



**ANNUAL REPORT
2008**



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

MAY 31, 2008

The following is Management's Discussion and Analysis ("MDA") of the financial condition and results of operations to enable a reader to assess material changes in financial condition and results of operations for the year ended May 31, 2008. This MDA has been prepared as at September 29, 2008, unless otherwise indicated. This MDA is intended to supplement and complement the financial statements and notes thereto for the period ended May 31, 2008. All amounts are expressed in Canadian dollars unless otherwise indicated.

Overview

Diadem Resources Ltd. is focused on acquiring near-production mining opportunities in North America, especially those related to diamonds and gold. Currently, its principal activity is diamond exploration in the Franklin Bay area within the Inuvialuit Settlement Region of the Northwest Territories. On that project Diadem now has identified 28 specific exploration targets on the Parry Peninsula, which currently constitutes most of the Franklin Bay project area. A ground magnetic survey has just been completed and diamond drilling is planned to evaluate these and other targets.

Selected Financial Information

	2008	2007	2006
Canadian dollars , except share amounts	\$	\$	\$
Cash	6,438	592,007	262,756
Mineral interests	3,851,614	2,760,573	2,788,881
Total assets	3,901,356	3,459,242	3,081,951
Working capital (deficiency)	(1,529,684)	209,530	(271,139)
Cash used in operations	(127,731)	(722,326)	(352,257)
Common Shares issued for cash	-	2,856,052	-
Common Shares outstanding	18,944,647	18,944,647	9,679,394
Revenue	6,628	65,984	87,496
Cost of operations	659,539	2,618,398	1,369,092
Net loss	(1,409,765)	(1,532,728)	(738,351)
Net loss per share- basic and diluted	(0.07)	(0.10)	(0.08)

Selected Quarterly Information

2008	Q1	Q2	Q3	Q4
	\$	\$	\$	\$
Revenues	4,406	1,882	112	228
Expenses	154,122	133,612	84,158	287,647
Net income (loss)	(149,716)	(131,730)	(832,472)	(295,847)
Basic and fully diluted income {loss} per share (Note)	(0.01)	(0.01)	(0.04)	(0.02)

2007	Q1	Q2	Q3	Q4
	\$	\$	\$	\$
Revenues	1,726	3,850	9,927	50,481
Expenses	142,562	118,946	216,285	2,140,605
Net income (loss)	(140,835)	(115,096)	813,328	(2,090,125)
Basic and fully diluted income {loss} per share (Note)	(0.01)	(0.01)	0.04	(0.11)

Results of Operations

General corporate costs were \$300,328 during 2008 compared to \$513,847 during 2007, excluding the effect of stock-based compensation. The decrease results principally from the elimination of financial advisory fees paid to two directors during 2007, a \$35,499 reduction in management compensation and a decrease in shareholder relations costs of \$10,065. The investor relations function was eliminated during 2006. Salaries, excluding the effect of stock-based compensation, approximate 65% (2007-45%) of general corporate costs. The Company recognised \$2,710 (2007-\$8,593) in non-cash stock-based compensation. There were no new grants of stock options during 2008 and 2007. At year end, all previous grants of stock options had been amortized to the statement of operations.

Interest costs totalled \$340,820 during fiscal 2008 (2007-\$94,265). Interest costs increased as a consequence of the imposition of Part XII.6 tax and penalties aggregating \$333,591 (2007-\$88,920) on unexpended Canadian exploration expenditures for flow-through purposes. In addition, the Company incurred \$7,109 in interest on a \$100,000 loan from Darnley Bay Resources in respect of payments to the Inuvialuit Regional Corporation and \$120 in other interest charges.

During fiscal 2007, the Company issued 7,876,403 flow-through shares for proceeds of \$2,823,053. During February 2007, the Company renounced the equivalent expenditure to its investors and recognized a non-cash future income tax recovery of \$1,019,686 (2006-\$543,245). During 2008, Diadem did not incur sufficient CEE during calendar 2007 to fully satisfy its flow-through commitments. The reversal of a previously recognized future income tax asset resulted in a charge to the statement of operations in the amount of \$756,854 during the year ended May 31, 2008 with an offsetting credit to deficit as a reduction of financing finance cost previously associated with the flow-through share issue.

At May 31, 2008, the Company had provided a valuation allowance of \$5,021,000 (2007-\$5,338,000) against future tax assets. As a consequence of issuing flow-through shares the Company created taxable temporary differences which can be reduced by previously unrecognized future tax assets. The recognition of the previously unrecognized future income tax asset results in a credit to the statement of operations with an offsetting charge to deficit as a cost of financing the flow-through share issue.

During fiscal 2008, other income decreased to \$6,628 from \$65,984 realized during fiscal 2007. Effective May 31, 2007, Diadem sold its investment in 20% of the common shares of Belitung Limited to the former Chairman in settlement of a \$44,000 claim for prior services rendered while still a director of Diadem but subsequent to the aforementioned transfer of assets. After deducting the cost basis for the shares, the Company recorded a net gain of \$43,989 on disposal of this investment.

During the year ended May 31, 2008, Diadem spent \$Nil (2007-\$1,787,742) on exploration of the Duquesne West gold project. The gold resource base was increased nominally but not sufficiently to justify continued exploration and development of the project. Consequently, the Company decided to write off the \$1,857,108 carrying value of its investment in the project. During 2007, the Company elected not to renew certain exploration permits held in respect of Franklin project prospects south of the 68th parallel and allowed the permits to lapse. The Company wrote off the \$144,585 carrying value attributable to the exploration permits.

As a result of its activities, the Company recorded a net loss, before recovery of future income taxes and write-down of mineral interests, of \$637,230 during fiscal 2008 compared to a loss of \$550,721 during fiscal 2007.

After reversal of future income taxes (2007-recovery) and write-down of mineral interests, the Company recorded a net loss of \$1,409,765 or \$0.07 per share during fiscal 2008 compared to a net loss of \$1,532,728 or \$0.10 per share during fiscal 2007.

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 reach positive cash flows from operations.

There is no assurance the Company can continue to finance its operations through the capital markets. Further, the Company needs to fund its administrative activities which constitute non-flow-through expenditures and is actively seeking funding of these expenditures.

The Company has reported significant losses for several years and has no mining operations and is, therefore, considered an exploration stage company. For the year ended May 31, 2007, the Company incurred negative operating cash flow. Operating cash flow for 2008 was positive solely as a result of reliance on suppliers to perform work on the promise of payment. Accounts payable includes fees and expenses payable to officers and directors of the Company in the aggregate amount of \$156,888. No officer of the Company has been paid since October, 2007.

At May 31, 2008, the Company had a working capital deficiency of \$1,529,684.

Contingent tax liability

As at December 31, 2007, Diadem was unable to satisfy approximately \$2,095,000 in flow-through funding pursuant to private placements for which flow-through proceeds had been received during 2006 and renounced to the subscribers with an effective date of December 31, 2006. In order to address the impact on subscribers to the Company's 2006 flow-through financings, the Company proposes to seek to enter into agreements with the affected subscribers to satisfy the indemnity provisions of the original subscription agreements.

Since the Company did not meet flow-through share expenditure requirements agreed to through various subscription agreements entered into during 2006, the Company has amended the renunciations provided to subscribers of these shares. The Company has accrued all penalties and interest charges related to this matter that could be reasonably estimated; however, the subscription agreements provided certain indemnities for certain amounts that will become payable by the subscribers upon reassessment of their personal tax returns with the amended and reduced renunciations. The contingent liability that may be created by this indemnity will depend on various items, including each individual subscriber's personal tax situation, and cannot therefore be reasonably estimated.

