

Sprott Physical Gold Trust

Report to Unitholders

DECEMBER 31,

2010



Sprott
PHYSICAL GOLD
Trust

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Management Report of Fund Performance*

Investment Objective and Strategies

Sprott Physical Gold Trust (the “Trust”) is a closed-end mutual fund trust organized under the laws of the Province of Ontario, Canada, created to invest and hold substantially all of its assets in physical gold bullion. The Trust seeks to provide a secure, convenient and exchange-traded investment alternative for investors interested in holding physical gold bullion without the inconvenience that is typical of a direct investment in physical gold bullion. The Trust intends to achieve its objective by investing primarily in long-term holdings of unencumbered, fully allocated, physical gold bullion and does not speculate with regard to short-term changes in gold prices.

The units of the Trust are listed on the New York Stock Exchange (“NYSE”) Arca and the Toronto Stock Exchange (“TSX”) under the symbols “PHYS” and “PHY.U”, respectively.

Risks

The risks of investing in the Trust are detailed in the Trust’s annual information form for the year ended December 31, 2010 dated March 11, 2011. There have been no material changes to the Trust since inception that affected the overall level of risk. The principal risks associated with investing in the Trust are the price of gold, the net asset value and/or the market price of the units, the purchase, transport, insurance and storage of physical gold bullion, liabilities of the Trust, and redemption of units.

Results of Operations

The following unit issuances took place during the period from January 1, 2010 to December 31, 2010:

- On March 3, 2010, the Trust closed its initial public offering with the sale of 40,000,000 units at \$10.00 per unit, for gross proceeds of \$400,000,000;
- On March 8, 2010, the Trust issued 3,000,000 units for gross proceeds of \$30,000,000 on the exercise by the underwriters of the over-allotment option of the initial public offering.
- On March 25, 2010, the Trust issued 1,250,000 units for gross proceeds of \$12,500,000 on the final exercise by the underwriters of the over-allotment option of the initial public offering.
- On May 26, 2010, the Trust issued 24,840,000 units at \$11.25 per unit, for gross proceeds of \$279,450,000 on the first follow-on offering of the units of the Trust.
- On September 17, 2010, the Trust issued 24,500,000 units at \$11.37 per unit, for gross proceeds of \$278,565,000 on the second follow-on offering of the units of the Trust.
- On September 24, 2010, the Trust issued 3,488,555 units at \$11.37 per unit, for gross proceeds of \$39,664,870 on the exercise by the underwriters of the over-allotment option on the second follow-on offering.
- On October 29, 2010, the Trust redeemed 28,982 units at a cost of \$318,426.

Of the \$1,040.2 million gross proceeds raised through the above transactions, the Trust paid approximately \$47.9 million in respect of underwriting commissions and other expenses related to the various offerings detailed above, invested \$983.3 million in physical gold bullion at an average cost of \$1,198.01 per troy ounce and retained \$9.0 million in cash in order to provide available funds for the Trust’s ongoing expenses and potential cash redemptions.

The value of the net assets of the Trust as of December 31, 2010 was \$1,171.7 million or \$12.07 per unit. The Trust held 820,753 ounces of physical gold bullion as of December 31, 2010.

* All references to currencies in this report are in United States Dollars, unless stated otherwise.

The annual management report of fund performance is an analysis and explanation that is designed to complement and supplement an investment fund’s financial statements. This report contains financial highlights but does not contain the complete annual financial statements of the investment fund. A copy of the annual financial statements has been included separately within the Report to Unitholders. You can also get a copy of the annual financial statements at your request, and at no cost, by calling 1-866-299-9906, by visiting our website at www.sprott.com or SEDAR at www.sedar.com or by writing to us at: Sprott Asset Management LP, Royal Bank Plaza, South Tower, 200 Bay Street, Suite 2700, P.O. Box 27, Toronto, Ontario M5J 2J1. Securityholders may also contact us using one of these methods to request a copy of the investment fund’s proxy voting policies and procedures, proxy voting disclosure record or quarterly portfolio disclosure.

Sprott Physical Gold Trust

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For the period from January 1, 2010 to December 31, 2010, total unrealized gains on physical gold bullion amounted to \$182.8 million. The units closed at \$12.35 on the NYSE Arca and \$12.32 on the TSX on December 31, 2010. The units are denominated in U.S. dollars on both exchanges.

The Trust's net asset value per unit on December 31, 2010 was \$12.07. During the period from February 25, 2010 to December 31, 2010, the Trust's units traded on the NYSE Arca at an average premium to net asset value of approximately 8.2%.

