



## **2009 ANNUAL REPORT**

## **MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING**

The accompanying consolidated financial statements of Diadem Resources Ltd. ("Company") have been prepared by the Company's management. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada and contain estimates based on management's judgment. Internal control systems are maintained by management to provide reasonable assurance that assets are safeguarded and financial information is reliable.

The Board of Directors of the Company is responsible for ensuring that management fulfils its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the consolidated financial statements and the accompanying management discussion and analysis. The Board of Directors carries out this responsibility principally through its Audit Committee.

The Audit Committee is appointed by the Board of directors and, until the resignation of Paul A. Carroll as a director, all of its members were independent directors. The Audit Committee meets periodically with Company management and the Company's external auditors and reviews internal control and financial reporting matters to ensure that management is properly discharging its responsibilities before submitting the financial statements to the Board of Directors for approval.

McGovern, Hurley, Cunningham, LLP were appointed as external auditors by the Company's shareholders at the Company's annual meeting in November 2009. They have examined the consolidated financial statements as at and for the two year period ended May 31, 2009 and their report follows.

"Aimé N. Bertrand"

Chief Executive Officer

"David J. Layman"

Vice-president, Finance

Montréal, Québec  
September 29, 2009



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

**MAY 31, 2009**

*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, 2009. This MDA has been prepared as at September 28, 2009, unless otherwise indicated. This MDA is intended to supplement and complement the financial statements and notes thereto for the year ended May 31, 2009. 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**

	<b>2009</b>	<b>2008</b>	<b>2007</b>
Canadian dollars , except share amounts	<b>\$</b>	<b>\$</b>	<b>\$</b>
Cash	<b>1,407</b>	6,438	592,007
Mineral interests	<b>3,927,174</b>	3,851,614	2,760,573
Total assets	<b>3,930,021</b>	3,901,356	3,459,242
Working capital (deficiency)	<b>(1,840,494)</b>	(1,529,684)	209,530
Cash provided by (used in) operations	<b>47,068</b>	(127,731)	(722,326)
Common Shares issued for cash	-	-	2,856,052
Common Shares outstanding	<b>19,944,647</b>	18,944,647	18,944,647
Revenue	<b>16</b>	6,628	65,984
Cost of operations	<b>356,575</b>	659,539	2,618,398
Net loss	<b>(356,559)</b>	(1,409,765)	(1,532,728)
Net loss per share- basic and diluted	<b>(0.02)</b>	(0.07)	(0.10)

**Selected Quarterly Information**

<b>2009</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Revenues	16	-	-	-
Expenses (recoveries)	52,720	181,493	(96,270)	218,632
Net income (loss)	(52,704)	(181,493)	96,270	(218,632)
Basic and fully diluted income {loss} per share (Note)	(0.00)	(0.01)	0.01	(0.01)

<b>2008</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
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)

## Results of Operations

General corporate costs were \$245,840 during the fourth quarter compared to a negative \$99,041 during the third quarter of fiscal 2009. The single largest component of general corporate costs consists of accrued compensation. During the year, the Chairman renounced his accrued compensation. The chairman had not been paid since August 2007 and other management, for whom fees continued to accrue through February 2009, have not been paid since October 2007. The Company recognized \$Nil (2008-\$Nil) in non-cash stock-based compensation. There were no new grants of stock options during 2009 and 2008. All previous grants of stock options have been amortized to the statement of operations in prior periods. Subsequent to May 31, 2009, the Chairman refuted the renunciation of his accrued compensation and, consequently, the Company re-accrued his deferred compensation.

Shareholder relations costs aggregated \$11,417 (2008-\$4,267) during the quarter. Costs vary according to activity during any given period.

Expense for raising funds increased during the quarter as a result of a non-cash charge of \$18,018 for valuation of compensation warrants issued to Wakabayashi Fund LLC.

Interest costs totalled \$29,781 during the fourth quarter of fiscal 2009 (2008-\$200,391). The comparable period of 2008 includes an accrual for Part XII.6 tax and penalties. Interest costs decreased as the effect of accruing Part XII.6 tax and penalties on unexpended Canadian exploration expenditures for flow-through purposes ended in February 2008. Interest continues to accrue on the Part XII.6 tax payable. The Company accrued interest in respect of the demand notes to three directors and three third party individuals at a simple interest rate of 10% per annum and in respect of the loan from Darnley Bay Resources Limited at its bank's prime rate plus 1%.

The Company received no interest income during the quarter (2008-\$Nil).

During calendar 2007, Diadem was unable to complete its exploration programs and satisfy obligations to expend Canadian Exploration Expense for flow-through expenditures renounced to investors effective December 31, 2006. Consequently, during the third quarter of fiscal 2008, the Company reversed \$748,426 of a previously recognized future tax benefit and recorded a credit for the same amount to the cost of issuing shares.

For the fourth quarter of fiscal 2009, Company recorded a net loss of \$218,632 or \$0.01 per share compared to a net loss of \$295,847 or \$0.02 per share during the fourth quarter of fiscal 2008.

