

Diversinet

2005 Annual Report



To Our Shareholders:

This past 12 months for Diversinet has been an exciting year of strategic change and tactical execution, where we positioned Diversinet as a leader in mobile based strong authentication and provisioning services and put in place the distribution agreements needed to reach the complex global security market.

Our significant 2005 business achievements included:

- A licensing agreement with VeriSign, where Diversinet's MobiSecure product will be integrated into the VeriSign extensive security product line and marketed by VeriSign's global sales force and partners;
- A similar agreement with Gemplus to market MobiSecure to their wireless network operator customers;
- Partnerships with SanDisk, where our product is being included in their new Trustedflash memory card;
- The deployment of our first pilot program with Magna Entertainment.

Based on the work that Diversinet has done for these partners and customers, we have developed one of the most advanced mobile-enabled strong authentication soft token and provisioning services available in the marketplace today. While other companies may have a soft token, none can match our product features or breadth of supported platforms. Some our significant product achievements include:

- Support for seven different mobile device classes, including a version that runs on virtually any Windows PC;
- A multi-token "credential wallet" that allows users to access multiple credentials through a single soft token, eliminating the need for a hard token "necklace" of individual tokens for various services;
- An advanced provisioning server through which end users can order a soft token, download it into their device over the air, install it and test it; all without direct involvement of their service provider.

This last product, Diversinet's MobiSecure Authentication Service Center (MASC) promises to revolutionize the strong authentication business by reducing deployment complexity and cost to the point where large-scale consumer deployments become economically feasible.

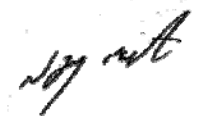
The company was able to leverage our partners, our industry associations like OATH and Liberty Alliance, and our incredible staff to magnify the value of our achievements well beyond the financial means available to us.

The strong authentication market has matured, with financial institutions, led by FFIEC mandate, finally taking concrete steps to increase the protection that they provide to their on-line customers. Diversinet is poised to lead the push to deploy strong authentication to protect the identities and transactions of consumers as they increase their use of on-line services.

As we head into 2006 we are looking to develop new distribution partners, extend out our technology advantage and to begin live pilot and customer activity in the second half of the year.

In conclusion, I would like to thank our shareholders, our staff and our new partners for their support over this past year. I look forward to working together to deliver on the promising opportunities that we developed in 2005.

Regards,



Nagy Moustafa
Chief Executive Officer

Management's Discussion and Analysis of Financial Condition and Results of Operations

When used herein, the words "may", "will", "expect", "anticipate", "continue", "estimate", "project", "intend", "plan" and similar expressions are intended to identify forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, regarding events, conditions and financial trends that may affect the Company's future plans of operations, business strategy, operating results and financial position. All statements, other than statements of historical facts, included or incorporated by reference in this document which address activities, events or developments which the Company expects or anticipates will or may occur in the future, including such things as future capital expenditures (including the amount and nature thereof), business strategy, expansion and growth of the Company's business and operations, and other such matters are forward-looking statements. These statements are based on certain assumptions and analyses made by the Company in light of its experience and its perception of historical trends, current conditions and expected future developments as well as other factors it believes are appropriate in the circumstances. Such statements are not guarantees of future performance and are subject to risks and significant uncertainties and that actual results may differ materially from those included within the forward-looking statements as a result of various factors. The occurrence of any unanticipated events may cause actual results to differ from those expressed or implied by the forward-looking statements contained herein. You are cautioned not to place undue reliance on these statements, which speak only as of the date of this report which is as at February 22, 2006.

Please find enclosed the Consolidated Balance Sheets as at December 31, 2005 and 2004 and the Consolidated Statements of Earnings and Deficit and the Consolidated Statements of Cash Flows for the years ending December 31, 2005, 2004, and 2003 and the Notes to Consolidated Financial Statements for Diversinet Corp. Our financial statements have been prepared in accordance with Canadian GAAP. These principles conform in all material respect with U.S. GAAP except as described in Note 14 to our consolidated statements. All financial figures are in U.S. dollars unless otherwise noted. The following discussion should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this annual report.