Related Party Transactions

MANAGEMENT FEES

The Trust pays the Manager, Sprott Asset Management LP, a monthly management fee equal to $\frac{1}{2}$ of 0.35% of the value of the net assets of the Trust (determined in accordance with the trust agreement), plus any applicable Canadian taxes. The management fee is calculated and accrued daily and payable monthly in arrears on the last day of each month. For the period from January 1 to December 31, 2010, the Trust incurred management fees of \$2,307,496 (not including applicable Canadian taxes).

EXPENSE CAP

The Manager has contractually agreed that if the expenses of the Trust, including the management fees, at the end of any month exceed an amount equal to $\frac{1}{2}$ of 0.65% of the value of the net assets of the Trust, the management fee payable to the Manager for such month will be reduced by the amount of such excess up to the gross amount of the management fee earned by the Manager for such month. For the period ending December 31, 2010, there was no such reduction in the management fee.

OPERATING EXPENSES

The Trust pays its own operating expenses, which include, but are not limited to, audit, legal, trustee fees, unitholder reporting expenses, general and administrative fees, filing and listing fees payable to applicable securities regulatory authorities and stock exchanges, storage fees for the physical gold bullion, costs incurred in connection with the Trust's continuous disclosure public filing requirements and investor relations and any expenses associated with the implementation and on-going operation of the Independent Review Committee of the Trust. Operating expenses for the period from January 1, 2010 to December 31, 2010 amounted to \$467,067 (not including applicable Canadian taxes).

Financial Highlights

The following table shows selected key financial information about the Trust and is intended to help you understand the Trust's financial performance for the period from January 1, 2010 to December 31, 2010. The pricing of the initial public offering took place on February 25, 2010 and closing took place on March 3, 2010.

Net assets per unit¹

	\$
Net assets per unit, beginning of period	10.00
Increase(decrease) from operations²:	
Total revenue	–
Total expenses	(0.05)
Realized gains (losses) for the period	–
Unrealized gains for the period	3.06
Total increase from operations	3.01
Net assets per unit, end of period	12.07

1 This information is derived from the Trust's annual financial statements.

2 Net assets per unit is calculated based on the actual number of units outstanding at the relevant time. The increase/decrease from operations is based on the weighted average number of units outstanding over the financial period from January 1, 2010 to December 31, 2010. This table is not intended to be a reconciliation of the beginning to ending net assets per unit.

Ratios and Supplemental Data

Total net asset value (000's) ¹	\$1,171,745
Number of Units outstanding ¹	97,049,573
Management expense ratio ²	0.46%
Trading expense ratio ³	Nil
Portfolio turnover rate ⁴	Nil
Net asset value per Unit	\$12.07
Closing market price – NYSE Arca	\$12.35
Closing market price – TSX	\$12.32

1 This information is provided as at December 31, 2010.

2 Management expense ratio ("MER") is based on total expenses (excluding commissions and other portfolio transaction costs) for the stated period and is expressed as an annualized percentage of daily average net asset value during the period from February 25, 2010 to December 31, 2010. The MER for the period from February 25, 2010 to December 31, 2010 on an unannualized basis is 0.39%.

3 The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of daily average net asset value during the period from February 25, 2010 to December 31, 2010. Since there are no trading costs associated with physical bullion trades, the trading expense ratio is nil.

4 The Trust's portfolio turnover rate indicates how actively the Trust's portfolio adviser trades its portfolio investments. A portfolio turnover rate of 100% is equivalent to the Trust buying and selling all of the securities in its portfolio once in the course of the year. The higher the Trust's portfolio turnover rate in a year, the greater the trading costs payable by the Trust in the year, and the greater the chance of an investor receiving taxable capital gains in the year. There is not necessarily a relationship between a high turnover rate and the performance of the Trust.

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December 31, 2010

Past Performance

In accordance with National Instrument 81-106, performance data will be shown after the Trust has been in operation for at least 12 consecutive months.

Summary of Investment Portfolio

As of December 31, 2010

	Ounces	Price \$	Average Cost \$	Fair Value \$	% of Net Assets %
Physical gold bullion	820,753	1,420.78	983,268,826	1,166,105,984	99.5
Cash and Cash Equivalents				5,862,468	0.6
Other Net Liabilities				(223,036)	(0.1)
Total Net Assets				1,171,745,416	100.0

This summary of investment portfolio may change due to the ongoing portfolio transactions of the Trust.

