(398,822)	(165,268)
Purchase of equipment	-	(5,678)	-	(5,678)
	(153,132)	(168,614)	(398,822)	(170,946)
FINANCING ACTIVITIES				
Cash received for common shares	-	1,186,430	-	1,332,303
Share issue costs	-	(15,516)	-	(15,516)
	-	1,170,914	-	1,316,787
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(517,020)	809,090	(909,025)	1,086,115
CASH AND CASH EQUIVALENTS, BEGINNING OF THE PERIOD	1,879,912	1,362,362	2,271,917	1,085,337
CASH AND CASH EQUIVALENTS, END OF THE PERIOD	\$ 1,362,892	\$ 2,171,452	\$ 1,362,892	\$ 2,171,452
Cash and cash equivalents consist of:				
Cash	\$ 135,442	\$ 642,352	\$ 135,442	\$ 642,352
GIC Investments	1,227,450	1,529,100	1,227,450	1,529,100
	\$ 1,362,892	\$ 2,171,452	\$ 1,362,892	\$ 2,171,452

See accompanying notes to consolidated financial statements

RARE ELEMENT RESOURCES LTD.
CONSOLIDATED STATEMENTS OF SHAREHOLDER'S EQUITY
(Expressed in US Dollars)

Issued and outstanding:	Number of Shares	Share Capital	Warrants	Contributed Surplus	Deficit	Total Shareholders' Equity
Balance as at June 30, 2007	21,704,389	\$ 4,973,386	\$ -	\$ 240,729	\$ (3,269,509)	\$1,944,606
Issued for cash:						
Private placement (Note 7a)	1,075,000	813,243	337,114	-	-	1,150,357
Exercise of warrants (Note 7b)	700,847	520,810	-	-	-	520,810
Exercise of options (Note 7c)	386,500	160,092	-	-	-	160,092
Fair value of the options exercised (Note 7c)	-	122,432	-	(122,432)	-	-
Share issue costs	-	(15,516)	-	-	-	(15,516)
Stock-based compensation	-	-	-	423,891	-	423,891
Net loss for the year	-	-	-	-	(853,866)	(853,866)
Balance as at June 30, 2008	23,866,736	6,574,447	337,114	542,188	(4,123,375)	3,330,374
Stock-based compensation	-	-	-	139,397	-	139,397
Net loss for the period	-	-	-	-	(706,478)	(706,478)
Balance as at December 31, 2008	23,866,736	\$ 6,574,447	\$ 337,114	\$ 681,585	\$ (4,829,853)	\$ 2,763,293

RARE ELEMENT RESOURCES LTD.
CUMULATIVE SCHEDULE OF MINERAL PROPERTY COSTS
(Expressed in US Dollars)

	Balance June 30, 2007	Expenditures for the year	Balance June 30, 2008	Expenditures for the period	Balance December 31, 2008
	(Audited)		(Audited)		(Unaudited)
Bear Lodge Property					
Property acquisition costs	\$ 17,721	\$ -	\$ 17,721	\$ -	\$17,721
Exploration expenditures					
Assays	7,751	5,623	13,374	5,447	18,821
Assessments and taxes	20,104	-	20,104	-	20,104
Drilling	323,922	136,038	459,960	274,712	734,672
Geological consulting	168,768	58,714	227,482	102,123	329,605
Geophysical	300	-	300	-	300
Metallurgical testing	38,530	55,000	93,530	15,000	108,530
Overhead expenses	9,679	1,160	10,839	1,140	11,979
Staking	17,949	-	17,949	-	17,949
Survey	34,338	-	34,338	-	34,338
Travel expenses	23,935	83	24,018	400	24,418
Wages	99,734	-	99,734	-	99,734
Total exploration expenditures on Bear Lodge property	762,731	256,618	1,019,349	398,822	1,418,171
Kipawa Property					
Exploration expenditures					
Geological consulting	4,949	-	4,949	-	-
Staking	1,308	-	1,308	-	-
Write-down of property	(4,841)	(1,416)	(6,257)	-	-
Total exploration expenditures on Kipawa property	1,416	(1,416)	-	-	-
TOTAL EXPENDITURES	\$ 764,147	\$ 255,202	\$ 1,019,349	\$ 398,822	\$ 1,418,171

See accompanying notes to consolidated financial statements

RARE ELEMENT RESOURCES LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008
(Expressed in US Dollars)
(Unaudited)

1. NATURE OF OPERATIONS

Rare Element Resources Ltd. (“Rare Element” or “the Company”) was incorporated under the laws of the Province of British Columbia on June 3, 1999.