## Comparative Quarterly Results

Fluctuation of the Company's results of operations is affected by regulatory and associated costs such as audit and other professional fees. These costs are recorded in the period incurred. Administrative costs, principally accruals for compensation, are regular in occurrence.

The Company has been unable to obtain financing for its operations, including exploration at its Franklin Project. Should the Company continue to be under-financed, it may discontinue accruing certain administrative expenditures and only record expenses invoiced.

## 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 retained Wakabayashi Fund LLC of Tokyo, Japan to assist Diadem in structuring and arranging one or more financings over a six month period. Under the agreement with Wakabayashi Fund, Diadem was to pay a 7%

cash fee on all capital raised by the fund. In addition, Diadem paid an initial work fee of \$50,000 through the issuance of 500,000 treasury common shares priced at \$0.10 per share. An additional work fee of \$50,000 was paid on November 30, 2008 through the issuance of 500,000 treasury common shares and a further work fee was due on January 31, 2009. Diadem had the right to make payment of the work fees by issuing treasury common shares at \$0.10 per share. Effective January 28, 2009, the agreement was cancelled.

Diadem granted Wakabayashi Fund an agent's option to purchase an additional 500,000 treasury common shares at a price of \$0.15 per share until September 30, 2009 and, if not previously exercised, thereafter at a price of \$0.25 per share until September 30, 2010. The agent's option was priced out-of-the-money compared to Diadem's share price. The warrants were valued at \$18,018. The fair value was estimated using the Black-Scholes option-pricing model with the following assumptions: expected dividend yield of 0%; expected stock volatility of 151%; risk-free interest rate of 2.76% and an expected life of 2 years.

The Company has reported significant losses for several years and has no mining operations and is, therefore, considered an exploration stage company. Operating cash flow consumed by operations was \$23,369 for the quarter ended May 31, 2009. The Company relies on suppliers, officers and directors to perform work on the promise of payment. Accounts payable includes fees and expenses payable to two officers of the Company in the aggregate amount of \$101,667. During the third quarter of 2009, the two directors renounced \$82,031 in respect of services rendered and the Chairman renounced \$141,667 of administrative service fees rendered.

At May 31, 2009, the Company had a working capital deficiency of \$1,840,494.

#### *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, totalling \$482,671, 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. Diadem has provided documentation to DBR to prove that 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%.

Without further funding, Diadem will be unable to fund the next stage of exploration on the Franklin Property. The Company continues to apprise Darnley Bay Resources of its efforts and to fulfill a minimum exploration program

acceptable to both parties. In addition, Darnley Bay has demanded payment of its \$100,000 loan plus accrued interest.

### *Funding*

The effect of credit market turmoil globally 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 28, 2009, there were 19,944,647 shares issued and outstanding. There were no employee stock options exercisable and 500,000 compensation options exercisable at a price of \$0.15 per share. As at September 28, 2009, none of the options or warrants is “in-the-money”.

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**

	<u>Balance</u> <u>May 31, 2008</u> \$	<u>Additions</u> \$	<u>Write-</u> <u>downs</u> \$	<u>Balance</u> <u>May 31, 2009</u> \$
<b>Acquisition costs</b>				
Franklin Project, Northwest Territories	1,142,696	-	-	1,142,696
<b>Deferred exploration costs</b>				
Franklin Project, Northwest Territories	2,708,918	75,560	-	2,784,478
	<u>3,851,614</u>	<u>75,560</u>	<u>-</u>	<u>3,927,174</u>

### *Franklin Project*

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 fall of 2009, assuming all required permits are received and adequate financing is obtained.

Expenditures during the fourth quarter of fiscal 2009 consisted mainly of paying assessment and property holding costs and fees related to planning the next stage of exploration with offsets arising from refunds of deposits made to secure exploration work.

## 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.

### Accounting Policies Adopted During 2009 Fiscal Year

#### i) Capital Disclosures and Financial Instruments

In December 2006, the CICA issued Section 3862, Financial Instruments - Disclosures; Section 3863, Financial Instruments - Presentation; and Section 1535, Capital Disclosures. All three Sections are applicable for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007. Section 3862 on financial instrument disclosures, places an increased emphasis on disclosures about risks associated with both recognized and unrecognized financial instruments and how these risks are managed and is consistent with Section 3861. The new section removes duplicative disclosures and simplifies the disclosures relating to concentrations of risk, credit risk, liquidity risk and price risk currently found in Section 3861. Section 3863 on the presentation of financial instruments is unchanged from the presentation requirements included in Section 3861. Section 1535 on capital disclosures requires the disclosure of information about an entity's objectives, policies and processes for managing capital. These new standards became effective for the Company on June 1, 2008. The Company has included the required disclosures in Notes 12 and 13 of these consolidated financial statements.

#### (ii) Credit Risk and the Fair Value of Financial Assets and Financial Liabilities

In January 2009, the CICA approved EIC 173 Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. This guidance clarified that an entity's own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and financial liabilities including derivative instruments. This guidance is applicable to fiscal periods ending on or after January 12, 2009. The Company has determined that there has been no impact from this new accounting standard on its consolidated financial statements.