Sprott Physical Gold Trust

Audited financial statements

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Sprott Asset Management

Management's Responsibility for Financial Information

Sprott Asset Management LP, the "Manager" of the Sprott Physical Gold Trust (the "Fund") is responsible for the integrity, consistency, objectivity and reliability of the Financial Statements of the Fund. International Financial Reporting Standards have been applied and management has exercised its judgment and made best estimates where appropriate.

The Manager's internal controls and supporting procedures maintained provide reasonable assurance that financial records are complete and accurate. These supporting procedures include the oversight of RBC Dexia, the Fund's valuation agent.

Management has assessed the effectiveness of the internal controls over financial reporting as at December 31, 2010 using the framework found in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this assessment, management has concluded that as at December 31, 2010 the Manager's internal controls over financial reporting were effective.

Ernst & Young LLP, the independent auditors appointed by the Manager of the Trust, have audited the effectiveness of the Trust's internal control over financial reporting as at December 31, 2010 in addition to auditing the Trust's Financial Statements as of the same date. Their reports, which expressed an unqualified opinion, can be found on pages 2 to 3 of the Financial Statements. Ernst & Young have full and free access to, and meet periodically with, the Manager of the Trust to discuss their audit and matters arising there from, such as, comments they may have on the fairness of financial reporting and the adequacy of internal controls.



Steven Rostowsky
Chief Financial Officer
Sprott Asset Management LP
March 11, 2011



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Independent Auditors' Report of Registered Public Accounting Firm

To Sprott Asset Management LP (the "Manager"), the Trustee and the Unitholders of the Sprott Physical Gold Trust

We have audited the accompanying financial statements of the Sprott Physical Gold Trust, which comprise the statements of financial position as at December 31, 2010 and December 31, 2009, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year ended December 31, 2010 and a summary of significant accounting policies and other explanatory information.

MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

AUDITORS' RESPONSIBILITY

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

OPINION

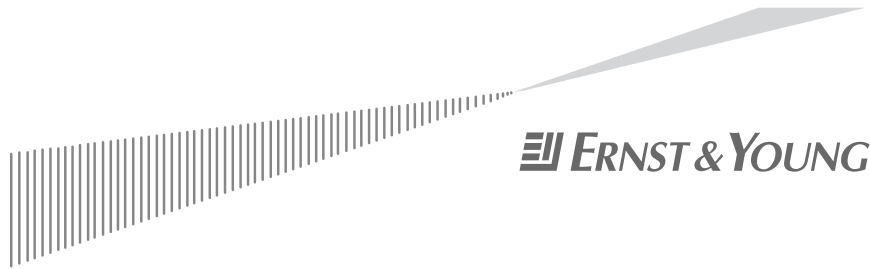
In our opinion, the financial statements present fairly, in all material respects, the financial position of the Sprott Physical Gold Trust as at December 31, 2010 and December 31, 2009, and its financial performance and its cash flows for the year ended December 31, 2010, in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

OTHER MATTER

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Sprott Physical Gold Trust's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 11, 2011 expressed an unqualified opinion on Sprott Physical Gold Trust's internal control over financial reporting.

Toronto, Canada
March 11, 2011

Chartered Accountants
Licensed Public Accountants



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Report of Independent Registered Public Accounting Firm

To Sprott Asset Management LP (the “Manager”), the Trustee and the Unitholders of the Sprott Physical Gold Trust

We have audited the Sprott Physical Gold Trust’s (the “Trust”) internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Manager is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management’s Responsibility for Financial Information. Our responsibility is to express an opinion on the Trust’s internal control over financial reporting based on our audit.

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

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Manager of the Sprott Physical Gold Trust maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on the COSO criteria.

We also have audited, in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States), the statements of financial position as at December 31, 2010 and December 31, 2009, and the statements of comprehensive income, changes in equity and cash flows for the year ended December 31, 2010 of the Sprott Physical Gold Trust and our report dated March 11, 2011 expressed an unqualified opinion thereon.

Toronto, Canada
March 11, 2011

Chartered Accountants
Licensed Public Accountants

Sprott Physical Gold Trust

Statement of comprehensive income

For the period from
January 1, 2010 to
December 31, 2010

	US\$
Income	
Unrealized gains on gold bullion	182,837,158
Unrealized gains on foreign denominated cash	3,539
	<hr/> 182,840,697
Expenses	
Management fees (note 11)	2,307,496
Harmonized Sales Tax	230,058
Bullion storage fees	178,969
Listing and regulatory filing fees	98,168
Audit fees	90,784
General and administrative	34,294
Independent Review Committee fees	34,082
Unitholder reporting costs	12,380
Legal fees	8,254
Net foreign exchange losses	6,009
Trustee fees	4,127
	<hr/> 3,004,621
Net income for the period	<hr/> 179,836,076
Other comprehensive income	–
Total comprehensive income for the period	<hr/> 179,836,076
Basic and diluted income per Unit (note 9)	<hr/> 3.01