Status of Joint Venture with Darnley Bay Resources Limited

On November 29, 2007, the Company and Darnley Bay Resources Limited ("DBR") entered into an amending agreement providing for an extension to June 30, 2008 of the period during which Diadem may earn-in to a 50% interest in the Franklin Project. To satisfy Diadem's 50% earn-in requirement it was required to incur expenditures aggregating \$1.0 million during the period from September 1, 2007 through June 30, 2008. This expenditure requirement was satisfied by June 30, 2008.

Now that Diadem has satisfied its earn-in requirements, DBR will be required to carry its 50% pro rata share of on-going exploration and development costs or suffer dilution of its interest. Under the amended agreement, Diadem will advance \$1.0 million to subsequent Franklin Project programs on behalf of DBR and DBR will not have to contribute the first \$1.0 million of its 50% share of costs. If Diadem advances the \$1.0 million, DBR will repay such advance, without interest, out of its share of production from a diamond mine on the Franklin Project.

If a decision is made to carry out a feasibility study for a diamond mine, Diadem has the right to fund the study and, if the property is advanced to commercial production, Diadem's 50% interest will increase to 75% and DBR's interest will decrease to 25%.

Funding

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.

During November 2006, the Company placed 4,767,654 Units at a price of \$0.34 per Unit for aggregate gross proceeds of \$1,621,002. Each Unit consisted of one flow-through common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to purchase one additional common share for a

period of one year with an exercise price of \$0.45 per share and thereafter at an exercise price of \$0.60 per share for the period ending 24 months from the date of issuance. The gross proceeds were prorated to capital stock and warrants based on the relative fair value of each component, as follows: capital stock - \$1,251,199; warrants - \$369,403. A total of \$81,050 in cash commissions was paid and 381,412 non-flow-through broker warrants were issued, exercisable for a period of one year with an exercise price of \$0.45 per share and thereafter at an exercise price of \$0.60 per share for the period ending 24 months from the date of issuance. The broker warrants were valued at \$39,173. The fair values of the warrants and broker warrants were estimated using the Black-Scholes option-pricing model with the following weighted average assumptions: expected dividend yield of 0%, expected stock volatility of 100%, risk-free interest rate of 4.18% and an expected warrant life of 2 years.

During December 2006, the Company placed 1,295,295 Units at a price of \$0.34 per Unit for gross proceeds of \$440,400. Each Unit consisted of one flow-through common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to purchase one additional common share for a period of one year with an exercise price of \$0.45 per share and thereafter at an exercise price of \$0.60 per share for the period ending 24 months from the date of issuance. The gross proceeds were prorated to capital stock and warrants based on the relative fair value of each component, as follows: capital stock - \$305,177; warrants - \$135,223.

The effect of credit market turmoil in the United States has affected the ability of junior mining companies, in Canada, to finance their continuing operations. In particular, Diadem needs to raise "hard" non-flow-through funds to pay its recorded and contingent liabilities. There is no assurance that the Company will be able to raise sufficient capital to satisfy its obligations.

Issued Common Shares

At September 29, 2008, there were 18,944,647 shares issued and outstanding. In addition there were 131,250 employee stock options exercisable at an average price of \$1.69 per share and 5,209,061 warrants exercisable at a price of \$0.60 per share.

The Company considers in its management of capital all components included in shareholders' equity plus accounts payable. Its objectives are to ensure that the Company will continue to operate as a going concern in order to pursue development of its Franklin Property as well as to maintain a flexible capital structure which optimizes the cost 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. In order to maintain or adjust the capital structure, the Company may issue shares, seek debt financing, or acquire or dispose of assets. The Company, on approval from the Board of Directors, will make changes to its capital structure as deemed appropriate under specific circumstances.

Exploration Programs

	Balance May 31, 2007	Additions	Write-downs	Balance May 31, 2008
	\$	\$	\$	\$
Acquisition costs				
Franklin Project, Northwest Territories	<u>1,142,696</u>	-	-	<u>1,142,696</u>
	<u>1,142,696</u>	-	-	<u>1,142,696</u>
Deferred exploration costs				
Franklin Project, Northwest Territories	<u>1,617,877</u>	<u>1,091,041</u>	-	<u>2,708,918</u>
	<u>1,617,877</u>	<u>1,091,041</u>	-	<u>2,708,918</u>
	<u>2,760,573</u>	<u>1,091,041</u>	-	<u>3,851,614</u>

Franklin Project

Effective November 26, 2003, the Company entered into an agreement to form a joint venture ("Franklin Project") with DBR for diamond exploration in an area near Paulatuk in the Northwest Territories.

On November 29, 2007, the Company and DBR entered into an amending agreement providing for an extension to June 30, 2008 of the period during which Diadem may earn-in to a 50% interest in the Franklin Project. To satisfy Diadem's 50% earn-in requirement it was required to incur expenditures aggregating \$1.0 million during the period from September 1, 2007 through June 30, 2008. This expenditure requirement was satisfied by June 30, 2008.

Now that Diadem has satisfied its earn-in requirements, DBR will be required to carry its 50% pro rata share of on-going exploration and development costs or suffer dilution of its interest. Under the amended agreement, Diadem will advance \$1.0 million to subsequent Franklin Project programs on behalf of DBR and DBR will not have to contribute the first \$1.0 million of its 50% share of costs. If Diadem advances the \$1.0 million, DBR will repay such advance, without interest, out of its share of production from a diamond mine on the Franklin Project.

If a decision is made to carry out a feasibility study for a diamond mine, Diadem has the right to fund the study and, if the property is advanced to commercial production, Diadem's 50% interest will increase to 75% and DBR's interest will decrease to 25%.

Diadem is formulating a diamond drill program to test a number of ground magnetic anomalies believed to be reflecting underlying, diamond-bearing, kimberlite pipes. This drill program is expected to commence in the spring of 2009, assuming all required permits are received and adequate financing is obtained.

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 project ("Project") north of Rouyn-Noranda, Quebec. The option agreement was with Jack Stoch Geoconsultant Services Inc. ("Vendor") and Globex Mining Enterprises Inc. ("Globex").

The option agreement became effective July 17, 2006. Under the agreement, Diadem could 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 was to be spent by June 30, 2007, an additional \$2,000,000 was to be spent by June 30, 2008 and an additional \$3,000,000 was to be spent by June 30, 2009. Diadem made initial cash payments to the Vendor of \$225,000, and issued to the vendor 1,250,000 Diadem common shares valued at \$338,750 based on the quoted, closing market price of the Company's shares on the day of closing the agreement.

During May 2007, the Company elected not to proceed further with the project, allowed the option to lapse and wrote-off the carrying value of the project.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in Canada requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and reported amounts revenue and expenditures during the reporting period.

The financial statements follow the same accounting policies and methods set forth in the Company's audited financial statements as at and for the year ending May 31, 2007, except as noted below.

Capital Disclosure and Financial Instruments-Disclosure and Presentation

On December 1, 2006, the Canadian Institute of Chartered Accountants ("CICA") issued three new accounting standards: Handbook Section 1535-Capital Disclosures; Handbook Section 3862-Financial Instruments-Disclosure; and Handbook Section 3863-Financial Instruments-Presentation. These new accounting standards are effective for interim and annual financial statements for reporting periods beginning January 1, 2008.

Handbook Section 1535 specifies the disclosure of (i) an entity's objectives, policies and processes for managing capital; (ii) qualitative data concerning what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such non-compliance.

Handbook Sections 3862 and 3863 replace Handbook Section 3861-Financial Instruments-Disclosure and Presentation, revising and enhancing disclosure requirements for financial instruments and carrying forward,

unchanged, its presentation requirements. These new Handbook Sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. The Company is assessing the impact of these accounting standards on its financial statements.