## Future Accounting Changes

#### (i) International Financial Reporting Standards ("IFRS")

In 2006, the Canadian Accounting Standards Board ("AcSB") published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB's strategic plan outlines the convergence of Canadian GAAP with IFRS over a five-year transitional period. In February 2008, the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canada's own GAAP. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Accordingly, the Company will be required to adopt IFRS on June 1, 2011. The transition will require the restatement, for comparative purposes, of amounts reported by the Company for the year ended May 31, 2010. While the Company has begun to assess the adoption of IFRS for fiscal 2012, the financial reporting impact of the transition to IFRS cannot be reasonably estimated at this time.

#### (ii) Goodwill and Intangible Assets

In February 2008, the Canadian Institute of Chartered Accountants ("CICA") issued Section 3064, Goodwill and Intangible assets, replacing Section 3062, Goodwill and Other Intangible Assets, and Section 3450, Research and Development Costs. The new section will be applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company will adopt the new standards for its fiscal year beginning June 1, 2009. Section 3064 establishes standards for recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. This standard is not expected to have a material impact on the Company's financial statements.

### (iii) Business Combinations

In January 2009, the CICA issued the new handbook Section 1582, Business Combinations, effective for fiscal years beginning on or after January 1, 2011. Earlier adoption of Section 1582 is permitted. This pronouncement further aligns Canadian GAAP with IFRS and changes the accounting for business combinations in a number of areas. It establishes principles and requirements governing how an acquiring company recognizes and measures in its financial statements identifiable assets acquired, liabilities assumed, any non-controlling interest in the acquire and goodwill acquired. The section also establishes disclosure requirements that will enable users of the acquiring company's financial statements to evaluate the nature and financial effects of its business combinations. Although the Company is considering the impact of adopting this pronouncement on its consolidated financial statements, it will be limited to any future acquisitions beginning in fiscal 2012.

### (iv) Consolidated Financial Statements and Non-controlling Interests

In January 2009, the CICA issued the new handbook Section, 1601, Consolidated Financial Statements, and Section 1602, Non-controlling Interests, effective for fiscal years beginning on or after January 1, 2011. Earlier adoption of these recommendations is permitted. These pronouncements further align Canadian GAAP with IFRS. Section 1601 and 1602 change the accounting and reporting for ownership interest in the subsidiaries held by parties other than the parent. Non-controlling interests are to be presented in the consolidated statement of financial position within the entity but separate from the parent's equity. The amount of consolidated net income attributable to the parent and to the non-controlling interest is to be clearly identified and presented on the face of the consolidated statement of operations. In addition, these pronouncements establish standards for a change in a parent's ownership interest in a subsidiary and the valuation of retained non-controlling equity investments when a subsidiary is de-consolidated. They also establish reporting requirements for providing sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. The Company is considering the impact of adopting these pronouncements on its consolidated financial statements in fiscal 2012 in connection with the conversion to IFRS.

### (v) Credit Risk and the Fair Value of Financial Assets and Financial Assets

In January 2009, the CICA issued the Emerging Issues Committee ("EIC") Abstract EIC-173, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities, effective for interim and annual financial statements ending on or after January 20, 2009. Earlier adoption of this abstract is permitted. EIC-173 provides further information on the determination of fair value of financial assets and financial liabilities under Section 3855, Financial Instruments-Recognition and Measurement. It states that an entity's own credit and the credit risk of the counterparty should be taken into account when determining the fair value of financial assets and financial liabilities, including derivative instruments. EIC-173 should be applied retroactively, without restatement of prior periods, to all financial assets and Company will adopt this abstract during the first quarter of the 2010 fiscal year. The standard is not expected to have a material impact on the Company's consolidated financial statements.

## 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 Vice-president, Finance 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, 2009. The audit committee is actively involved in quarterly reviews and is comprised of three independent directors.

The Issuer's certifying officers are responsible for ensuring that processes are in place to provide them with sufficient knowledge to support the representations they are making.. Investors should be aware that inherent limitations on the ability of certifying officers of a venture issuer to design and implement on a cost effective basis DC&P and ICFR as defined in NI 52-109 may result in additional risks to the quality, reliability, transparency and timeliness of interim and annual filings and other reports provided under securities legislation.

## 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 Company's financial assets and liabilities consist of cash, due from related parties, taxes recoverable, accounts payable and accrued liabilities, demand notes, due to Darnley Bay Resources Limited and other taxes payable. Cash is classified as held-for-trading and is carried at fair value. Amounts due from related parties and taxes recoverable are classified as loans and receivables, which are measured at amortized cost. Accounts payable and accrued liabilities approximate their fair values due to the relatively short periods to maturity. Accounts payable and accrued liabilities, demand notes, due to DBR and other taxes payable are classified as other financial liabilities, which are measured at amortized cost.

The carrying amounts of the Company's financial assets and liabilities approximate fair values because of the limited term of these instruments.