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

On behalf of the Manager, Sprott Asset Management LP,
by its General Partner, Sprott Asset Management GP Inc.:



Eric Sprott
DIRECTOR



Steven Rostowsky
DIRECTOR

Sprott Physical Gold Trust

Statements of financial position

	<i>As at December 31,</i> 2010	<i>As at December 31,</i> 2009
	US\$	US\$
Assets		
Cash <i>(note 6)</i>	5,862,468	10
Gold bullion	1,166,105,984	–
Total assets	1,171,968,452	10
Liabilities		
Accounts payable	223,036	–
Total liabilities	223,036	–
Equity		
Unitholders' capital	1,039,844,685	10
Unit premium and reserves	16,759	–
Retained earnings	179,836,076	–
Underwriting commissions and issue expenses	(47,952,104)	–
Total equity <i>(note 8)</i>	1,171,745,416	10
Total liabilities and equity	1,171,968,452	10
Total equity per Unit	12.07	10.00

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

Sprott Physical Gold Trust

Statement of changes in equity

	Number of Units outstanding	Unitholders' Capital	Retained Earnings (Deficit)	Underwriting Commissions and Issue Expenses	Total Equity
		US\$	US\$	US\$	US\$
Balance at December 31, 2009	1	10	–	–	10
Cancellation of Unit	(1)	(10)	–	–	(10)
Proceeds from issuance of Units (note 8)	97,078,555	1,040,179,870	–	–	1,040,179,870
Cost of Redemption of Units (note 8)	(28,982)	(318,426)	–	–	(318,426)
Net income for the period	–	–	179,836,076	–	179,836,076
Underwriting commissions and issue expenses	–	–	–	(47,952,104)	(47,952,104)
Balance at December 31, 2010	97,049,573	1,039,861,444	179,836,076	(47,952,104)	1,171,745,416

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

Sprott Physical Gold Trust

Statement of cash flows

	For the period from January 1, 2010 to December 31, 2010
	US\$
Cash flows from operating activities	
Net income for the period	179,836,076
Adjustment to reconcile net income for the period to net cash from operating activities	
Unrealized gains on gold bullion	(182,837,158)
Net changes in operating assets and liabilities	
Increase in accounts payable	223,036
Net cash generated by operating activities	(2,778,046)
Cash flows from investing activities	
Purchase of gold bullion	(983,268,826)
Net cash used in investing activities	(983,268,826)
Cash flows from financing activities	
Proceeds from issuance of Units <i>(note 8)</i>	1,040,179,870
Payments on cancellation of Unit <i>(note 8)</i>	(10)
Payments on redemption of Units <i>(note 8)</i>	(318,426)
Underwriting commissions and issue expenses	(47,952,104)
Net cash provided by financing activities	991,909,330
Net increase in cash during the period	5,862,458
Cash at beginning of period	10
Cash at end of period <i>(note 6)</i>	5,862,468

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

Sprott Physical Gold Trust

Notes to the Annual Financial Statements December 31, 2010

1. Organization of the Trust

Sprott Physical Gold Trust (the “Trust”) is a closed-end mutual fund trust created under the laws of the Province of Ontario, Canada, pursuant to a trust agreement dated as of August 28, 2009, as amended and restated as of December 7, 2009 and as further amended and restated as of February 1, 2010 (the “Trust Agreement”). The Trust’s initial public offering was priced on February 25, 2010 and closed on March 3, 2010. The Trust is authorized to issue an unlimited number of redeemable, transferable trust units (the “Units”). All issued Units have no par value, are fully paid for, and are listed and traded on the New York Stock Exchange Arca (the “NYSE Arca”) and the Toronto Stock Exchange (the “TSX”) under the symbols “PHYS” and “PHY.U”, respectively.

The investment objective of the Trust is to seek to provide a secure, convenient and exchange-traded investment alternative for investors interested in holding physical gold bullion without the inconvenience that is typical of a direct investment in physical gold bullion. As part of its investment strategy, the Trust invests and holds substantially all of its assets in physical gold bullion. The Trust invests and intends to continue to invest primarily in long-term holdings of unencumbered, fully allocated, physical gold bullion and does not speculate with regard to short-term changes in gold prices. The Trust has only purchased and expects only to own “London Good Delivery” bars as defined by the London Bullion Market Association (“LBMA”), with each bar purchased being verified against the LBMA source.