On February 13, 2008, the Financial Accounting Standards Board confirmed that publicly accountable entities will be required to prepare financial statements in accordance with International Financial Reporting Standards ("IFRS") for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The Company is assessing the impact of the conversion from Canadian generally accepted accounting principles to IFRS on the financial statements and will develop a conversion implementation plan.

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 three officers, the Chief Executive Officer, the Chief Financial Officer, the Corporate Secretary and no employees. The involvement of these 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, 2008 and provides reasonable assurance that all material information relating to the Company is disclosed. The audit committee is actively involved in quarterly reviews and is comprised of three independent directors.

The Company evaluated the design of its internal controls and procedures over financial reporting as defined under Multilateral Instrument 52-109 for the year ended May 31, 2008. Based on this evaluation, management has concluded that the design of these internal controls and procedures over financial reporting was effective.

There were no changes in the operation of disclosure controls and procedures during 2008.

Financial Instruments

Canadian generally accepted accounting principles require that the Company disclose information about the fair value of its financial assets and liabilities effective for financial years commencing on or after October 1, 2007. 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.

Related Party Information

At May 31, 2008, due from related parties includes \$4,504 (2007-\$3,746) due from a corporation over which the Chairman has direction and control. The expenses were incurred on behalf of the related party and in respect of its regulatory filings. The amount was collected subsequent to May 31, 2008. At May 31, 2007, due from related parties includes \$707 from a corporation over which a former director exercised control and direction. The receivable resulted from mailing expenses incurred on behalf of the related party and was collected during the year ended May 31, 2008.

Included in accounts payable and accrued liabilities is \$71,888 due to two directors in their capacity of overseeing the Franklin exploration program (2007-\$12,040 due to one director). In addition, at May 31, 2008 \$75,000 was payable to the Chairman of the Company in respect of administrative services (2007-\$Nil) and \$10,000 as a loan to cover the cost of certain expenditures incurred by the Company in the ordinary course of business. The cost of services rendered to the Company, directly and indirectly, by these three directors was \$171,763 (2007-\$312,847) during 2008. 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.

During fiscal 2007, directors and officers of the Company subscribed for 808,726 common shares of Diadem for gross proceeds of \$309,900 pursuant to the private placements described in notes 6(b) and 6(c) to the financial statements.

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 exploited minerals and metals. The Company is subject to various regulatory risks, many of which also are beyond the control of the Company.

The Company is considered to be in the development stage and has not yet recorded any revenues from its mining operations nor has the Company commenced commercial production on any of its properties. There can be no assurance that the Company will generate any revenues or that the assumed levels of expenses will prove to be accurate.

The Company expects to incur losses unless and until such time as its properties enter into commercial production and generate sufficient revenues to fund its continuing operations. The development of the Company's properties will require substantial resources to complete the development of its properties. There can be no assurance that significant losses will not occur in the near future or that the Company will be profitable in the future. The Company's operating expenses and capital expenditures may increase in subsequent years as needed consultants, personnel and equipment associated with advancing exploration, development and commercial production of its properties are added. The amounts and timing of expenditures will depend on the progress of ongoing development, the results of consultants' analyses and recommendations, the rate at which operating losses are incurred, the execution of any joint venture agreements with strategic partners, the Company's acquisition of additional properties and other factors, many of which are beyond the Company's control.

The Company's vulnerability to changes in metal prices may cause its share price to be volatile and may affect the Company's operations and financial results.

The Company's primary source of revenue will be the sale of diamonds. Accordingly, changes in the market price of diamonds will significantly impact the Company's profitability and share price. The Company's financial results will be very sensitive to external economic factors related to the price of diamonds. A major risk will arise if there is a prolonged period of lower diamond prices. Many factors beyond the Company's control influence the market price of diamonds. These factors include: global supply and demand; availability and costs of substitutes; speculative activities; international political and economic conditions; and production levels and costs in other gold-producing countries.

The Company is subject to extensive environmental legislation and the costs of complying with these regulations may be significant. Changes in environmental legislation could increase the costs of complying with applicable regulations and reduce levels of production.

Environmental legislation relating to land, air and water affects nearly all aspects of the Company's operations. This legislation requires the Company to obtain various operating licenses and also imposes standards and controls on activities relating to exploration, development and production of gold and other precious metals. The cost of obtaining operating licenses and abiding by standards and controls on its activities may be significant. Further, if the Company fails to obtain or maintain such operating licenses or breaches such standards or controls imposed on its activities, it may not be able to continue its operations in its usual manner, or at all, or the Company may be subject to fines or other claims for remediation which may have a material adverse impact on its operations or financial results. While the Company is unaware of any existing material environmental liabilities, it cannot guarantee that no such liabilities currently exist or will occur in the future.

Changes in environmental laws, new information on existing environmental conditions or other events may increase future compliance expenditures or otherwise have a negative effect on the Company's financial condition and results of operations. In addition to existing requirements, it is expected that other environmental regulations will likely be implemented in the future with the objective of protecting human health and the environment. Some of the issues currently under review by environmental agencies include reducing or stabilizing air emissions, mine reclamation and restoration, and water quality. Other changes in environmental legislation could have a negative effect on production levels, product demand, product quality and methods of production and distribution. The complexity and breadth of these issues make it difficult for the Company to predict their impact. The Company expects that capital and operating expenditures will increase as a result of compliance with the introduction of new,

more stringent environmental regulations. Failure to comply with environmental legislation may result in the issuance of clean-up orders, imposition of penalties, liability for related damages and the loss of operating permits. While the Company believes it is now in material compliance with existing environmental legislation, it cannot give assurances that it will, at all future times, be in compliance with all federal and provincial environmental regulations or that steps to bring the Company into compliance would not have a negative effect on its financial condition and results of operations.

The mining industry is intensely competitive and the Company must compete in all aspects of its operations with a substantial number of other junior mining companies, some of which have greater technical and financial resources. The Company may be at a disadvantage with respect to some of its competitors in the acquisition and/or development of high potential mining properties throughout the principal markets and geographical areas in which the Company carries on its business activities.

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 reach positive cash flows from operations.

Forward Looking Information

This MDA contains "forward looking information". Forward looking information includes, but is not limited to, statements concerning mineral resource estimates and exploration budgets for the Franklin Project and other statements which are not historical facts.

In certain cases, forward looking information can be identified by the use of words such as "plans", "expects" or "does not expect", "is expected", "budget", "scheduled", "estimates", "forecasts", "intends", "anticipates" or "does not anticipate", or "believes", or variations of such words and phrases or state that certain actions, events or results "may", "could", "would", "should", "might" or "will be taken", "occur" or "be achieved" and include the negative variation of such phrases.

With respect to forward looking information contained in this MDA, the Company has made assumptions regarding, among other things, the Company's ability to generate sufficient cash flow from operations and access existing credit facilities and capital markets to meet its future obligations, the regulatory framework in the provinces in which its properties are located with respect to, among other things, permits, licenses, authorizations, royalties, taxes and environmental matters, and the Company's ability to obtain qualified staff and equipment in a timely and cost-efficient manner to meet the Company's demand.

Although the Company believes that its expectations reflected in forward looking information are reasonable, such forward looking information involves known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company or the Company's projects to be materially different from any future results, performance or achievements expressed or implied by the forward looking information. Such factors include, risks related to failure to convert estimated mineral resources to reserves, conclusions of economic evaluations, changes in project parameters as plans continue to be refined, future prices of gold, unexpected increases in capital or operating costs, possible variations in mineral resources, grade or recovery rates, failure of equipment or processes to operate as anticipated, accidents, labour disputes and other risks of the mining industry, delays in obtaining governmental consents, permits, licences and registrations or financing or in the completion of development or construction activities, uncertainties relating to the availability and costs and availability of financing needed in the future, changes in equity markets, inflation, changes in exchange rates, fluctuations in commodity prices and uninsured risks, as well as those factors discussed under "Risks" in this MDA.