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

## Related Party Information

At May 31, 2009, due from related parties includes \$Nil (2008 - \$4,504) 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. This amount is unsecured, non-interest bearing, and due on demand.

At May 31, 2009, accounts payable and accrued liabilities includes \$Nil (May 31, 2008 - \$71,888) due to two directors in their capacity of overseeing the Franklin Project exploration program. This amount is unsecured, non-interest bearing, and due on demand. During 2009, these two directors forgave \$77,887 owing to them in respect of services rendered.

Included in accounts payable and accrued liabilities at May 31, 2009 is \$150,000 recorded as owing to a former director and officer of the Company. Management believes that the former director and officer waived his right to these amounts during 2009, however, management has not recorded the reversal of such amounts as the former director and officer maintains that he remains entitled to them. Management intends to defend its position that the former director and officer waived these amounts.

See Note 6. Interest accrued on demand notes owing to the two directors and former Chairman during the year ended May 31, 2009 totalled \$4,887.

## 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 diamond-producing countries. By 2012 it is forecast that rough prices will rise by about 40% on average across diamond categories as supply continues to be almost flat and demand, particularly from India, China and the Gulf (together making up 18% of the retail market in 2006), continues its robust growth. Purchases in those three areas, which are growing at almost twice the world average, are on a cash basis. Latin America and Asia (6% of retail sales) are also doing well.

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.

*"Aimé Bertrand"*  
Chief Executive Officer

*"David J. Layman"*  
Vice-President, Finance

September 29, 2009



**(A Development Stage Company)**

**CONSOLIDATED FINANCIAL STATEMENTS**

**MAY 31, 2009 AND 2008**

**(Expressed in Canadian Dollars)**



(A Development Stage Company)

**CONSOLIDATED FINANCIAL STATEMENTS**

**MAY 31, 2009 AND 2008**

**(Expressed in Canadian Dollars)**

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**AUDITORS' REPORT**

To the Shareholders of  
**DIADEM RESOURCES LTD.**  
**(A Development Stage Company)**

We have audited the consolidated balance sheets of Diadem Resources Ltd. (a Development Stage Company) as at May 31, 2009 and 2008 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. 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, 2009 and 2008 and the results of its operations and its cash flows for the years then ended 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 23, 2009

	2009 \$	2008 \$ (Note 14)
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash	1,407	6,438
Accounts receivable -		
Due from related parties (Note 8)	-	4,504
Taxes recoverable (Note 4)	-	28,872
Prepaid expenses	-	5,197
	<u>1,407</u>	<u>45,011</u>
<b>MINERAL INTERESTS</b> (Note 3)	3,927,174	3,851,614
<b>EQUIPMENT</b> (Note 5)	<u>1,440</u>	<u>4,731</u>
	<u>3,930,021</u>	<u>3,901,356</u>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities (Notes 3 and 8)	1,151,080	967,325
Demand notes (Note 6)	81,197	-
Due to Darnley Bay Resources Limited (Note 3)	111,807	107,109
Other taxes payable (Note 11)	<u>497,817</u>	<u>500,261</u>
	<u>1,841,901</u>	<u>1,574,695</u>
<b>SHAREHOLDERS' EQUITY</b>		
<b>CAPITAL STOCK</b> (Notes 7(a) and (b))	33,924,873	33,824,873
<b>WARRANTS</b> (Note 7(c))	18,018	543,799
<b>CONTRIBUTED SURPLUS</b> (Note 7(e))	2,211,337	1,667,538
<b>DEFICIT</b>	<u>(34,066,108)</u>	<u>(33,709,549)</u>
	<u>2,088,120</u>	<u>2,326,661</u>
	<u>3,930,021</u>	<u>3,901,356</u>

Commitments and contingencies (Notes 1, 3 and 11)

APPROVED ON BEHALF OF THE BOARD:

Signed "Tom Skimming" \_\_\_\_\_, Director

Signed "Aime Bertrand" \_\_\_\_\_, Director

DIADEM RESOURCES LTD.  
 (A Development Stage Company)  
**CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT**  
 FOR THE YEARS ENDED MAY 31,

Page 3

	2009 \$	2008 \$ (Note 14)
<b>REVENUE</b>		
Interest income	16	6,400
Foreign exchange	-	228
	<u>16</u>	<u>6,628</u>
<b>EXPENSES</b>		
Amortization	1,419	2,028
Interest and penalties (Note 11)	7,693	340,820
Costs associated with raising funds (Note 7(b)(i))	118,018	-
Management fees, salaries and benefits	136,651	192,000
Office expenses and other	5,982	12,147
Professional fees	37,802	45,333
Shareholder relations	46,457	48,820
Travel	930	-
Stock-based compensation	-	2,710
Loss on disposal of equipment	1,623	-
Write-down of mineral interests	-	15,681
	<u>356,575</u>	<u>659,539</u>
<b>Loss before income taxes</b>	(356,559)	(652,911)
Future income taxes (Note 10)	-	(756,854)
	<u>-</u>	<u>(756,854)</u>
<b>NET LOSS FOR THE YEAR</b>	(356,559)	(1,409,765)
<b>DEFICIT, beginning of year</b>	(33,709,549)	(33,056,638)
Costs associated with issuance of capital stock (Note 10)	-	756,854
<b>DEFICIT, end of year</b>	<u>(34,066,108)</u>	<u>(33,709,549)</u>
<b>NET LOSS PER SHARE - basic and diluted</b>	(0.02)	(0.07)
<b>WEIGHTED AVERAGE NUMBER OF COMMON SHARES</b>	19,502,181	18,944,647

See accompanying notes to the consolidated financial statements.