The Trust’s registered office is located at Suite 2700, South Tower, Royal Bank Plaza, 200 Bay Street, Toronto, Ontario, Canada, M5J 2J1.

Sprott Asset Management LP (the “Manager”) acts as the manager of the Trust pursuant to the Trust Agreement and a management agreement with the Trust. RBC Dexia Investor Services Trust, a trust company organized under the laws of Canada, acts as the trustee of the Trust. RBC Dexia Investor Services Trust also acts as custodian on behalf of the Trust for the Trust’s assets other than physical gold bullion. The Royal Canadian Mint acts as custodian on behalf of the Trust for the physical gold bullion owned by the Trust.

The financial statements of the Trust for the year ended December 31, 2010 were authorized for issue by the Manager on March 11, 2011. The Trust’s owners have the power to amend the financial statements of the Trust if applicable.

2. Basis of Preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB” or the “Board”).

The financial statements have been prepared on a historical cost basis, except for physical gold bullion and financial assets and financial liabilities held at fair value through profit or loss, that have been measured at fair value.

The financial statements are presented in U.S. dollars and all values are rounded to the nearest dollar unless otherwise indicated.

Comparative figures have not been presented for the statements of comprehensive income, changes in equity and cash flows because the Trust had no operations prior to the initial public offering which closed on March 3, 2010 other than the issuance of one Unit for proceeds of \$10 in 2009.

2.1 Summary of Significant Accounting Policies

(i) Cash and cash equivalents

Cash and cash equivalents consist of cash on deposit with the Trust’s custodian, which is not subject to restrictions.

Sprott Physical Gold Trust

Notes to the Annual Financial Statements December 31, 2010

(ii) Gold bullion

Investments in gold bullion are measured at fair value determined by reference to published price quotations, with unrealized and realized gains and losses recorded in income based on the International Accounting Standards (“IAS”) 40 *Investment Property* fair value model as IAS 40 is the most relevant IFRS to apply. Investment transactions in physical gold bullion are accounted for on the business day following the date the order to buy or sell is executed.

(iii) Other financial liabilities

This category includes all financial liabilities, other than those classified at fair value through profit and loss. The Trust includes in this category management fees payable, due to brokers and other short-term accounts payable.

(iv) Share Capital

Classification of redeemable units

Redeemable units are classified as equity instruments when:

- The units entitle the holder to a *pro rata* share of the Trust’s net assets in the event of the Trust’s liquidation;
- The redeemable units are in the class of instruments that is subordinate to all other classes of instruments;
- All redeemable units in the class of instruments that is subordinate to all other classes of instruments have identical features;
- The redeemable units do not include any contractual obligation to deliver cash or another financial asset other than the holder’s rights to a *pro rata* share of the Trust’s net assets; and
- The total expected cash flows attributable to the redeemable units over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the Trust over the life of the instrument.

In addition to the redeemable units having all the above features, the Trust must have no other financial instrument or contract that has:

- Total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the Trust; and
- The effect of substantially restricting or fixing the residual return to the redeemable unitholders.

The Trust continuously assesses the classification of the redeemable units. If the redeemable units cease to have all the features or meet all the conditions set out to be classified as equity, the Trust will reclassify them as financial liabilities and measure them at fair value at the date of reclassification, with any differences from the previous carrying amount recognised in equity.

(v) Fees and commission expenses

Fees and commission expenses are recognized on an accrual basis.

(vi) Income taxes

In each taxation year, the Trust will be subject to income tax on taxable income earned during the year, including net realized taxable capital gains. However, the Trust intends to distribute its taxable income to unitholders at the end of every fiscal year and therefore the Trust itself would not have any income tax liability.

(vii) Functional and presentation currency

The Trust’s functional and presentation currency is the US Dollar. The Trust’s performance is evaluated and its liquidity is managed in US Dollars. Therefore, the US Dollar is considered as the currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

Sprott Physical Gold Trust

Notes to the Annual Financial Statements December 31, 2010

3. Significant Accounting Judgements, Estimates and Assumptions

The preparation of the Trust's financial statements requires the Manager to make judgments, estimates and assumptions that affect the amounts recognized in the financial statements. However, uncertainty about these assumptions and estimates could result in outcomes that may require a material adjustment to the carrying amount of the asset or liability affected in future periods.

Judgements

In the process of applying the Trust's accounting policies, management has made the following judgements, which have the most significant effect on the amounts recognized in the financial statements:

Going Concern

The Trust's management has made an assessment of the Trust's ability to continue as a going concern and is satisfied that the Trust has the resources to continue in business for the foreseeable future. Furthermore, management is not aware of any material uncertainties that may cast significant doubt upon the Trust's ability to continue as a going concern. Therefore, the financial statements continue to be prepared on a going concern basis.