The Company is in the process of exploring its mineral property interests and has not yet determined whether its mineral property interests contain mineral reserves that are economically recoverable. The Company’s continuing operations and the underlying value and recoverability of the amounts shown for mineral property interests are entirely dependent upon the existence of economically recoverable mineral reserves, the ability of the Company to obtain the necessary financing to complete the exploration and development of the mineral property interests, obtaining the necessary permits to mine, and on future profitable production or proceeds from the disposition of the mineral property interests. To date, the Company has no revenue and has a deficit of \$4,829,853.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Interim financial statements

These interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and follow the same accounting policies and methods of application as the annual financial statements. These interim consolidated financial statements do not include in all respects the annual disclosure requirements of generally accepted accounting principles and should be read in conjunction with the most recent annual statements.

Basis of presentation and principles of consolidation

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and are inclusive of the accounts of the Company and Paso Rico Resources Ltd. (“Paso Rico”), together with those of Paso Rico’s wholly-owned subsidiaries, Minera Santa Regina, S.A. de C.V., Compania Minera Real de las Lomas, S.A. de C.V. and Paso Rico (USA), Inc. The Company is in the process of winding down the two Mexican companies.

Use of estimates

The preparation of these consolidated financial statements requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from these estimates.

Foreign currency translation

The Company’s reporting currency is the US Dollar. The Company’s Canadian operations are considered to be integrated with foreign currency transactions translated into US Dollars as follows:

- monetary assets and liabilities at the rates of exchange prevailing at the balance sheet dates;
 - other assets and liabilities at the applicable historical exchange rates;
 - revenues and expenses at the average rates of exchange for the period, and;
 - gains and losses arising from the conversion of foreign-currency balances and transactions are reported in income as they occur.
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RARE ELEMENT RESOURCES LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008
(Expressed in US Dollars)
(Unaudited)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Mineral properties and deferred exploration costs

The cost of mineral properties and related exploration expenditures are deferred until the properties are placed into production, sold or abandoned. These deferred costs will be amortized over the estimated useful life of the properties following the commencement of production, or written-off if the properties are allowed to lapse or are abandoned.

Cost includes the cash consideration and the fair market value of shares issued for the acquisition of mineral properties. Properties acquired under option agreements are recorded in the accounts at such time as payments are made. Proceeds from options granted are applied to the cost of the related property and any excess is included in income for the period.

The recorded amounts of mineral claim acquisition costs and their related deferred exploration costs represent actual expenditures incurred and are not intended to reflect present or future values.

The Company reviews capitalized costs on its mineral properties periodically and will recognize an impairment in value based upon current exploration results and upon management's assessment of the future probability of profitable revenues from the property or from the sale of the property. Management's assessment of a property's estimated current fair market value may also be based upon a review of other property transactions that have occurred in the same geographic area as that of the property under review.

Cash and cash equivalents

Provided that the instruments are readily convertible at the balance sheet date into cash without penalty at their carrying value, the Company considers its highly liquid term investments, typically with Canadian Chartered banks, to be cash equivalents. The Company maintains its cash and cash equivalents in bank deposit accounts which exceed federally insured limits. At December 31, 2008, the Company had its cash and cash equivalents with one financial institution. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk on cash and cash equivalents and holds no asset backed commercial paper.

Amortization

The Company provides for amortization on its computer equipment at 55%, and software at 100%, declining balance (one-half of the rate is taken in the year of acquisition and disposition).

Income taxes

The Company accounts for and measures future tax assets and liabilities in accordance with the liability method, where future income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amount of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively-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 date of enactment or substantive enactment of the change. When the future realization of income tax assets does not meet the test of being more likely than not to occur, a valuation allowance in the amount of the future benefit is taken and no asset is recognized. Such an allowance applies fully to all potential income tax assets of the Company.