The differences between line items under Canadian GAAP and those under U.S. GAAP are not significant except that, under U.S. GAAP, our total loss would be less by \$439,000 and \$578,000 for the years ended ending December 31, 2005 and December 31, 2004 respectively. These differences relate to differences in accounting for stock-based compensation.

Overview

Founded in 1997 and based in Toronto, Canada, Diversinet is a provider of personal authentication and security solutions for the wireless world. Our software and services protect user identity and provide secure access for consumer and business applications using a variety of mobile phones, Personal Digital Assistants and personal computers. Our scaleable, open mobile security platform enables enterprises and service providers to rapidly develop, deploy and manage next-generation wireless security services. Our technology simplifies what had previously been a complex set of technical problems in both information security and wireless data communications. In January 2005 Diversinet began to focus on the evolving protection and trust needs of mobile users. These financial results reflect this shift in focus and the time required to build up a customer base under this new strategy and a rebuilding of the sales and marketing strategy of the company.

Diversinet's MobiSecure soft tokens and MobiSecure Authentication Service Center (MASC) enable financial service providers, mobile network operators and security service providers to rapidly develop, deploy and manage secure on-line services for mobile device and PC users worldwide. Our MobiSecure soft tokens are securely provisioned and managed by MASC and are available on the leading intelligent mobile device platforms, including Symbian, Microsoft, RIM, Palm and Java-based phones as well as on personal computers running Microsoft Windows.

Diversinet's combination of client software and wireless provisioning services enables the issuance and management of mobile device authentication tokens and also creates a technology platform from which we can provide an entirely new and powerful set of capabilities in the mobile e-commerce environment in the form of digital identities, digital permissions and wireless wallets. In addition to providing mobile device security and provisioning solutions, Diversinet deploys an experienced professional services team for application development, consulting, training and technical support.

On September 26, 2005, we completed a private placement of 5,000,000 common shares for gross proceeds of \$2,000,000 and issued 71,250 common share purchase warrants to our placement agent. The warrants expire on September 26, 2008 and are exercisable at \$0.40 per share. This transaction was effected as a private placement in accordance with Rule 506 of Regulation D promulgated under the Securities Act of 1933, as amended. We will use the net proceeds of that private placement for ongoing sales operations, working capital purposes, to continue our research and development activities and for general corporate purposes.

In February 2005 DSS completed an asset sale agreement whereby it sold the majority of its current assets, capital assets, current liabilities, consultant and customer accounts for \$250,000. Diversinet is entitled to a five year annual fee of up to \$120,000 per year based on the purchaser meeting certain gross profit and net profit criteria. With the sale of DSS, we have included the results of DSS as a single line item ('discontinued operations') in the Consolidated Statements of Earnings and Deficit on a retroactive basis.

During 2004 and 2005 the Company completed three financings in which Lakefront Partners, LLC and James B. Wigdale, Jr. participated in. After the completion of the financings, Lakefront beneficially owned 3,242,795 common shares, and Mr. Wigdale owned 330,000 common shares and 1,400,000 common share purchase warrants. As a result of the transactions, Lakefront, together with Mr. Wigdale, beneficially owned, as of December 31, 2005, a total of 3,572,795 common shares and 1,400,000 common share purchase warrants, together representing approximately 19.34% of the issued and outstanding common shares of the Company, presuming the exercise of such warrants.

We have incurred operating losses in each of the last nine fiscal years, most recently from our continuing operations of developing security solutions. We have sustained our business during this period through the sale of common shares in a series of private placements, by raising gross proceeds \$3.1 million in June 2003, \$2 million in January 2004, \$2.65 million in December 2004 and most

recently by raising \$2.0 million in September 2005. We cannot provide assurance that we will be able to raise sufficient funds in the future to sustain our operations.