Functional Currency

The primary objective of the Trust is to invest and hold substantially all of its assets in physical gold bullion, the market value of which is denominated in U.S. dollars. The liquidity of the Trust is managed on a day-to-day basis in U.S. dollars in order to handle the issue, acquisition and redemption of the Trust's Units. Therefore, the Manager considers the U.S. dollar as the currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

Estimates and Assumptions

The key accounting assumptions concerning the future and other key sources of estimation uncertainty at the recording date, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year, are discussed below. The Trust based its assumptions and estimates on parameters available when the financial statements were prepared. However, existing circumstances and assumptions about future developments may change due to market changes or circumstances arising beyond the control of the Trust. Such changes are reflected in the assumptions when they occur.

For tax purposes, the Trust generally treats gains from the disposition of gold bullion as capital gains, rather than income, as the Trust intends to be a long-term passive holder of gold bullion, and generally disposes of its holdings in gold bullion only for the purposes of meeting redemptions. The Canada Revenue Agency has, however, expressed its opinion that gains (or losses) of mutual fund trusts resulting from transactions in commodities should generally be treated for tax purposes as ordinary income rather than as capital gains, although the treatment in each particular case remains a question of fact to be determined having regard to all the circumstances.

4. Standards, Interpretations and Amendments Issued But Not Yet Effective

Standards issued but not yet effective at the date of the issuance of the Trust's financial statements are listed below.

IFRS 9 Financial Instruments: Classification and Measurement

IFRS 9 as issued reflects the first phase of the Board's work on the replacement of IAS 39 *Financial Instruments: Recognition and Measurement*, and applies to classification and measurement of financial assets as defined in IAS 39. The standard is effective for annual periods beginning on or after January 1, 2013. In subsequent phases, the Board will address classification and measurement of financial liabilities, hedge

Sprott Physical Gold Trust

Notes to the Annual Financial Statements December 31, 2010

accounting and derecognition. The completion of this project is expected in early 2011. The adoption of IFRS 9 is not expected to have a material effect on the classification and measurement of the Trust's financial assets.

IAS 24 *Related Party Disclosures* (Amendment)

The amended standard is effective for annual periods beginning on or after January 1, 2011. It clarified the definition of a related party to simplify the identification of such relationships and to eliminate inconsistencies in its application. The Trust does not expect any impact on its financial position or performance. Early adoption is permitted.

Improvements to IFRSs (issued in May 2010)

The IASB issued *Improvements to IFRS*, an omnibus of amendments to its IFRS standards. The amendments have not been adopted as they become effective for annual periods beginning on or after January 1, 2011.

- IFRS 7 *Financial Instruments: Disclosures*
- IAS 1 *Presentation of Financial Statements*
- IAS 34 *Significant Events and Changes*

The Trust expects no impact from the adoption of the amendments on its financial position or performance. The adoption of the amendment to IFRS 7 is expected to have a limited impact on the disclosure of credit risk.

5. Segment Information

For management purposes, the Trust is organized into one main operating segment, which invests in physical gold bullion. All of the Trust's activities are interrelated, and each activity is dependent on the others. Accordingly, all significant operating decisions are based upon an analysis of the Trust as one segment. The financial results from this segment are equivalent to the financial statements of the Trust as a whole. The Trust's operating income is earned entirely in Canada and is primarily generated from its investment in physical gold bullion.

6. Cash and Cash Equivalents

As at December 31, 2010, cash and cash equivalents consisted entirely of cash on deposit.

7. Fair Value of Financial Instruments

As at December 31, 2010, due to the short-term nature of financial assets and financial liabilities recorded at cost, it is assumed that the carrying amount of those instruments approximates their fair value.

8. Unitholders' Capital

The Trust is authorized to issue an unlimited number of redeemable, transferrable Units in one or more classes and series of Units. The Trust's capital is represented by the issued, redeemable, transferable Trust Units. Quantitative information about the Trust's capital is provided in the statement of changes in equity. Under the Trust Agreement, Units may be redeemed at the option of the unitholder on a monthly basis for physical gold bullion or cash. Units redeemed for physical gold bullion will be entitled to a redemption price equal to 100% of the NAV of the redeemed Units on the last business day of the month in which the redemption request is processed. A unitholder redeeming Units for

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physical gold bullion will be responsible for expenses in connection with effecting the redemption and applicable delivery expenses, including the handling of the notice of redemption, the delivery of the physical gold bullion for Units that are being redeemed and the applicable gold storage in-and-out fees. Units redeemed for cash will be entitled to a redemption price equal to 95% of the lesser of (i) the volume-weighted average trading price of the Units traded on the NYSE Arca, or, if trading has been suspended on the NYSE Arca, on the TSX for the last five business days of the month in which the redemption request is processed and (ii) the NAV of the redeemed Units as of 4:00 p.m., Toronto time, on the last business day of the month in which the redemption request is processed.