DIADEM RESOURCES LTD.  
 (A Development Stage Company)  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
 FOR THE YEARS ENDED MAY 31,

(Expressed in Canadian Dollars)	2009 \$	2008 \$ (Note 14)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss for the year	(356,559)	(1,409,765)
Adjustment for items not affecting cash:		
Amortization	1,419	2,028
Shares and warrants issued for services	118,018	-
Loss on disposal of equipment	1,623	-
Accrued interest	9,893	
Stock-based compensation	-	2,710
Future income taxes	-	756,854
	<u>(225,606)</u>	<u>(648,173)</u>
Net changes in non-cash working capital balances:		
Prepaid expenses	5,197	(1,859)
Taxes recoverable	28,872	63,240
Due from related parties	4,504	(51)
Accounts payable and accrued liabilities	236,794	122,799
Other taxes payable	(2,444)	336,313
	<u>272,923</u>	<u>520,442</u>
Cash flows from operating activities	<u>47,317</u>	<u>(127,731)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from issuance of demand notes	<u>76,002</u>	<u>-</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Mineral interests	<u>(128,350)</u>	<u>(457,838)</u>
Change in cash during the year	(5,031)	(585,569)
<b>CASH</b> , beginning of year	<u>6,438</u>	<u>592,007</u>
<b>CASH</b> , end of year	<u>1,407</u>	<u>6,438</u>

**SUPPLEMENTAL INFORMATION** (Note 9)

**(A Development Stage Company)****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**FOR THE YEARS ENDED MAY 31, 2009 AND 2008

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**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 a development stage company as defined by the Canadian Institute of Chartered Accountants ("CICA") Accounting Guideline 11.

The business of mining and exploring for minerals involves a high degree of risk and there can be no assurance that current exploration and development programs will result in profitable mining operations. The recoverability of the carrying value of exploration and development properties and the Company's continued existence is dependent upon the preservation of its interest in the underlying property, the discovery of economically recoverable reserves, the achievement of profitable operations, or the ability of the Company to raise additional financing, if necessary, or alternatively upon the Company's ability to dispose of its interest on an advantageous basis. Changes in future conditions could require material writedowns of the carrying values.

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 Company has a need for equity capital and financing for working capital and exploration and development of its properties. Because of continuing operating losses, the Company's continuance as a going concern is dependent upon its ability to obtain adequate financing and to reach profitable levels of operation. It is not possible to predict whether financing efforts will be successful or if the Company will attain profitable levels of operations.

The consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles applicable to a going concern. Accordingly, they do not give effect to adjustments that would be necessary should the Company be unable to continue as a going concern and therefore be required to realize its assets and liquidate its liabilities and commitments in other than the normal course of business and at amounts different from those in the accompanying consolidated financial statements. Such adjustments could be material.

**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%
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**(A Development Stage Company)****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**FOR THE YEARS ENDED MAY 31, 2009 AND 2008

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**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)****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.

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 mineral interests, 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.

## 2. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

### **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, warrants, 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, 2009 and 2008, 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.

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. The outstanding warrants included in Note 7(c) were not included in the computation of the diluted loss per share as the effect would be anti-dilutive.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### **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.

The Company indemnifies the subscribers of flow-through shares from any tax consequences arising from the failure of the Company to meet its commitments under the flow-through subscription agreements.

### **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.

### **Changes in Accounting Policies:**

#### i) Capital Disclosures and Financial Instruments

In December 2006, the CICA issued Section 3862, Financial Instruments - Disclosures; Section 3863, Financial Instruments - Presentation; and Section 1535, Capital Disclosures. All three Sections are applicable for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007. Section 3862 on financial instrument disclosures, places an increased emphasis on disclosures about risks associated with both recognized and unrecognized financial instruments and how these risks are managed and is consistent with Section 3861. The new section removes duplicative disclosures and simplifies the disclosures relating to concentrations of risk, credit risk, liquidity risk and price risk currently found in Section 3861. Section 3863 on the presentation of financial instruments is unchanged from the presentation requirements included in Section 3861. Section 1535 on capital disclosures requires the disclosure of information about an entity's objectives, policies and processes for managing capital. These new standards became effective for the Company on June 1, 2008. The Company has included the required disclosures in Notes 12 and 13 of these consolidated financial statements.

