

# DIADEM

## RESOURCES LTD.

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

AUGUST 31, 2006

#### Overview

Management of Diadem Resources Ltd. ("Diadem" or the "Company"), in addition to gold and diamond exploration and development, is now focused on acquiring near-production mining opportunities in North America, especially those related to gold. The acquisition of the option to acquire up to a 57.5% interest in the Duquesne West gold project is a step in that transition. At the same time, Diadem continues work on the Franklin diamond exploration project in the Northwest Territories, Canada.

The Company is active in diamond exploration in the Franklin Bay area of the Northwest Territories and gold exploration in the Rouyn-Noranda region of Quebec. On the exploration property on the Parry Peninsula, which constitutes most of the Franklin Bay project area, the Company has identified 23 potential drill targets. The Company also has acquired a right to acquire a 50% interest in the Duquesne West Project which has a gold resource, with the right to increase to a 57.5% interest.

#### Selected Quarterly Information

	Revenues	Expenses	Net income/ (loss)	Basic and fully diluted net income/ (loss) per share
	\$	\$	\$	\$
2005-Q2 – November 30, 2004	2,339	558,224	(555,885)	(0.10)
2005-Q3 – February 28, 2005	23,022	191,835	117,851	0.02
2005-Q4 – May 31, 2005	(19,341)	5,415,502	(5,434,843)	(0.83)
2006-Q1 – August 31, 2005	14,486	183,875	(169,389)	(0.02)
2006-Q2 – November 30, 2005	3,937	518,644	(514,707)	(0.05)
2006-Q3 – February 28, 2006	66,092	168,857	440,480	0.05
2006-Q4 – May 31, 2006	2,981	497,716	(494,735)	(0.05)
2007-Q1 – August 31, 2006	1,726	142,562	(140,835)	(0.01)

*Note: At a special meeting of shareholders held on January 27, 2006, the shareholders approved that the outstanding common shares of the Company be consolidated on a one-for-sixteen basis (1:16). Common Shares outstanding and basic and fully diluted income (loss) per share, in prior periods, have been adjusted to reflect the share consolidation.*

#### Results of Operations

General corporate costs were \$59,816 (2005-\$107,443) during the first quarter. The decrease results principally from a \$30,000 reduction in salaries and benefits and an \$18,000 reduction in shareholder and investor relations costs. Stock-based compensation fell on the elimination of vesting options associated with the resignation of the Company's former president. Salaries approximate 57% (2005-60%) of general corporate costs and are accrued for management who have made nominal cash draws while the Company remains in the development stage. At August 31, 2006, unsettled management fees aggregated \$26,917. Costs associated with the shareholder relations and regulatory compliance function approximate 7% (2005-12%) of corporate costs.

Interest costs totalled \$2,874 (2005-\$2,260) during the first quarter. Interest expense arises from vendor-financed obligations which are being retired gradually over time.

Financial advisory services were rendered by two directors during the quarter ended August 31, 2006.

As a result of its activities, the Company recorded a net loss of \$140,835 or \$0.01 per share during the first quarter of fiscal 2007 compared to a net loss of \$169,389 or \$0.02 per share during the first quarter of fiscal 2006.

### **Capital Resources and Liquidity**

The consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles and on the assumption that Diadem will be able to realize the carrying value of its assets and discharge its liabilities in the normal course of business as a going concern.

There is uncertainty about the Company's ability to realize the carrying value of its assets and discharge its liabilities as they come due. The ability of the Company to continue as a going concern is dependent upon, among other things, being able to obtain additional financing and maintain positive cash flows from operations. At August 31, 2006, the Company had \$579,498 in cash. On May 31, 2005, the Company had raised \$1,504,000 by way of flow-through financing. The Company must incur an equivalent amount on qualifying Canadian exploration expenditures before the end of calendar 2006. There is no assurance the Company can continue to finance its operations through the capital markets.

The Company has reported significant losses for several years and has no mining operations and is considered a development stage company. For the three months ended August 31, 2006, the Company recorded a loss of \$140,835 (2006 - \$169,389) and had negative operating cash flow for the three month periods ended August 31, 2006 and 2005. At August 31, 2006, the Company had working capital of \$99,189 and an accumulated deficit of \$30.4 million.

During May 2005, the Company placed 1,880,000 common shares at a price of \$0.80 per share for gross proceeds of \$1,504,000. The funds were used to incur Canadian exploration expense on its Franklin, Attawapiskat and Otish Mountain diamond projects, which expense was renounced to investors. At August 31, 2006, the Company had a commitment to spend approximately \$975,000 on qualified Canadian exploration expense before December 31, 2006. Diadem has commenced a diamond drill program on its Duquesne West project and expects to satisfy this commitment before December 31, 2006.