When Units are redeemed and cancelled and the cost of such Units is either above or below their stated or assigned value, the cost is allocated to unitholders' capital in an amount equal to the stated or assigned value of the Units and any difference is allocated to the Unit premiums and reserves account.

Net Asset Value

Net Asset Value ("NAV") is defined as the Trust's net assets (fair value of total assets less fair value of total liabilities, excluding all liabilities represented by outstanding Units, if any) calculated using the value of physical gold bullion based on the end-of-day price provided by a widely recognized pricing service.

Capital management

As a result of the ability to issue, repurchase and resell Units of the Trust, the capital of the Trust as represented by the Unitholders capital in the statement of financial position can vary depending on the demand for redemptions and subscriptions to the Trust. The Trust is not subject to externally imposed capital requirements and has no legal restrictions on the issue, repurchase or resale of redeemable Units beyond those included in the Trust Agreement. The Trust may not issue additional Units except (i) if the net proceeds per Unit to be received by the Trust are not less than 100% of the most recently calculated NAV immediately prior to, or upon, the determination of the pricing of such issuance or (ii) by way of Unit distribution in connection with an income distribution.

The Trust's objectives for managing capital are:

- To invest and hold substantially all of its assets in physical gold bullion; and
- To maintain sufficient liquidity to meet the expenses of the Trust, and to meet redemption requests as they arise.

Refer to "Financial risk and management objectives and policies" (Note 10) for the policies and procedures applied by the Trust in managing its capital.

9. Earnings Per Unit

Basic earnings per unit ("EPU") is calculated by dividing the net income for the period attributable to the Trust's unitholders by the weighted average number of units outstanding during the period.

The Trust's diluted EPU is the same as basic EPU, since the Trust has not issued any instrument with dilutive potential.

	<i>For the period from January 1, 2010 to December 31, 2010</i>
Net income for the year attributable to the Trust's redeemable units	\$179,836,076
Weighted average number of redeemable units outstanding	59,766,609
Basic and diluted income per redeemable unit	\$3.01

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10. Financial Risk and Management Objectives and Policies

Introduction

The Trust's objective in managing risk is the creation and protection of unitholder value. Risk is inherent in the Trust's activities, but it is managed through a process of ongoing identification, measurement and monitoring, subject to risk limits and other controls. The process of risk management is critical to the Trust's continuing profitability. The Trust is exposed to market risk (which includes price risk, interest rate risk and currency risk), credit risk and liquidity risk arising from the gold bullion that it holds.

Risk management structure

The Trust's Investment Manager is responsible for identifying and controlling risks.

Risk mitigation

The Trust has investment guidelines that set out its overall business strategies, its tolerance for risk and its general risk management philosophy.

Excessive risk concentration

Concentration indicates the relative sensitivity of the Trust's performance to developments affecting a particular industry or geographical location. Concentrations of risk arise when a number of financial instruments or contracts are entered into with the same counterparty, or where a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations of liquidity risk may arise from the repayment terms of financial liabilities, sources of borrowing facilities or reliance on a particular market in which to realise liquid assets. The discussion below clarifies the Trust's management of various risks, including risk concentration.

Price risk

Price risk arises from the possibility that changes in the market price of the Trust's investments, which consist almost entirely of gold bullion, will result in changes in fair value of such investments. As at December 31, 2010, investments in physical gold bullion were approximately 99.5% of total assets.

If the market value of gold increased by 1%, with all other variables held constant, this would have increased comprehensive income by approximately \$11.7 million; conversely, if the value of gold bullion decreased by 1%, this would have decreased comprehensive income by the same amount.

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect the value of financial instruments. The Trust does not hedge its exposure to interest rate risk as that risk is minimal. The Trust invests in short-term debt securities issued by the Government of Canada with maturities of less than 90 days from the date of purchase. Due to the short-term duration of these instruments, they have minimal interest rate risk.