#### (ii) Credit Risk and the Fair Value of Financial Assets and Financial Assets

In January 2009, the CICA approved EIC 173 Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. This guidance clarified that an entity's own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and financial liabilities including derivative instruments. This guidance is applicable to fiscal periods ending on or after January 12, 2009. The Company has determined that there has been no impact from this new accounting standard on its consolidated financial statements.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Future Accounting Changes:

#### (i) International Financial Reporting Standards (“IFRS”)

In 2006, the Canadian Accounting Standards Board (“AcSB”) published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB’s strategic plan outlines the convergence of Canadian GAAP with IFRS over a five-year transitional period. In February 2008, the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canada’s own GAAP. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. Accordingly, the Company will be required to adopt IFRS on June 1, 2011. The transition will require the restatement, for comparative purposes, of amounts reported by the Company for the year ended May 31, 2010. While the Company has begun to assess the adoption of IFRS for fiscal 2012, the financial reporting impact of the transition to IFRS cannot be reasonably estimated at this time.

#### (ii) Business Combinations

In January 2009, the CICA issued the new handbook Section 1582, Business Combinations, effective for fiscal years beginning on or after January 1, 2011. Earlier adoption of Section 1582 is permitted. This pronouncement further aligns Canadian GAAP with IFRS and changes the accounting for business combinations in a number of areas. It establishes principles and requirements governing how an acquiring company recognizes and measures in its financial statements identifiable assets acquired, liabilities assumed, any non-controlling interest in the acquire and goodwill acquired. The section also establishes disclosure requirements that will enable users of the acquiring company’s financial statements to evaluate the nature and financial effects of its business combinations. Although the Company is considering the impact of adopting this pronouncement on its consolidated financial statements, it is expected to be limited to any future acquisitions beginning in fiscal 2012.

#### (iii) Goodwill and Intangible Assets

In February 2008, the CICA issued a new accounting standard: Handbook Section 3064, Goodwill and Intangible Assets. These standards become effective for interim and annual financial statements for the Company’s reporting periods beginning on June 1, 2009. The Company is currently assessing the impact of this new accounting standard on its financial statements.

#### (iv) Consolidated Financial Statements and Non-controlling Interests

In January 2009, the CICA issued the new handbook Section, 1601, Consolidated Financial Statements, and Section 1602, Non-controlling Interests, effective for fiscal years beginning on or after January 1, 2011. Earlier adoption of these recommendations is permitted. These pronouncements further align Canadian GAAP with IFRS. Section 1601 and 1602 change the accounting and reporting for ownership interest in the subsidiaries held by parties other than the parent. Non-controlling interests are to be presented in the consolidated statement of financial position within the entity but separate from the parent’s equity. The amount of consolidated net income attributable to the parent and to the non-controlling interest is to be clearly identified and presented on the face of the consolidated statement of operations. In addition, these pronouncements establish standards for a change in a parent’s ownership interest in a subsidiary and the valuation of retained non-controlling equity investments when a subsidiary is de-consolidated. They also establish reporting requirements for providing sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. The Company is considering the impact of adopting these pronouncements on its consolidated financial statements in fiscal 2012 in connection with the conversion to IFRS.

**3. MINERAL INTERESTS**

	Balance <u>May 31, 2008</u> \$	<u>Additions</u> \$	<u>Write-downs</u> \$	Balance <u>May 31, 2009</u> \$
<b>Acquisition costs</b>				
Franklin Project, Northwest Territories	<u>1,142,696</u>	<u>-</u>	<u>-</u>	<u>1,142,696</u>
<b>Deferred exploration costs</b>				
Franklin Project, Northwest Territories	<u>2,708,918</u>	<u>75,560</u>	<u>-</u>	<u>2,784,478</u>
	<u>3,851,614</u>	<u>75,560</u>	<u>-</u>	<u>3,927,174</u>
	Balance <u>May 31, 2007</u> \$	<u>Additions</u> \$	<u>Write-downs</u> \$	Balance <u>May 31, 2008</u> \$
<b>Acquisition costs</b>				
Franklin Project, Northwest Territories	<u>1,142,696</u>	<u>-</u>	<u>-</u>	<u>1,142,696</u>
<b>Deferred exploration costs</b>				
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>

**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 ("DBR") for diamond exploration in an area near Paulatuk in the Northwest Territories.

Under the agreement, the Company was to expend \$5,000,000 on diamond exploration within the Inuvialuit settlement region north of the 68<sup>th</sup> parallel by December 31, 2006. When this earn-in level of expenditure is completed, the Company 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, the Company will have the right to fund the feasibility study, and if the property is placed into commercial production, the Company's interest will increase to 75% and DBR's interest will decrease to 25%.

Effective March 25, 2005, Diadem's earn-in requirement on the lands north of the 68<sup>th</sup> parallel was reduced to approximately \$3,100,000 and the earn-in period was extended to December 31, 2007.

**3. MINERAL INTERESTS** (Continued)

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. 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 agreed to 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 production from a diamond mine on the Franklin Project.

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, 2009, \$100,000 is payable to DBR in respect of payments made to the Inuvialuit Regional Corporation ("IRC"), plus accrued interest of \$11,807. 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, 2009, the loan remains outstanding. Also included in accounts payable and accrued liabilities is \$140,544 payable directly to the IRC.