Although the Company has attempted to identify important factors that could cause actual actions, events or results to differ materially from those described in forward looking information, there may be other factors that cause actions, events or results not to be as anticipated, estimated or intended. There can be no assurance that forward looking information will prove to be accurate, as actual results and future events could differ materially from those anticipated in such information. Accordingly, readers should not place undue reliance on forward looking information. The forward looking information contained herein, unless stated otherwise, is made as of the date of this MDA and the Company makes no responsibility to update them or to revise them to reflect new events or circumstances, except as required by law.

Any mineral resource and mineral reserve figures referred to in this MDA are estimates and no assurances can be given that the indicated levels of minerals will be produced. Such estimates are expressions of judgment based on knowledge, mining experience, analysis of drilling results and industry practices. Valid estimates made at a given time may significantly change when new information becomes available. While the Company believes that the resource and reserve estimates referred to in this MDA are well established, by their nature resource and reserve estimates are imprecise and depend, to a certain extent, upon statistical inferences which may ultimately prove unreliable. If such estimates are inaccurate or are reduced in the future, this could have a material adverse impact on the Company. Due to the uncertainty that may be attached to inferred mineral resources, it cannot be assumed that all or any part of an inferred mineral resource will be upgraded to an indicated or measured mineral resource as a result of continued exploration.

Paul A. Carroll
Chairman and
Chief Executive Officer

David J. Layman
Vice-President, Finance

September 29, 2008



(An Exploration Stage Company)

CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 2008 AND 2007

(Expressed in Canadian Dollars)

DIA  DEM
R E S O U R C E S L T D.

(An Exploration Stage Company)

CONSOLIDATED FINANCIAL STATEMENTS

MAY 31, 2008 AND 2007

(Expressed in Canadian Dollars)

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AUDITORS' REPORT

To the Shareholders of
DIADEM RESOURCES LTD.

We have audited the consolidated balance sheets of Diadem Resources Ltd. (a Development Stage Company) as at May 31, 2008 and 2007 and the consolidated statements of operations and deficit and cash flows for each of the years in the two-year period ended May 31, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at May 31, 2008 and 2007 and the results of its operations and its cash flows for each of the years in the two-year period ended May 31, 2008 in accordance with Canadian generally accepted accounting principles.

MCGOVERN, HURLEY, CUNNINGHAM, LLP

A handwritten signature in cursive script that reads 'McGovern, Hurley, Cunningham, LLP'.

**Chartered Accountants
Licensed Public Accountants**

Toronto, Canada
September 15, 2008

(Expressed in Canadian Dollars)	2008 \$	2007 \$
ASSETS		
CURRENT		
Cash	6,438	592,007
Accounts receivable-		
Due from related parties (Note 7)	4,504	4,453
Taxes recoverable (Note 4)	28,872	92,112
Prepaid expenses	<u>5,197</u>	<u>3,338</u>
	45,011	691,910
MINERAL INTERESTS (Note 3)	3,851,614	2,760,573
EQUIPMENT (Note 5)	<u>4,731</u>	<u>6,759</u>
	<u>3,901,356</u>	<u>3,459,242</u>
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities (Notes 3 and 7)	1,074,434	318,432
Other taxes payable (Note 10)	<u>500,261</u>	<u>163,948</u>
	<u>1,574,695</u>	<u>482,380</u>
SHAREHOLDERS' EQUITY		
CAPITAL STOCK (Notes 6(a) and (b))	33,824,873	33,824,873
WARRANTS (Note 6(d))	543,799	543,799
CONTRIBUTED SURPLUS (Note 6(f))	1,667,538	1,664,828
DEFICIT	<u>(33,709,549)</u>	<u>(33,056,638)</u>
	<u>2,326,661</u>	<u>2,976,862</u>
	<u>3,901,356</u>	<u>3,459,242</u>

Commitments and contingencies (Notes 1, 3 and 10)

APPROVED ON BEHALF OF THE BOARD:

Signed "P. A. Carroll"_____, Director

Signed "Aime Bertrand"_____, Director

(An Exploration Stage Company)

**CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
FOR THE YEARS ENDED MAY 31**

(Expressed in Canadian Dollars)	2008 \$	2007 \$
REVENUE		
Gain on sale of investment and other	-	43,979
Interest income	6,400	22,005
Foreign exchange	<u>228</u>	<u>22,005</u>
	<u>6,628</u>	<u>65,984</u>
EXPENSES		
Amortization	2,028	2,210
Business development	52	2,357
Capital tax (recovered)	(79)	4,234
Advisory fees	-	106,200
Interest and penalties (Note 10)	340,820	94,265
Management fees, salaries and benefits	192,000	227,499
Office expenses and other	12,174	54,822
Professional fees	45,333	53,728
Shareholder relations	48,820	58,885
Travel	-	3,912
Stock-based compensation	2,710	8,593
Write-down of mineral interests (Note 3(b))	<u>15,681</u>	<u>2,001,693</u>
	<u>659,539</u>	<u>2,618,398</u>
Loss before income taxes	(652,911)	(2,552,414)
Future income taxes (Note 9)	<u>(756,854)</u>	<u>1,019,686</u>
NET LOSS FOR THE YEAR	(1,409,765)	(1,532,728)
DEFICIT , beginning of year	(33,056,638)	(30,266,479)
Costs associated with issuance of capital stock (Note 9)	<u>756,854</u>	<u>(1,257,431)</u>
DEFICIT , end of year	<u>(33,709,549)</u>	<u>(33,056,638)</u>
NET LOSS PER SHARE - basic and diluted	(0.07)	(0.10)
WEIGHTED AVERAGE NUMBER OF COMMON SHARES	18,944,647	15,413,488

See accompanying notes to the consolidated financial statements.

DIADEM RESOURCES LTD.
(An Exploration Stage Company)
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED MAY 31

(Expressed in Canadian Dollars)	2008 \$	2007 \$
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss for the year	(1,409,765)	(1,532,728)
Adjustment for items not affecting cash:		
Amortization	2,028	2,210
Write-down of mineral interests	-	2,001,693
Gain on disposal of investment and other	-	(43,979)
Stock-based compensation	2,710	8,593
Future income taxes	<u>756,854</u>	<u>(1,019,686)</u>
	<u>(648,173)</u>	<u>(583,897)</u>
Net changes in non-cash working capital balances:		
Prepaid expenses	(1,859)	1,175
Taxes recoverable	63,240	(55,587)
Sundry receivable	-	1,555
Due from related parties	(51)	(4,453)
Accounts payable and accrued liabilities	122,799	(137,538)
Other taxes payable	<u>336,313</u>	<u>56,419</u>
	<u>520,442</u>	<u>(138,429)</u>
Cash flows from operating activities	<u>(127,731)</u>	<u>(722,326)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Common shares issued for cash	-	2,856,053
Costs associated with issuance of capital stock	<u>-</u>	<u>(198,572)</u>
Cash flows from financing activities	<u>-</u>	<u>2,657,481</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Equipment	-	(2,280)
Mineral interests	<u>(457,838)</u>	<u>(1,603,624)</u>
Cash flows from investing activities	<u>(457,838)</u>	<u>(1,605,904)</u>
Change in cash during the year	(585,569)	329,251
CASH , beginning of year	<u>592,007</u>	<u>262,756</u>
CASH , end of year	<u>6,438</u>	<u>592,007</u>

SUPPLEMENTAL INFORMATION (Note 8)

1. NATURE OF OPERATIONS AND GOING CONCERN

Diadem Resources Ltd. (the "Company" or "Diadem") is in the process of acquiring, exploring and developing its mineral interests in North America and is thus considered to be an exploration stage company. The business of mining and exploring for minerals involves a high degree of risk and there can be no assurance that current exploration programs will result in profitable mining operations.