Currency risk

Currency risk arises from the possibility that changes in the price of foreign currencies will result in changes in carrying value. The Trust's assets, substantially all of which consist of an investment in gold bullion, are priced in U.S. dollars. Some of the Trust's expenses are payable in Canadian dollars. Therefore, the Trust is exposed to currency risk, as the value of its liabilities denominated in Canadian dollars will fluctuate

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due to changes in exchange rates. Most of such liabilities, however, are short term in nature and are not significant in relation to the net assets of the Trust, and, as such, exposure to foreign exchange risk is limited. The Trust does not enter into currency hedging transactions.

As at December 31, 2010, approximately \$155,421 of the Trust's liabilities were denominated in Canadian dollars.

Credit risk

Credit risk arises from the potential that counterparties will fail to satisfy their obligations as they come due. The Trust primarily incurs credit risk when entering into and settling gold bullion transactions. It is the Trust's policy to only transact with reputable counterparties. The Manager closely monitors the creditworthiness of the Trust's counterparties, such as bullion dealers, by reviewing their financial statements, when available, regulatory notices and press releases. The Trust seeks to minimize credit risk relating to unsettled transactions in gold bullion by only engaging in transactions with bullion dealers with high creditworthiness. The risk of default is considered minimal, as payment for securities purchased, such as treasury bills, as well as gold bullion, is only made against the receipt of the securities or bullion by the custodian.

Liquidity risk

Liquidity risk is defined as the risk that the Trust will encounter difficulty in meeting obligations associated with financial liabilities and redemptions. Liquidity risk arises because of the possibility that the Trust could be required to pay its liabilities earlier than expected. The Trust is also subject to redemptions for both cash and gold bullion on a regular basis. The Trust manages its obligation to redeem units when required to do so and its overall liquidity risk by only allowing for redemptions monthly, which require 15-day advance notice to the Trust. The Trust's liquidity risk is minimal, since its primary investment is physical gold bullion, which trades in a highly liquid market. All of the Trust's financial liabilities, including due to brokers, accounts payable and management fees payables have maturities of less than three months.

11. Related Party Disclosures

The following parties are considered related parties to the Trust:

Investment Manager – Sprott Asset Management LP

The Trust pays the Manager a monthly management fee equal to $\frac{1}{2}$ of 0.35% of the value of net assets of the Trust (determined in accordance with the Trust Agreement) plus any applicable Canadian taxes, calculated and accrued daily and payable monthly in arrears on the last day of each month. Total management fees for the period from February 25 to December 31, 2010 amounted to \$2,307,496.

Also, the Manager has agreed that if the expenses of the Trust, including the management fee, at the end of any month exceed an amount equal to $\frac{1}{2}$ of 0.65% of the value of the net assets of the Trust, the management fee payable to the Manager for such month will be reduced by the amount of such excess up to the gross amount of the management fee earned by the Manager from the Trust for such month. Any such reduction in the management fee will not be carried forward or remain payable to the Manager in future months. The Manager did not waive any amounts payable for the period ended December 31, 2010.

In calculating the expenses of the Trust for purposes of the expense cap, the following will be excluded: any applicable taxes payable by the Trust or to which the Trust may be subject, and any extraordinary expenses of the Trust.

Ownership and Other

As at December 31, 2010, the Trust's related parties included, Eric Sprott, CEO and Chief Investment Officer of the Manager, the Sprott Foundation, a charitable organization established by Mr. Sprott's family and Charles Oliver and Jamie Horvat, Senior Portfolio Managers of the Manager. Eric Sprott and Sprott Foundation owned 6.18% and 2.06% of the units of the Trust, respectively.

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All related party transactions were made at arm's length on normal commercial terms and conditions. There have been no other transactions between the Trust and its related parties during the reporting period.

12. Independent Review Committee (“IRC”)

In accordance with National Instrument 81-107, Independent Review Committee for Investment Funds (“NI 81-107”), the Manager has established an IRC for a number of funds managed by it, including the Trust. The mandate of the IRC is to consider and provide recommendations to the Manager on conflicts of interest to which the Manager is subject when managing certain funds, including the Trust. The IRC is composed of three individuals, each of whom is independent of the Manager and all funds managed by the Manager, including the Trust. Each fund subject to IRC oversight pays a share of the IRC member fees, costs and other fees in connection with operation of the IRC. The IRC reports annually to unitholders of the funds subject to its oversight on its activities, as required by NI 81-107.

13. Soft Dollar Commissions

There were no soft dollar commissions for the year ended December 31, 2010.

14. Personnel

The Trust did not employ any personnel during the period, as its affairs were administered by the personnel of the Manager and/or the Trustee, as applicable.

15. Events After the Reporting Period

There were no material events after the reporting period.

Corporate Information

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