RARE ELEMENT RESOURCES LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008
(Expressed in US Dollars)
(Unaudited)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Loss per share

The loss per share is computed using the weighted average number of shares outstanding during the period. Diluted loss per share is not presented as the effect on the basic loss per share would be anti-dilutive.

Stock-based compensation

The Company recognizes compensation expense for all stock options granted using the fair value based method of accounting. Under the fair value method, stock-based payments are measured at the fair value of the consideration received or the fair value of the equity instruments issued or liabilities incurred, whichever is more reliably measurable, and are charged to operations over the vesting period. The offset is initially credited to contributed surplus and subsequently transferred to share capital if and when the related options are exercised. Cash received on the exercise of stock options is also credited to share capital.

Asset retirement obligations

The Company recognizes the fair value of a liability for an asset retirement obligation in the year in which it is incurred when a reasonable estimate of fair value can be made.

The associated asset retirement costs are capitalized as part of the carrying amount of long lived assets. The liability is accreted over the estimated time period until settlement of the obligation and asset is depreciated over the estimated remaining useful life of the asset. Changes in the liability for an asset retirement obligation due to the passage of time will be measured by applying an interest method of allocation. The amount will be recognized as an increase in the liability and an accretion expense in the statement of operations. Changes resulting from revisions to the timing or the amount of the original estimate of undiscounted cash flows are recognized as an increase or a decrease in the carrying amount of the liability and the related capitalized asset retirement cost.

Changes in accounting policies

On January 23, 2008, the Company adopted the following provisions of the Canadian Institute of Chartered Accountants ("CICA") Handbook Sections. There was no material impact on the Company's financial condition or operating results as a result of the adoption of these new standards:

- (a) Section 3862 – Financial Instruments – Disclosures, which replaces Section 3861 and provides expanded disclosure requirements that provide additional detail by financial asset and liability categories (see Note 11).
 - (b) Section 3863 – Financial Instruments – Presentation, to enhance financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows (see Note 11).
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RARE ELEMENT RESOURCES LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008
(Expressed in US Dollars)
(Unaudited)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Changes in accounting policies, Continued

(c) Section 1535 – Capital Disclosures, which establishes standards for disclosing information about an entity’s capital and how it is managed (see Note 12). Under this standard, the Company will be required to disclose the following:

- qualitative information about its objectives, policies and processes for managing capital;
- summary quantitative data about what it manages as capital;
- whether during the period it complied with any externally imposed capital requirement to which it is subject; and
- when the Company has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

(d) Section 1400 – General Standards of Financial Statement Presentation, to include requirements for management to assess and disclose an entity’s ability to continue as a going concern (see Note 1).

Convergence with International Financial Reporting Standards

In February 2008, the Canadian Accounting Standards Board confirmed that publicly accountable enterprises will be required to adopt IFRS for fiscal years beginning on or after January 1, 2011, with earlier adoption permitted. Accordingly, the conversion to IFRS will be applicable to the Company’s reporting no later than in the first quarter of 2011, with restatement of comparative information presented. The conversion to IFRS will impact the Company’s accounting policies, information technology and data systems, internal control over financial reporting, and disclosure controls and procedures. The transition may also impact business activities, such as foreign currency activities, certain contractual arrangements, capital requirements and compensation arrangements. The Company is currently evaluating the future impact of IFRS on its financial statements and will continue to invest in training and additional resources to ensure a timely conversion.

Comparative figures

Certain of the prior year’s figures have been reclassified to conform with the current year’s financial statement presentation.

3. MINERAL PROPERTIES AND DEFERRED EXPLORATION COSTS

The amounts shown represent costs incurred to date, and do not necessarily represent present or future values as they are entirely dependent upon the economic recovery of future ore reserves. A summary of carrying values by property is as follows:

Bear Lodge Property

The Company, through its wholly-owned subsidiary, Paso Rico (USA), Inc., holds a 100% interest in a group of unpatented mineral claims known as the Bear Lodge Property. The property is situated in the Bear Lodge Mountains of Crook County, northeast Wyoming. These claims were, in part, acquired from Freeport-McMoRan Copper & Gold (“Freeport”) by way of a “Mineral Lease and Option for Deed”. Certain claims and a portion of a defined area of influence surrounding the claims are subject to a production royalty of 2% of Net Smelter Returns (“NSR”) royalty payable to Freeport. Paso Rico (USA), Inc. also owns a portion of the claim group outright and these claims are not subject to the NSR.