Although the Company has taken steps to verify title to the properties on which it is conducting exploration and in which it has an interest, in accordance with industry standards for the current stage of exploration of such properties, these procedures do not guarantee the Company's title. Property title may be subject to unregistered prior agreements, aboriginal claims and non-compliance with regulatory and environmental requirements.

The recoverability of the amounts shown for mineral interests is dependent upon the existence of economically recoverable reserves, the ability of the Company to obtain necessary financing to complete the development of those reserves, upon future profitable production and/or the proceeds from the disposition thereof. To date, the Company has not earned significant revenues.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the Company and its subsidiary are in accordance with Canadian generally accepted accounting principles and their basis of application is consistent with that of the previous year, except as described below. Outlined below are those policies considered particularly significant.

Basis of Consolidation:

The consolidated financial statements include the accounts of Diadem Resources Ltd. and its wholly-owned subsidiary Diadem Explorations Inc.

Equipment and Amortization:

Equipment is recorded at cost and is amortized over its estimated useful life using the declining balance basis at the following annual rates:

Computer and office equipment	30%
-------------------------------	-----

Accounting Changes:

On June 1, 2007, the Company adopted the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 1530, *Comprehensive Income*; Section 3251, *Equity*; section 3855, *Financial Instruments-Recognition and Measurement*; Section 3861, *Financial Instruments-Disclosure and Presentation*; and section 3865, *Hedges*.

Financial Instruments:

Under the new standards, financial assets and liabilities, including derivative instruments, are initially recognized and subsequently measured based on their classification as "held-for-trading", "available-for-sale financial assets", "held-to-maturity", "loans and receivables", or "other" financial liabilities. Held-for-trading financial instruments are measured at their value with changes in fair value recognized in net income for the period. Available-for-sale financial assets are measured at their fair value and changes in fair value are included in other comprehensive income until the asset is removed from the balance sheet.

(An Exploration Stage Company)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**FOR THE YEARS ENDED MAY 31, 2008 and 2007

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Held-to-maturity investments, loans and receivables and other financial liabilities are measured at amortized cost using the effective interest rate method. Derivative instruments, including embedded derivatives, are measured at their fair value with changes in fair value recognized in net income for the period, unless the instrument is a cash flow hedge and hedge accounting applies, in which case changes in fair value are recognized in other comprehensive income.

Comprehensive Income

Section 1530 of the CICA Handbook establishes standards for reporting and presenting comprehensive income. Comprehensive income, composed of net income and other comprehensive income, is defined as the change in shareholders' equity from transactions and other non-owner sources. The Company has no accumulated other comprehensive income and, therefore, no statement of other comprehensive income has been prepared.

Hedging

Section 3865 of the CICA Handbook specifies the circumstances under which hedge accounting is permissible and how hedge accounting may be performed. As at and for the year ended May 31, 2008, the Company had no hedges in place.

The application of these new standards has no impact on the Company's consolidated financial statements as at and for the year ended May 31, 2008.

Foreign Currency Translation:

The Company's functional and reporting currency is the Canadian dollar. Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the rate of exchange prevailing at the statement date. Non-monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at historical exchange rates. Revenue and expense items, other than amortization, are translated at the average rate of exchange for the year. An exchange gain or loss that arises on translation or settlement of a foreign currency denominated monetary item is included in operations for the period.

Mineral Interests:

The exploration activities of the Company are directed towards the search, evaluation and development of mineral properties. Major expenditures are required to locate and establish ore reserves to develop metallurgical processes and to construct mining and processing facilities at a particular site.

The recoverability of values assigned to mineral interests is dependent upon discovery of economically recoverable reserves, confirmation of the Company's interest in the mineral claims, the ability to obtain necessary financing to complete development and future profitable production or proceeds from disposition. Management reviews the carrying value of the Company's interest in each property whenever events or changes in circumstances indicate that their carrying amount may not be recoverable and, where necessary, these properties are written down to their estimated recoverable amount. It is reasonably possible that certain events could adversely affect management's estimates of recoverable amounts and the need for, as well as the amount of, provision for impairment in the carrying value of mineral interests and related assets.

The cost of acquisition of mineral interests and related exploration costs are deferred until the properties to which they relate are placed into production, sold or allowed to lapse. These costs will be amortized over the estimated useful life of the properties following commencement of commercial production or written off if the properties are sold or allowed to lapse. The Company does not accrue future costs to keep the properties in good standing. Administrative expenditures, not directly related to property maintenance, are charged to operations as incurred.

Continued...

(An Exploration Stage Company)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**FOR THE YEARS ENDED MAY 31, 2008 and 2007

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Company recognizes government assistance in the form of mineral exploration and mining tax credits when the amounts to be received can be reasonably estimated and collection can be reasonably assured. The amount of mineral exploration and mining tax credit reduces the Company's capitalized mineral property costs.

Stock-based Compensation:

All stock-based awards made to employees and non-employees are measured and recognized using a fair value based method. For employees, the fair value of the options at the date of grant is accrued and charged to operations or capitalized to a resource property, with the offsetting credit to contributed surplus, on a straight line basis over the vesting period. If and when the stock options are ultimately exercised, the applicable amounts of contributed surplus are transferred to share capital. For non-employees, the fair value of the options is measured on the earlier of the date at which the counterparty performance is complete or the date the performance commitment is reached or the date upon which the equity instruments are granted if they are fully vested and non-forfeitable.

Use of Estimates:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses during the year. Actual results could differ from estimates. During the fiscal years presented, management has made a number of significant estimates and valuation assumptions regarding the recoverability of investments in mining interests and deferred exploration costs. These estimates and valuation assumptions are in accordance with Canadian mining industry practice. Other significant estimates include the valuation of stock-based compensation, contingencies, asset retirement obligations and tax accounts.

Share Purchase Warrants:

The Company, from time-to-time, issues units which are normally comprised of a common share and a share purchase warrant. The common shares are issued at the then current market value with the share purchase warrant exercisable at a price equal to or higher than the market value of the common share. The Company allocates the proceeds of the unit offering between the common shares and the share purchase warrants based on the fair value of each component.

Asset Retirement Obligations:

The fair value of a liability for an asset retirement obligation is recognized in the period in which it is incurred. Also, when the liability is initially recorded, a corresponding increase in the carrying amount of the related asset is recorded.

On an annual basis, the liability is increased by the interest factor that was applied in the initial measurement of fair value and the asset is amortized over the estimated life of the related asset. The amount of the liability will be subject to re-measurement at the end of each reporting period. Any adjustment to this liability will impact the related asset.

As at May 31, 2008 and 2007, the Company had no significant asset retirement obligations.

Loss Per Share:

Basic loss per share is calculated using the weighted number of shares outstanding for the period. Diluted loss per share is calculated using the treasury stock method. In order to determine diluted loss per share, the treasury stock method assumes that any proceeds from the exercise of dilutive stock options and warrants would be used to repurchase common shares at the average market price during the period, with the incremental number of shares being included in the denominator of the diluted loss per share calculation.

Continued...

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The diluted loss per share calculation excludes any potential conversion of options and warrants that would increase earnings per share or decrease loss per share.

Flow-through Financing:

The Company has financed a portion of its exploration activities in Canada through the issue of flow-through shares, which transfers the tax deductibility of Canadian exploration expenditures to the investor. Proceeds received on the issue of such shares are credited to capital stock. The related exploration costs, when incurred, are charged to mineral interests.