During July 2006, the Company placed 1,813,454 flow-through common shares at a price of \$0.42 per share for gross proceeds of \$761,650. A total of \$16,260 in cash commissions was paid. The Company is committed to expending these funds on flow-through exploration before December 31, 2007. There is no assurance that the Company can raise sufficient funds to satisfy these commitments.

Effective August 27, 2003, the Company formed a wholly-owned subsidiary, Diadem Explorations Inc. ("DEI"), to implement agreements entered into by the Company on July 24, 2003 with several companies to acquire mining claims in the Otish Mountains region of Quebec. The acquisition of the claims was effected by issuing 384,248 First Preferred Series B Shares of DEI having a value equal to the staking costs and cost of work carried out on the claims by the vendors.

During August 2003, DEI issued Series B First Preferred Shares having a value of \$384,248 to the vendors of the Otish Mountain claims. This was equal to the historical staking costs and work carried out by the vendors on those claims. The Series B First Preferred Shares, displayed on the balance sheet under the caption Shares to be issued, are exchangeable, at any time after December 31, 2004 and up to December 31, 2006, into 203,518 Common Shares of the Company at the option of either the Company or the vendor based on a weighted average trading price of \$1.888 per share during the three month period ended December 31, 2004. During 2005, three vendors exchanged 100,049 Series B First Preference Shares for 52,992 common shares of the Company. During fiscal 2006, three vendors exchanged 229,724 Series B First Preference Shares for 121,676 common shares of the Company. If the balance of the Series B First Preference Shares is not exchanged by the vendors, the Company intends to exercise its right to effect the exchange during the quarter ending November 30, 2006.

### **Consolidation of Issued Common Shares**

At a special meeting of shareholders held on January 27, 2006, the shareholders approved that the outstanding common shares of the Company be consolidated on a one-for-sixteen basis (1:16). Subsequently, the TSX Venture Exchange granted its approval for the consolidation of common shares and the Articles of the Company were amended under the Business Corporations Act (Ontario). On October 22, 2006, 2,239,583 warrants to acquire common shares of the Company expired unexercised. At October 25, 2006, there are 12,742,848 post consolidated shares (fully diluted: 13,162,323) issued and outstanding.

## Exploration Programs

	Balance May 31, 2006 \$	Additions \$	Writedowns \$	Balance August 31, 2006 \$
<b>Acquisition costs</b>				
Franklin Project,				
Northwest Territories	1,190,764	-	-	1,190,764
Duquesne West, Quebec	25,000	-	-	25,000
	1,215,764	338,750	-	1,215,764
<b>Deferred exploration costs</b>				
Franklin Project,				
Northwest Territories	1,528,751	52,061	-	1,580,812
Duquesne West, Quebec	44,366	174,418	-	218,784
	1,573,117	226,479	-	1,799,596
	2,788,881	226,479	-	3,015,360

### **Franklin Project**

Effective November 26, 2003, the Company entered into an agreement to form a joint venture ("Franklin Diamond Project") with Darnley Bay Resources Ltd. ("DBR") for diamond exploration in an area near Paulatuk in the Northwest Territories. Diadem's earn-in requirement on the lands north of the 68<sup>th</sup> parallel is approximately \$3,100,000 and the earn-in period extends to December 31, 2007. DBR relinquished its participating interest in the joint venture lands south of the 68<sup>th</sup> parallel and transferred to Diadem 100% ownership in the permits and claims south of the 68<sup>th</sup> parallel.

Diadem and DBR entered into a Cooperation Agreement with the Inuvialuit Regional Corporation ("IRC") whereby the IRC agreed to cooperate to develop the diamond potential of certain Inuvialuit and Crown lands. The agreement is for a term of five years commencing January 1, 2004 with provisions for renewal and termination. Diadem and DBR are required to obtain all necessary Inuvialuit permits and approvals and will pay fees and charges under the Inuvialuit Rules with a minimum amount payable each year of \$50,000. Diadem and DBR were to incur at least \$2,000,000 of work by June 30, 2005. On March 1, 2005 the IRC extended the date from June 30, 2005 to September 30, 2005. Expenditures through August 31, 2006 were approximately \$1,831,000. Management believes that the main concern of the IRC is the completion of the field program, which, at the time of writing, is ongoing, and as such the IRC will look favourably upon the project. Through August 31, 2006, the Company has spent \$2,771,576 on assembly and exploration of the Franklin Project.

During the quarter ending August 31, 2006 exploration work was focused on completion of work carried out mostly in calendar 2005 and analyses thereof and culminated in the filing in August 2006 of a comprehensive assessment report with Natural Resources Canada.

During 2004 and 2005, the Company made various exploration deposits, totalling \$238,513, relating to the Franklin Project which were recoverable upon an equivalent amount being spent on qualified exploration expenditures. The Company did not spend a sufficient amount on qualified exploration to hold all its claims and permits and, consequently, applied the exploration deposits as amounts in lieu of work on the properties retained.