RARE ELEMENT RESOURCES LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008
(Expressed in US Dollars)
(Unaudited)

3. MINERAL PROPERTIES AND DEFERRED EXPLORATION COSTS, Continued

Bear Lodge Property, Continued

The property comprises 90 federal unpatented mineral claims and a 640-acre Wyoming state lease for a total of approximately 2,100 acres.

On June 1, 2006, Paso Rico (USA), Inc. and Newmont North America Exploration Limited (“Newmont”), a subsidiary of Newmont Mining Corporation, signed an agreement to establish a gold-exploration venture on the Company’s Bear Lodge, Wyoming property (“Venture”). Under the agreement, Newmont has the right to earn a 65% participating interest in the Bear Lodge property, excluding any rights to the rare-earth elements and uranium, but including rights to gold and other metals, by spending \$5 million on property exploration by 2011.

Newmont also has the right to earn an additional 15% participating interest by completing a positive feasibility study. If the Company’s interest is reduced to 20%, the Company shall have a financing option by which it may elect for Newmont to carry the Company’s share of Venture expenditures, without further dilution to the Company, until commencement of mining on the property. The funds advanced by Newmont under the financing option, plus interest at LIBOR plus 3%, shall be recouped from 90% of the Company’s portion of the proceeds from production.

Newmont staked an additional 116 Federal lode mineral claims, which are included as part of the Venture’s property. The total Venture area of interest consists of approximately nine square miles, mostly located in the north portion of the Bear Lodge Mountains.

Newmont is the operator of the gold-exploration program. The Company will continue to operate its own rare-earth-element exploration program; however, if the two exploration programs conflict, the Venture, under Newmont, may choose to operate both programs. The Company is advancing the exploration and evaluation of the rare-earth mineralization on the Bear Lodge property.

All claims are located on federal lands and are subject to annual maintenance fees payable to the United States Bureau of Land Management. These fees are now paid by Newmont as long as the Newmont agreement remains in effect.

Kipawa Property

In April 2006, the Company acquired the property by staking 26 claims, totaling approximately 1,531 hectares. The property is located in Quebec, 90 km northwest of North Bay, Ontario. The Company wrote off \$4,841 in fiscal 2007 upon making an agreement to sell the property. On October 12, 2007, the Company sold the property for its residual carrying amount of \$1,500 CDN (\$1,416).

4. EQUIPMENT

	December 31, 2008	June 30, 2008
Computer equipment	\$ 4,962	\$ 4,962
Software	1,338	1,338
Accumulated amortization	(3,597)	(2,033)
Net book value	<u>\$ 2,703</u>	<u>\$ 4,267</u>

RARE ELEMENT RESOURCES LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

(Expressed in US Dollars)

(Unaudited)

5. INVESTMENT

In fiscal 2008, the Company sold to Almaden Minerals Ltd. (“Almaden”) its 2% NSR royalty on a Mexican property which has been previously written off by the Company. The NSR was sold for \$20,000 and 25,000 Almaden warrants exercisable at a price of \$3.00 CDN until March 20, 2010. A fair value of \$15,083 was assigned to these warrants and was estimated using the Black-Scholes Option Pricing Model based on the following assumptions: A risk free interest rate of 3.98%, a volatility rate of 52.42%, and an expected time to exercise of 3 years.

Almaden has an officer in common with the Company.

6. RECLAMATION BOND

The Company was required to post a reclamation bond which covers the cost to reclaim the ground disturbed during its exploration programs at the Bear Lodge Property. On July 23, 2004, \$10,000 was transferred to the Wyoming Department of Environmental Quality for the bond required to cover the exploration program. The Company must complete certain reclamation work for these funds to be released, but may leave the bond in place for future exploration programs, even if such work is completed.

In August 2006, an additional bond of \$10,000 was set up in the name of Paso Rico (USA), Inc., but it was paid by Newmont. This bond covers Newmont’s gold-exploration reclamation work and is not included in these financial statements. It will revert to Newmont if and when Newmont completes its reclamation.