Resource expenditure deductions for income tax purposes related to exploration and development activities funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. The tax benefit forgone on renunciation of Canadian exploration expenditures to investors is charged to deficit as a cost of equity financing when such amounts are renounced.

Income Taxes:

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method of tax allocation, future income taxes are determined based on the differences between the financial reporting and tax bases of assets and liabilities. These income tax assets and liabilities are measured using the substantially enacted tax rates in which the income tax assets and liabilities are expected to be settled or realized. A valuation allowance is provided to the extent that it is more likely than not that future income tax assets will not be realized.

New Accounting Pronouncements:

- (i) Financial Instruments-Disclosure (Section 3862) and Financial Instruments-Presentation (Section 3863)

Section 3862 replaces the disclosure portion of Section 3861, Financial Instruments-Disclosure and Presentation, and enhances the disclosure requirements on the nature and extent of risks arising from financial instruments and how these risks are managed. Section 3863 carries forward the presentation requirements from Section 3861. Effective June 1, 2008, the Company adopted these standards. Beyond additional disclosures, the adoption of these new pronouncements would not have an effect on the Company's financial position or results of operations.

- (ii) Capital Disclosures (Section 1535)

Section 1535 establishes standards for disclosure of qualitative and quantitative disclosure about an entity's capital and how it is managed in order to enable users of its financial statements to evaluate the entity's objectives, policies and processes of managing its capital. Effective June 1, 2008, the Company adopted these standards. Beyond additional disclosures, the adoption of these standards would not have an effect on the Company's financial position or results of operations.

- (iii) General Standards of Financial Statement Presentation (Section 1400)

The amendment to this section provides revised guidance related to management's responsibility to assess the ability of the entity to continue as a going concern. Effective June 1, 2008, the Company adopted the amendment to this section. Beyond additional disclosure, the adoption of this amendment would not have an effect on the Company's financial position or results of operations.

(An Exploration Stage Company)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2008 and 2007

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(iv) International Financial Reporting Standards

On February 13, 2008, the Accounting Standards Board confirmed that publicly accountable entities will be required to prepare financial statements in accordance with International Financial Reporting Standards ("IFRS") for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The Company is assessing the impact of the conversion from Canadian generally accepted accounting principles to IFRS on its consolidated financial statements and will develop a conversion implementation plan.

3. MINERAL INTERESTS

	Balance May 31, 2007 \$	Additions \$	Write-downs \$	Balance May 31, 2008 \$
Acquisition costs				
Franklin Project, Northwest Territories	<u>1,142,696</u>	<u>-</u>	<u>-</u>	<u>1,142,696</u>
Deferred exploration costs				
Franklin Project, Northwest Territories	<u>1,617,877</u>	<u>1,091,041</u>	<u>-</u>	<u>2,708,918</u>
	<u>2,760,573</u>	<u>1,091,041</u>	<u>-</u>	<u>3,851,614</u>

	Balance May 31, 2006 \$	Additions \$	Write-downs \$	Balance May 31, 2007 \$
Acquisition costs				
Franklin Project, Northwest Territories	1,190,764	-	(48,068)	1,142,696
Duquesne West, Quebec	<u>25,000</u>	<u>563,750</u>	<u>(588,750)</u>	<u>-</u>
	<u>1,215,764</u>	<u>563,750</u>	<u>(636,818)</u>	<u>1,142,696</u>
Deferred exploration costs				
Franklin Project, Northwest Territories	1,528,751	185,643	(96,517)	1,617,877
Duquesne West, Quebec	<u>44,366</u>	<u>1,223,992</u>	<u>(1,268,358)</u>	<u>-</u>
	<u>1,573,117</u>	<u>1,409,635</u>	<u>(1,364,875)</u>	<u>1,617,877</u>
	<u>2,788,881</u>	<u>1,973,385</u>	<u>(2,001,693)</u>	<u>2,760,573</u>

(a) Franklin Project, Northwest Territories

Effective November 26, 2003, the Company entered into an agreement to form a joint venture ("Franklin Project") with Darnley Bay Resources Limited ("DBR") for diamond exploration in an area near Paulatuk in the Northwest Territories.

The transaction resulted from an acquisition from Carnarvon Capital Corporation ("CCC") of that company's right to enter into the joint venture. To acquire the rights to form the joint venture, Diadem issued to CCC 375,000 Diadem common shares, valued at \$600,000. Paul Carroll, Chairman and CEO of Diadem, also is President of CCC and all of its share capital is owned by members of his immediate family. As part of the transfer to Diadem of the transaction with DBR, CCC and Mr. Carroll

Continued...

(An Exploration Stage Company)**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**FOR THE YEARS ENDED MAY 31, 2008 and 2007

3. MINERAL INTERESTS (Continued)

have agreed that, during the period ending December 31, 2008, neither CCC nor Mr. Carroll would acquire a controlling interest in any diamond exploration or development project in Canada (or in California) other than through Diadem or with the consent of Diadem.

Under the agreement, Diadem was to expend \$5,000,000 on diamond exploration within the Inuvialuit settlement region north of the 68th parallel by December 31, 2006. When this earn-in level of expenditure is completed, Diadem will have earned an undivided 50% participating interest in the selected lands, with DBR holding the other 50%. If a decision is made to carry out a feasibility study on the lands, it will have the right to fund the feasibility study, and if the property is placed into commercial production Diadem's interest will increase to 75% and DBR's interest will decrease to 25%.

Effective March 15, 2005, Diadem's earn-in requirement on the lands north of the 68th parallel was reduced to approximately \$3,100,000 and the earn-in period was extended to December 31, 2007.

DBR relinquished its participating interest in the joint venture lands south of the 68th parallel and transferred to Diadem 100% ownership in the permits and claims south of the 68th parallel. In fiscal 2007, the Company relinquished and wrote-off the carrying value of the lands south of the 68th parallel.

On November 29, 2007, the Company and DBR entered into an amending agreement providing for an extension to June 30, 2008 of the period during which Diadem may earn a 50% interest in the Franklin Project. To satisfy Diadem's 50% earn-in requirement, Diadem was required to incur expenditures aggregating \$1.0 million during the period September 1, 2007 through June 30, 2008. A list of expenditures in excess of \$1.0 million has been provided to DBR for the amended period for earn-in. DBR has not yet ratified the list of expenditures. Under the terms of the agreement, DBR will be required to carry its 50% pro rata share of on-going exploration and development costs or suffer dilution of its interest. Under the amended agreement, Diadem will advance \$1.0 million to subsequent Franklin Project programs on behalf of DBR and DBR will not have to contribute the first \$1.0 million of its 50% share of costs. If Diadem advances the \$1.0 million, DBR will repay such advance, without interest, out of its share of any future production from a diamond mine on the Franklin Project.

If a decision is made to carry out a feasibility study for a diamond mine, Diadem has the right to fund the study and, if the property is advanced to commercial production, Diadem's 50% interest will increase to 75% and DBR's interest will decrease to 25%.

The Company 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 5 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 the fees and charges under the Inuvialuit Rules with a minimum amount payable each year of \$50,000.

At May 31, 2008, accounts payable includes an amount of \$100,000 payable to DBR in respect of payments made to the IRC, plus interest of \$7,109. This amount is considered a loan from DBR and bears interest at DBR's bank prime plus 1%. Diadem was to repay the loan by March 31, 2008; however, at May 31, 2008, the loan remains outstanding. Also included in payables is \$100,000 payable directly to the IRC.

Continued...

(An Exploration Stage Company)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2008 and 2007

3. MINERAL INTERESTS (Continued)

The Inuvialuit will receive a 2% diamond royalty on mining rights exploited by the joint venture. The Inuvialuit can hold certain claims in the area in which there is a 15-year deferral of Crown royalties. In such cases the Inuvialuit will receive an additional 4% royalty while the deferral applies. If a positive feasibility is completed, the Inuvialuit have the right to acquire up to a 10% participating interest by paying the corresponding percentage of the cost of the feasibility study.