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.

The Company and DBR continue to negotiate the terms of their ongoing relationship.

**4. TAXES RECOVERABLE**

Taxes recoverable consist of:

	<u>2009</u>	<u>2008</u>
	\$	\$
Government of Canada goods and services tax credits	-	<u>28,872</u>
	<u>-</u>	<u>28,872</u>

**5. EQUIPMENT**

	2009		
	<u>Cost</u>	<u>Accumulated</u> <u>Amortization</u>	<u>Net</u>
	\$	\$	\$
Computer and office equipment	4,355	2,915	1,440

  

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

**6. DEMAND NOTES**

The demand notes are unsecured, bear interest at 10% and are due on demand. Two directors of the Company provided loans of \$5,000 each and the former Chairman of the Company provided a loan of \$50,000 during the year ended May 31, 2009.

**7. 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.

**(b) Issued and Outstanding Shares**

Details of issued and outstanding common shares are as follows:

	2009		2008	
	#	\$	#	\$
<b>Balance, beginning of year</b>	18,944,647	33,824,873	18,944,647	33,824,873
<b>Issued pursuant to:</b>				
Compensation shares (i)	<u>1,000,000</u>	<u>100,000</u>	-	-
<b>Balance, end of year</b>	<u>19,944,647</u>	<u>33,924,873</u>	<u>18,944,647</u>	<u>33,824,873</u>

(i) During the second quarter of fiscal 2009, the Company retained Wakabayashi Fund LLC of Tokyo, Japan to assist Diadem in structuring and arranging one or more financings over a six month period. Under the agreement with Wakabayashi Fund, Diadem was to pay a 7% cash fee on all capital raised by the fund. In addition, Diadem paid an initial work fee of \$50,000 through the issuance of 500,000 treasury common shares of the Company. An additional work fee of \$50,000 was paid on November 30, 2008 through the issuance of 500,000 treasury common shares of the Company and a further work fee was due on January 31, 2009. Diadem had the right to make payment of the work fees by issuing treasury common shares at \$0.10 per share. Effective January 28, 2009, the agreement was cancelled and as a result, the final payment was not made.

**7. SHAREHOLDERS' EQUITY (Continued)**

**(c) Warrants**

A summary of the Company's warrant activity during the years ended May 31, 2009 and 2008 is as follows:

	2009		2008	
	<u>Warrants</u>	<u>Weighted Average</u>	<u>Warrants</u>	<u>Weighted Average</u>
		<u>Exercise price</u>		<u>Exercise price</u>
	#	\$	#	\$
Outstanding, beginning of year	5,209,061	0.60	5,209,061	0.45
Expired	(5,209,061)	(0.60)	-	-
Granted	<u>500,000</u>	\$0.15 / \$0.25	<u>-</u>	-
Outstanding, end of year	<u>500,000</u>	\$0.15 / \$0.25	<u>5,209,061</u>	0.60

Diadem granted Wakabayashi Fund warrants to purchase an additional 500,000 treasury common shares at a price of \$0.15 per share until September 30, 2009 and, if not previously exercised, thereafter at a price of \$0.25 per share until September 30, 2010. The warrants were valued at \$18,018. The fair value was estimated using the Black-Scholes option-pricing model with the following assumptions: expected dividend yield of 0%; expected stock volatility of 151%; risk-free interest rate of 2.76% and an expected life of 2 years.

**(d) 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, 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:

	<u>Options</u>	<u>Weighted average</u>
	<u>#</u>	<u>exercise price</u>
		\$
Outstanding, May 31, 2007	390,625	1.63
Expired	(259,375)	(1.63)
Outstanding, May 31, 2008	131,250	1.62
Expired	(43,750)	(1.62)
Forfeited	(87,500)	(1.61)
Outstanding, May 31, 2009	-	-

Effective November 30, 2008, four individuals forfeited, in aggregate, the right to acquire 87,500 common shares pursuant to the plan. At May 31, 2009, there were no unexercised options outstanding pursuant to the Company's stock option plan.

**7. SHAREHOLDERS' EQUITY** (Continued)

**(e) Contributed Surplus**

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

	<u>2009</u>	<u>2008</u>
	\$	\$
Balance, May 31,	1,667,538	1,664,828
Stock-based compensation	-	2,710
Expiry of warrants	<u>543,799</u>	<u>-</u>
Balance, May 31,	<u>2,211,337</u>	<u>1,667,538</u>

**8. RELATED PARTY TRANSACTIONS AND BALANCES**

At May 31, 2009, due from related parties includes \$Nil (2008 - \$4,504) 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. This amount is unsecured, non-interest bearing, and due on demand.

At May 31, 2009, accounts payable and accrued liabilities includes \$Nil (May 31, 2008 - \$71,888) due to two directors in their capacity of overseeing the Franklin Project exploration program. This amount is unsecured, non-interest bearing, and due on demand. During 2009, these two directors forgave \$77,887 owing to them in respect of services rendered.