7. SHARE CAPITAL

a. Authorized – unlimited number of common shares without par value.

b. Issued

- i) On November 5, 2007, the Company completed a non-brokered private placement for \$1,075,000 CDN. The offering consists of 1,075,000 units at \$1.00 CDN per unit. Each unit comprises one common share and one-half of a non-transferable share-purchase warrant. A whole warrant may be exercised to purchase one additional common share of the Company at \$1.35 CDN until May 5, 2009. Of total cash proceeds received of \$1,150,357, an aggregate fair value of \$337,114 was assigned to these warrants using the Black-Scholes Option Pricing Model.
 - ii) In fiscal 2008, the Company closed a non-brokered private placement of 1,666,698 units at \$0.60 CDN per unit. Each unit comprises one common share and one-half of a non-transferable share purchase warrant. A whole warrant may be exercised to purchase one additional common share of the Company at \$0.75 CDN per share until March 22, 2008. 700,847 warrants were exercised in fiscal 2008, and 3,336 warrants expired unexercised.
 - iii) During the fiscal year 2008, a total of 386,500 options at prices ranging from \$0.25 CDN to \$0.55 CDN were exercised for proceeds of \$160,092. A fair value of \$122,432 recognized on the vesting of these options was transferred from contributed surplus.
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RARE ELEMENT RESOURCES LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008
(Expressed in US Dollars)
(Unaudited)

7. SHARE CAPITAL, Continued

c. Stock Options

The following table summarizes the Company's stock option activity:

	Number of Options	Weighted Average Exercise Price (CDN\$)
Outstanding, June 30, 2007	2,082,500	0.42
Granted	850,000	1.02
Exercised	(386,500)	0.42
Outstanding, June 30, 2008	2,546,000	0.62
Expired	(750,000)	0.35
Outstanding, December 31, 2008	1,796,000	0.74

At December 31, 2008, the following options were outstanding:

Expiry Date	Number of Options	Exercise Price (CDN\$)
July 24, 2010	200,000	0.25
April 28, 2011	350,000	0.55
January 10, 2012	396,000	0.55
September 1, 2012	350,000	1.00
October 12, 2012	350,000	1.00
October 15, 2012	25,000	1.00
November 17, 2012	50,000	1.15
February 19, 2013	75,000	1.15
	1,796,000	

d. Stock-based compensation

The fair value of options reported as compensation expense has been estimated using the Black-Scholes Option Pricing Model using the following assumptions:

	2008	2007
Risk-free interest rate	3.03 – 4.29%	4.08%
Annualized volatility	86 – 89%	88%
Expected dividend yield	Nil	Nil
Expected option life in years	5 years	4 years

Based on these variables, stock-based compensation expense for the options vested during the six months ended December 31, 2008 was \$139,397 (2007 – \$155,698).

Option pricing models require the input of highly subjective assumptions, particularly as to the expected price volatility of the stock. Changes in these assumptions can materially affect fair value estimates and, therefore, it is management's view that the existing models do not necessarily provide a single reliable measure of the fair value of the Company's stock-option grants.

RARE ELEMENT RESOURCES LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008
(Expressed in US Dollars)
(Unaudited)

7. SHARE CAPITAL, Continued

e. Warrants

The following table summarizes the Company's warrant activity:

	Number of Shares	Weighted Average Exercise Price (CDN\$)
Outstanding, June 30, 2007	704,183	0.75
Exercised	(700,847)	0.75
Expired	(3,336)	0.75
Granted	537,500	1.35
Outstanding, June 30, 2008 and December 31, 2008	537,500	1.35

At December 31, 2008, the following warrants were outstanding:

Expiry Date	Number of Warrants	Exercise Price (CDN\$)
May 5, 2009	537,500	1.35

8. RELATED PARTY TRANSACTIONS

During the six months ended December 31, 2008:

- a) \$Nil (2007 - \$47,891) was charged for management fees by a private company controlled by the former president.
- b) \$52,260 (2007 - \$Nil) was charged for management fees by an officer and director of the Company.
- c) \$53,326 (2007 - \$53,232) was charged by a private company controlled by one of the directors and officers for accounting, management fees and rent.