In recognition of the large amounts of money involved in diamond exploration in Canada's far north, Diadem is endeavouring to identify a senior industry partner to drill test known diamondiferous kimberlite pipes and highly prospective geophysical targets that have magnetic signatures similar to known kimberlite pipes and around which kimberlite indicator minerals have been found.

### **Duquesne Project**

On April 18, 2006, Diadem entered into an option agreement to acquire a 50% vested interest and the right to increase the vested interest to 57.5% in the Duquesne West gold project ("Project") north of Rouyn-Noranda, Quebec. The option agreement is with Jack Stoch Geoconsultant Services Inc. ("Vendor") and Globex Mining Enterprises Inc. ("Globex"). At the time the agreement was entered into Diadem made an initial cash payment to the Vendor of \$25,000.

The definitive option agreement is dated July 17, 2006. Under the agreement, Diadem can earn a 50% fully vested interest in the Project by spending \$6,000,000 over three years on exploration and development, of which \$1,000,000 is to be spent by June 30, 2007, an additional \$2,000,000 is to be spent by June 30, 2008 and an additional \$3,000,000 is to be spent by June 30, 2009. On September 5, 2006, Diadem made an additional cash payment to the Vendor of \$225,000, and issued 1,250,000 Diadem common shares to the Vendor having an assigned value of \$338,750. Diadem is also required to make additional cash payments of \$150,000 to the Vendor by June 30, 2007 and \$200,000 by June 30, 2008. Upon Diadem acquiring its 50% interest in the Project, Diadem would grant to the Vendor a 2.25% gross metal royalty based on Diadem's 50% interest in the Project. Once the 50/50 joint venture is formed, further exploration and development costs will be shared proportionately by Diadem and Globex.

Upon Diadem earning its 50% fully vested interest in the Project, it will have a one-time option to complete, at its cost, a positive bankable feasibility study required to put the Project into commercial production. Upon completion of a positive bankable feasibility study, or upon Diadem putting the Project into commercial production, including arranging the financing therefore, it will have the right to acquire from Globex an additional 7.5% fully vested interest in the Project upon payment to Globex of \$250,000 cash and the issue to Globex of 5% of the then issued and outstanding common shares of Diadem.

During September 2006, Diadem commenced a diamond drill program on the property. All costs incurred in respect of this program qualify as Canadian exploration expense.

### **Disclosure Controls and Procedures**

Management is responsible for the information disclosed in this management's discussion and analysis and has in place the appropriate information systems, procedures and controls to ensure that information used internally by management and disclosed externally is, in all material respects, complete and reliable. The Company has five officers, including the Chief Executive Officer, the Chief Financial Officer and the Corporate Secretary and no employees. The involvement of these three officers in all aspects of the design and operation of disclosure controls and procedures was effective as at and for the year ended May 31, 2006 and the period ended August 31, 2006 and provides reasonable assurance that all material information relating to the Company is disclosed.

### **Related Party Information**

Included in accounts payable and accrued liabilities is \$61,222 (May 31, 2006-\$120,167) due to directors for administrative, financial and geological services rendered to and expenses paid on behalf of the Company. Cost of services rendered to the Company by directors was \$54,000 (2006-\$44,000) during the three month periods ended August 31. In addition and during the three months ended August 31, 2006, \$75,000 was paid to two directors in respect of financial advisory services. These related party transactions are in the normal course of business and are measured at the exchange amount which is the amount of consideration established and agreed to by the related parties.

### **Financial Instruments**

Canadian generally accepted accounting principles require that the Company disclose information about the fair value of its financial assets and liabilities. Fair value estimates are made at the balance sheet date based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties in significant matters of judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect these estimates.

The carrying amounts for sundry receivables and accounts payable and accrued liabilities on the balance sheet approximate fair value because of the limited term of these instruments.

### **Risks**

The Company's assets are subject to the risk of increases in taxes and royalties, renegotiation of contracts and currency exchange fluctuations. Operational risks include finding and developing economic ore reserves. Financial risks include interest and U.S. dollar exchange rates, which are beyond the control of the Company. The ability of the Company to develop its properties and the future profitability of the Company are directly related to the market price of diamonds. The Company is subject to various regulatory risks, many of which also are beyond the control of the Company.

At August 31, 2006, the Company had commitments to expend approximately \$975,000 before December 31, 2006 on previously renounced flow-through exploration. In addition and during July 2006, Diadem raised flow-through proceeds of \$761,650. The Company is committed to expending these funds on flow-through exploration before December 31, 2007. There is no assurance that the Company can raise sufficient funds to satisfy these commitments.

*Paul A. Carroll*  
Chairman and  
Chief Executive Officer

*David J. Layman*  
Vice-President, Finance

October 30, 2006