Included in accounts payable and accrued liabilities at May 31, 2009 is \$150,000 recorded as owing to a former director and officer of the Company. Management believes that the former director and officer waived his right to these amounts during 2009, however, management has not recorded the reversal of such amounts as the former director and officer maintains that he remains entitled to them. Management intends to defend its position that the former director and officer waived these amounts.

See Note 6. Interest accrued on demand notes owing to the two directors and former Chariman during the year ended May 31, 2009 totalled \$4,889.

These related party transactions, except for the loans, 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.

**9. SUPPLEMENTARY CASH FLOW INFORMATION**

	<u>2009</u>	<u>2008</u>
	\$	\$
Income taxes paid	-	-
Interest paid	-	121
Shares and warrants issued for services	118,018	-
Expiry of warrants	(543,799)	-
Expiry of warrants credited to contributed surplus	543,799	25,173
Change in accrued mineral interest costs	25,098	737,327

**10. 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 33% (2008 – 35%) were as follows:

	<u>2009</u>	<u>2008</u>
	\$	\$
(Loss) before income taxes:	<u>(356,559)</u>	<u>(652,911)</u>
Expected income tax benefit based on statutory rate	(118,000)	(229,000)
Adjustments to benefit resulting from:		
Warrants issued for services	6,000	-
Expiry of losses	304,000	294,000
Mineral interests	-	(169,000)
Change in tax rates	(21,000)	1,327,854
Other	2,000	(150,000)
Change in valuation allowance	<u>(173,000)</u>	<u>(317,000)</u>
	<u>-</u>	<u>756,854</u>

**Future Income Tax Balances**

The tax effects of temporary differences that give rise to future income tax assets at May 31, 2009 and 2008 are as follows:

	<u>2009</u>	<u>2008</u>
	\$	\$
Non-capital losses	1,234,000	1,380,000
Financing costs	24,000	48,000
Capital losses	161,000	161,000
Resource properties	3,315,000	3,319,000
Equipment	114,000	113,000
Valuation allowance	<u>(4,848,000)</u>	<u>(5,021,000)</u>
Net future income tax asset	<u>-</u>	<u>-</u>

**10. INCOME TAXES** (Continued)

As at May 31, 2009, the Company had available for deduction against future taxable income, non-capital losses of approximately \$4,247,000 which expire as follows:

<u>Year</u>	<u>Amount</u>
	\$
2010	238,000
2014	732,000
2015	1,075,000
2026	369,000
2027	671,000
2028	745,000
2029	<u>417,000</u>
	<u>4,247,000</u>

In addition, the Company has capital losses aggregating \$1,111,000, Canadian exploration and development expenditures of \$4,990,000, and foreign exploration and development expenses aggregating \$12,238,000, each of which is available for deduction against future taxable income under certain circumstances.

At May 31, 2009, the Company had provided a valuation allowance of \$4,848,000 (2008 - \$5,021,000) 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. For the fiscal year ended May 31, 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 finance cost previously associated with the flow-through share issue.

**11. COMMITMENTS AND CONTINGENCIES**

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 during 2007 to fully satisfy its flow-through commitments. As a consequence, Diadem recorded approximately \$458,671 of Part XII.6 tax which is included in other taxes payable.

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.

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.

## 12. FINANCIAL INSTRUMENTS

The Company's financial assets and liabilities consist of cash, due from related parties, taxes recoverable, accounts payable and accrued liabilities, demand notes, due to Darnley Bay Resources Limited and other taxes payable. Cash is classified as held-for-trading and is carried at fair value. Amounts due from related parties and taxes recoverable are classified as loans and receivables, which are measured at amortized cost. Accounts payable and accrued liabilities approximate their fair values due to the relatively short periods to maturity. Accounts payable and accrued liabilities, demand notes, due to Darnley Bay Resources Limited and other taxes payable are classified as other financial liabilities, which are measured at amortized cost.

The carrying amounts of the Company's financial assets and liabilities approximate fair values because of the limited term of these instruments.

The Company's financial instruments are exposed to certain financial risks including currency risk, interest rate risk, liquidity risk and price 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 amount due to Darnley Bay Resources Limited bears interest at prime plus 1%. Sensitivity to a plus or minus 1% change in interest rates could affect its net loss by approximately \$1,000.

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

c) 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.

d) 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 does not have sufficient liquidity to meet these obligations, management will consider securing additional funds through debt or equity transactions. At May 31, 2009, the Company is indebted to suppliers who may not provide future services if not paid.

e) Price risk

Price risk is remote as the Company is not a producing entity.

**13. MANAGEMENT OF CAPITAL**

The Company considers in its management of capital all components included in shareholders' equity and its debt obligations. Its objectives are to ensure that the Company will continue to operate as a going concern in order to pursue the development of its mineral interests, to sustain future development and growth 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.

The Company is not subject to any externally imposed capital requirements or debt covenants. There was no change to the Company's approach to capital management during the year ended May 31, 2009.

See Note 12(e).

**14. COMPARATIVE FIGURES**

Certain comparative figures have been reclassified to conform to the current year's presentation.