As at December 31, 2008, a total of \$16,899 (June 30, 2008 - \$15,257) was owed to a director and a private company controlled by one of the directors and officers for accounting, management fees and rent.

Related party transactions are measured at the fair value amount as determined by management. The amounts owed bear no interest and are unsecured with no repayment terms.

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9. COMMITMENTS AND CONTINGENCIES

Potential environmental contingency

The Company's mining and exploration activities are subject to various federal, provincial and state laws and regulations governing the protection of the environment. These laws and regulations are continually changing and generally becoming more restrictive. The Company conducts its operations so as to protect public health and the environment, and believes its operations are materially in compliance with all applicable laws and regulations. The Company has made, and expects to make in the future, expenditures to comply with such laws and regulations. The ultimate amount of reclamation and other future site-restoration costs to be incurred for existing mining interests is uncertain.

10. SEGMENTED INFORMATION

The Company operates in a single reportable operating segment, being exploration and development of mineral properties.

Summarized financial information for the geographic segments the Company operates in are as follows:

	Canada	United States	Total
<u>As at December 31, 2008</u>			
Assets	\$ 1,383,015	\$ 1,443,254	\$ 2,826,269
<u>As at June 30, 2008</u>			
Assets	\$ 2,349,794	\$ 1,044,431	\$ 3,394,225
<hr/>			
	Canada	United States	Total
<u>For the six months ended December 31, 2008</u>			
Loss for the period	\$ 706,218	\$ 260	\$ 706,478
Capital expenditures	\$ -	\$ 398,822	\$ 398,822
<hr/>			
<u>For the six months ended December 31, 2007</u>			
Loss for the period	\$ 262,629	\$ 804	\$ 263,433
Capital expenditures	\$ 5,678	\$ 165,268	\$ 170,946

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11. FINANCIAL INSTRUMENTS

The fair values of the Company's cash and cash equivalents, accounts receivable, prepaid expenses, accounts payables and accrued liabilities and due to related parties approximate their carrying values.

The Company's financial instruments are exposed to certain financial risks, including currency risk, credit risk, liquidity risk, interest risk and commodity price risk.

(a) Currency risk

The Company's property interests in United States make it subject to foreign currency fluctuations and inflationary pressures which may adversely affect the Company's financial position, results of operations and cash flows. The Company is affected by changes in exchange rates between the Canadian Dollar and foreign functional currencies. The Company does not invest in foreign currency contracts to mitigate the risks.

(b) Credit risk

The Company's cash and cash equivalents are held in a Canadian financial institution. The Company does not have any asset-backed commercial paper in its cash and cash equivalents. The Company's amount receivable consists primarily of goods and services tax due from the federal government of Canada and interest receivable on term investments.

(c) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company manages liquidity risk through the management of its capital structure.

Accounts payable and accrued liabilities are due within the current operating period.

(d) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The risk that the Company will realize a loss as a result of a decline in the fair value of the cash and cash equivalents is limited because they are generally held to maturity.

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12. MANAGEMENT OF CAPITAL RISK

The Company manages its cash and cash equivalents, common shares, stock options and warrants as capital (Note 7). The Company's objectives when managing capital are to safeguard the Company's ability to continue as a going concern in order to pursue the development of its mineral properties and to maintain a flexible capital structure which optimizes the costs of capital at an acceptable risk.

The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. To maintain or adjust the capital structure, the Company may attempt to issue new shares, issue new debt, acquire or dispose of assets or adjust the amount of cash and cash equivalents.

In order to facilitate the management of its capital requirements, the Company prepares expenditure budgets that are updated as necessary depending on various factors, including successful capital deployment and general industry conditions.

In order to maximize ongoing development efforts, the Company does not pay out dividends. The Company's investment policy is to invest its short-term excess cash in highly liquid short-term interest-bearing investments with maturities 90 days or less from the original date of acquisition, selected with regards to the expected timing of expenditures from continuing operations.

The Company expects its current capital resources will be sufficient to carry its exploration plans and operations through 2009.

13. SUBSEQUENT EVENT

On January 27, 2009, 1,400,000 stock options at a price of CDN\$0.58 were granted to directors, officers, and consultants of the Company.