(b) Duquesne West Project, Quebec

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 project north of Rouyn-Noranda, Quebec. The option agreement was with Jack Stoch Geoconsultant Services Inc. ("Vendor") and Globex Mining Enterprises Inc. ("Globex").

The option agreement became effective July 17, 2006. Under the agreement, Diadem could have earned 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 was to be spent by June 30, 2007, an additional \$2,000,000 was to be spent by June 30, 2008 and an additional \$3,000,000 was to be spent by June 30, 2009. Diadem made initial cash payments to the Vendor of \$225,000, and issued to the Vendor 1,250,000 Diadem common shares valued at \$338,750 based on the quoted, closing market price of the Company's shares on the day of closing the agreement.

During May 2007, the Company elected not to proceed further with the project, allowed the option to lapse and wrote-off the carrying value of the project. During 2008, the Company incurred \$15,681 in exploration expenditure which was expensed.

4. TAXES RECOVERABLE

Taxes recoverable consist of:

	<u>2008</u>	<u>2007</u>
	\$	\$
Province of Quebec income and mining tax credits	-	18,910
Province of Quebec sales tax credits	-	64,744
Government of Canada goods and services tax credits	<u>28,872</u>	<u>8,458</u>
	<u>28,872</u>	<u>92,112</u>

5. EQUIPMENT

	<u>2008</u>		<u>2007</u>	
	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net</u>	<u>Net</u>
	\$	\$	\$	\$
Computer and office equipment	15,694	10,963	4,731	6,759

6. SHAREHOLDERS' EQUITY

(a) Capital Stock

Authorized capital stock of the Company consists of an unlimited number of special shares, redeemable and retractable at paid-up value and an unlimited number of common shares.

(An Exploration Stage Company)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2008 and 2007

6. SHAREHOLDERS' EQUITY (Continued)

(b) Issued and Outstanding Shares

Details of issued and outstanding common shares are as follows:

	2008		2007	
	#	\$	#	\$
Balance, beginning of year	18,944,647	33,824,873	9,679,394	31,080,221
Issued pursuant to:				
Shares issued for cash	-	-	110,000	33,000
Conversion of Series B Preference Shares	-	-	28,850	54,475
Flow-through financings (Note 6(c))	-	-	7,876,403	2,823,053
Shares issued for property	-	-	1,250,000	338,750
Issue of warrants (Notes 6 (c) and (d))	-	-	-	(504,626)
Balance, end of year	<u>18,944,647</u>	<u>33,824,873</u>	<u>18,944,647</u>	<u>33,824,873</u>

(c) Flow-through Financings

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.

During November 2006, the Company placed 4,767,654 Units at a price of \$0.34 per Unit for aggregate gross proceeds of \$1,621,002. Each Unit consisted of one flow-through common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to purchase one additional common share for a period of one year with an exercise price of \$0.45 per share and thereafter at an exercise price of \$0.60 per share for the period ending 24 months from the date of issuance. The gross proceeds were prorated to capital stock and warrants based on the relative fair value of each component, as follows: capital stock - \$1,251,599; warrants - \$369,403. A total of \$81,050 in cash commissions was paid and 381,412 non-flow-through broker warrants were issued, exercisable for a period of one year with an exercise price of \$0.45 per share and thereafter at an exercise price of \$0.60 per share for the period ending 24 months from the date of issuance. The broker warrants were valued at \$39,173. The fair values of the warrants and broker warrants were estimated using the Black-Scholes option-pricing model with the following weighted average assumptions: expected dividend yield of 0%, expected stock volatility of 100%, risk-free interest rate of 4.18% and an expected warrant life of 2 years.

During December 2006, the Company placed 1,295,295 Units at a price of \$0.34 per Unit for gross proceeds of \$440,400. Each Unit consisted of one flow-through common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to purchase one additional common share for a period of one year with an exercise price of \$0.45 per share and thereafter at an exercise price of \$0.60 per share for the period ending 24 months from the date of issuance. The gross proceeds were prorated to capital stock and warrants based on the relative fair value of each component, as follows: capital stock - \$305,177; warrants - \$135,223.

Continued...

(An Exploration Stage Company)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2008 and 2007

6. SHAREHOLDERS' EQUITY (Continued)

(d) Warrants

A summary of the Company's warrant activity during the years ended May 31, 2008 and 2007 is as follows:

	2008		2007	
	Warrants	Weighted Average	Warrants	Weighted Average
		Exercise price		Exercise price
	#	\$	#	\$
Outstanding, beginning of year	5,209,061	0.45	2,239,583	1.60
Granted	-	-	6,444,361	0.45
Cancelled	-	-	(1,235,300)	(0.45)
Expired	-	-	(2,239,583)	1.60
Outstanding, end of year ⁽¹⁾	<u>5,209,061</u>	0.60	<u>5,209,061</u>	0.45

A summary of warrants outstanding at May 31, 2008 is as follows:

Expiry date	Warrants	Exercise Price	Fair Value
	#	\$	\$
November 15, 2008	3,913,766	0.60	408,576
December 20, 2008	<u>1,295,295</u>	0.60	<u>135,223</u>
	<u>5,209,061</u>	0.60	<u>543,799</u>

(1) During 2008 and pursuant to the terms of the warrants described in Note 6(c), the exercise price of the outstanding warrants increased from \$0.45 per share to \$0.60 per share.

(e) Stock Option Plan

The Company has a stock option plan to aid in retaining and encouraging directors, senior officers, employees and service providers of the Company. Diadem's stock option plan permits reserving for issuance under the stock option plan, at any time, of a maximum of 10% of the issued and outstanding shares of the Company at the date of grant. The options are non-assignable and may be granted for a term not exceeding five years. The exercise price is fixed by the board of directors of the Company at the time of grant, subject to all applicable regulatory requirements.

A summary of the Company's stock option activity is as follows:

	Options	Weighted average
	#	exercise price
		\$
Outstanding, May 31, 2006	812,500	1.62
Expired	(421,875)	1.63
Outstanding, May 31, 2007	390,625	1.63
Expired	(259,375)	1.60
Outstanding, May 31, 2008	<u>131,250</u>	1.62

Continued...

6. SHAREHOLDERS' EQUITY (Continued)

The following is a summary of stock options outstanding at May 31, 2008:

<u>Expiry Date</u>	<u>Exercise Price</u>	Options Outstanding	Options Exercisable
	\$	#	#
October 8, 2008	1.84	6,250	6,250
October 8, 2008	1.60	31,250	31,250
November 20, 2008	1.60	6,250	6,250
October 18, 2009	1.68	15,625	15,625
November 1, 2009	1.60	46,875	46,875
July 19, 2010	1.60	<u>25,000</u>	<u>20,000</u>
		<u>131,250</u>	<u>126,250</u>

(f) Contributed Surplus

A summary of the Company's contributed surplus activity is as follows:

	<u>2008</u>	<u>2007</u>
	\$	\$
Balance, beginning of year	1,664,828	872,805
Stock-based compensation	2,710	8,593
Expiry of warrants	-	<u>783,430</u>
Balance, end of year	<u>1,667,538</u>	<u>1,664,828</u>

7. RELATED PARTY TRANSACTIONS AND BALANCES

At May 31, 2008, due from related parties includes \$4,504 (2007-\$3,746) due from a corporation over which the Chairman of the Company has direction and control. The expenses were incurred on behalf of the related party and in respect of its regulatory filings. The amount was collected subsequent to May 31, 2008. At May 31, 2007, due from related parties includes \$707 from a corporation over which a former director of the Company exercised control and direction. The receivable resulted from mailing expenses incurred on behalf of the related party and was collected during the year ended May 31, 2008.

Included in accounts payable and accrued liabilities is \$71,888 due to two directors in their capacity of overseeing the Franklin Project exploration program (2007-\$12,040 due to one director). In addition, at May 31, 2008, \$75,000 was payable to the Chairman of the Company in respect of administrative services (2007-\$Nil) and \$10,000 as a loan to cover the cost of certain expenditures incurred by the Company in the ordinary course of business. The cost of services rendered to the Company, directly and indirectly, by these three directors was \$171,763 (2007-\$312,847) during 2008.

During fiscal 2007, directors and officers of the Company subscribed for 808,726 common shares of Diadem for gross proceeds of \$309,900 pursuant to the private placements described in notes 6(b) and 6(c) to the financial statements.

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.

8. SUPPLEMENTARY CASH FLOW INFORMATION

	<u>2008</u>	<u>2007</u>
	\$	\$
Income taxes paid	-	-
Interest paid	121	34,624
Value of Series B first preference shares exchanged for common shares of the Company	-	54,475
Disposal of investment to settle accounts payable	-	44,000
Common shares issued to acquire Duquesne West Project	-	338,750
Broker warrants issued	-	39,173

9. INCOME TAXES

Provision for Income Taxes

Major items causing the Company's income tax rate to differ from the combined Canadian federal and provincial statutory rate of approximately 35% (2007 – 36%) were as follows:

	<u>2008</u>	<u>2007</u>
	\$	\$
(Loss) before income taxes:	<u>(652,911)</u>	<u>(2,552,414)</u>
Expected income tax benefit based on statutory rate	(229,000)	(922,000)
Adjustments to benefit resulting from:		
Non-taxable portion of capital gains	-	(8,000)
Equity finance costs	-	(72,000)
Non-deductible expenses	-	4,000
Expiry of losses	294,000	238,000
Mineral interests	(169,000)	-
Change in tax rates	1,327,854	
Other	(150,000)	201,314
Change in valuation allowance	<u>(317,000)</u>	<u>(461,000)</u>
	<u>756,854</u>	<u>(1,019,686)</u>

Future Income Tax Balances

The tax effects of temporary differences that give rise to future income tax assets at May 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
	\$	\$
Non-capital losses	1,380,000	1,711,000
Financing costs	48,000	99,000
Capital losses	161,000	201,000
Resource properties	3,319,000	3,187,000
Equipment	113,000	140,000
Valuation allowance	<u>(5,021,000)</u>	<u>(5,338,000)</u>
Net future income tax asset	<u>-</u>	<u>-</u>

Continued...

9. INCOME TAXES (Continued)

As at May 31, 2008, the Company had available for deduction against future taxable income, non-capital losses of approximately \$4,735,000 which expire as follows:

<u>Year</u>	<u>Amount</u>
	\$
2009	921,000
2010	238,000
2014	732,000
2015	1,075,000
2026	369,000
2027	671,000
2028	<u>729,000</u>
	<u>4,735,000</u>

In addition, the Company has capital losses aggregating \$1,111,000, Canadian exploration and development expenditures of \$4,899,000, and foreign exploration and development expenses aggregating \$12,238,000, each of which is available for deduction against future taxable income under certain circumstances.

During the year ended May 31, 2007, the Company issued 7,876,403 flow-through shares for proceeds of \$2,823,053. During February 2007, the Company renounced the equivalent expenditure to its investors and recognized a non-cash future income tax recovery of \$1,019,686.

At May 31, 2008, the Company had provided a valuation allowance of \$5,021,000 (2007 - \$5,338,000) against future tax assets. As a consequence of issuing flow-through shares the Company created taxable temporary differences which can be reduced by previously unrecognized future tax assets. The recognition of the previously unrecognized future income tax asset resulted in a credit to the statement of operations in the amount of \$1,019,686 during the year ended May 31, 2007 with an offsetting charge to deficit as a cost of financing the flow-through share issue. During 2008, Diadem did not incur sufficient Canadian exploration expenditures ("CEE") during calendar 2007 to fully satisfy its flow-through commitments. The reversal of a previously recognized future income tax asset resulted in a charge to the statement of operations in the amount of \$756,854 during the year ended May 31, 2008 with an offsetting credit to deficit as a reduction of financing finance cost previously associated with the flow-through share issue.

10. COMMITMENTS AND CONTINGENCIES

As at May 31, 2007, the Company was committed to incur prior to December 31, 2007, on a best efforts basis, approximately \$2,600,000 in qualifying CEE pursuant to private placements for which flow-through proceeds had been received during 2006 and renounced to the subscribers with an effective date of December 31, 2006. As at December 31, 2007, this shortfall in expenditure was reduced to approximately \$2,095,000.

Diadem did not incur sufficient CEE in 2007 to fully satisfy its flow-through commitments. As a consequence, Diadem recorded approximately \$333,591 during 2008 (2007-\$88,920) in Part XII.6 tax and penalties which is included in the consolidated statement of operations under interest and penalties expense. Other taxes payable includes Part XII.6 tax payable in the aggregate amount of \$487,782.

Since the Company did not meet flow-through share expenditure requirements agreed to through various subscription agreements entered into during 2006, the Company has amended the renunciations provided to subscribers of these shares. The Company has accrued all penalties and interest charges related to this matter that could be reasonably estimated; however, the subscription agreements provided certain indemnities for certain amounts that will become payable by the subscribers upon reassessment of their

10. COMMITMENTS AND CONTINGENCIES (Continued)

personal tax returns with the amended and reduced renunciations. The contingent liability that may be created by this indemnity will depend on various items, including each individual subscriber's personal tax situation, and cannot therefore be reasonably estimated.

The ability of the Company to develop its properties and the future profitability of the Company is directly related to the market price of exploited minerals and metals.

11. FINANCIAL INSTRUMENTS

The Company's financial assets and liabilities consist of cash, receivables, due from related parties, accounts payable and accrued liabilities and other taxes payable. Cash is classified as held-for-trading and is carried at fair value on the balance sheet due to the short-term nature of this financial instrument. Amounts receivable, accounts payable and accruals approximate their fair values due to the relatively short periods to maturity.

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

a) Currency risk

The Company operates solely in Canada and a small portion of the Company's capital expenditures are denominated in the United States dollar and a significant portion of the Company's operating costs are denominated in the Canadian dollar. As a consequence, the Company is exposed to currency fluctuations relative to the United States dollar. A significant change in the currency exchange rate between the United States dollar and the Canadian dollar would not have a material effect on the Company's results of operations, financial position or cash flows. The Company has not hedged its exposure to currency fluctuations.

b) Interest rate risk

The Company is not exposed to significant interest rate price risk due to the short-term maturity of its monetary assets and liabilities.

c) Credit risk

Credit risk is the risk of unexpected financial loss to the Company if a customer or third party to a financial instrument fails to meet its contractual obligations.

The Company is exposed to credit risk with respect to its accounts receivable comprised principally of goods and services tax recoverable; however, the risk is minimized because the amount due is from a subdivision of the Canadian federal government.

d) Derivatives – mineral properties

The Company retains and/or has obligations related to certain carried interest rights and net smelter royalties ("NSR"), the value of which is derived from future events and commodity prices. These rights are derivative instruments. However, the mineral property interests to which they relate are not sufficiently developed to reasonably determine value.

e) 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 and continuously monitors its capital expenditures and cash used in operations. To the extent that the Company expects that it does not have sufficient liquidity to meet these obligations, management will consider securing additional funds through debt or equity transactions. At May 31, 2008, the Company is indebted to suppliers who may not provide future services if not paid.

CORPORATE INFORMATION

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