Selected Annual Information

The selected annual information presented below is based on the audited consolidated financial statements as at December 31, 2005.

For the year ended December 31	2005	2004	2003
Revenue	\$1,101,104	\$2,602,894	\$1,394,630
Loss from continuing operations	(7,038,636)	(6,975,356)	(4,713,182)
Loss for the period	(7,109,496)	(7,516,842)	(4,958,751)
Loss per share	(0.35)	(0.62)	(0.71)
Weighted average number of common shares	20,578,427	12,144,565	7,022,447
Dividends declared per share	–	–	–
As at December 31	2005	2004	2003
Cash and short term investments	1,355,562	2,723,498	1,791,493
Total assets	2,013,122	7,307,634	11,003,509
Total long-term liabilities	–	–	300,000

Operating Results

Year ended December 31, 2005 compared to year ended December 31, 2004

For the year ending December 31, 2005 and 2004, we reported revenue of \$1,101,000 and \$2,603,000 respectively. We generated 73% (90% in 2004) of our revenues from the United States, 18% (2% in 2004) from the Asia Pacific region, 9% (4% in 2004) from Canada and nil (4% in 2004) from other areas during the year ended December 31, 2005. During this year, we generated 100% (87% in 2004) from consulting services and nil (13% in 2004) from licensing. The lower revenue for 2005 was due to a reduction in the Caradas revenues of approximately \$1.5 million. During the third quarter of 2005 we received notice from one of our customers that they would not be renewing our contract to provide test lab services. This contract represented \$479,000 in 2005 revenues (\$355,000 in 2004). In 2004, we received \$195,000 from a license sale of our Connexus Client software. In January 2005 Diversinet began to focus on the evolving protection and trust needs of mobile users. This shift resulted in a decrease in our US professional services in the amount of \$833,000. These financial results reflect this shift in focus and the time required to build up a customer base under this new strategy and a rebuilding of the sales and marketing strategy of the company.

During 2005, 67% (64% in 2004) of our revenue came from two customers. While we are endeavoring to increase our customer base, the market that we operate in is still in an evolving stage and our revenue is still quite small. Therefore, it is reasonable to expect that our revenue may continue to be concentrated among relatively few customers for the near future.

Cost of sales were \$563,000 (gross margin of 49%) for the year ended December 31, 2005 compared to \$1,427,000 (gross margin of 45%) for 2004. This represents the direct costs associated for completing the software solutions and consulting services revenue. The increase in the gross margins for 2005 are due in part to a \$200,000 higher margin test lab project.

Research and development expenses were \$1,242,000 for the year ended December 31, 2005 compared to \$1,154,000 for 2004. During 2004 we received \$141,000 relating to investment tax credits for R&D work done in 2003 and the two month stub period in 2002.

Sales and marketing expenses were \$1,290,000 for the year ended December 31, 2005 compared to \$1,195,000 for 2004. The increase in sales and marketing is largely due to the implementation of the new strategy of the evolving protection and trust needs of mobile users started in January 2005.

General and administrative expenses were \$2,301,000 for the year ended December 31, 2005 compared to \$2,369,000 for 2004. Included in the December 31, 2005 general and administrative expenses is \$986,000 (\$761,000 for 2004) relating to stock-based compensation expenses. Remuneration and travel increased \$146,000 over 2004 as a result of the addition to our executive team of a President offset by the reduction of an employee at head office. Professional fees decreased by \$353,000 over 2004 due to non-recurring legal settlements and consulting services which were not incurred in 2005. Two large accounts were written off in 2004 resulting in bad debt charges of \$85,000 (2005 for \$0). Rent expense increased to \$158,000 (\$119,000 for 2004) relating to our head office in Toronto, Canada.

Depreciation and amortization expense was \$540,000 for the year ended December 31, 2005 compared to \$920,000 for 2004. During the fourth quarter of 2004 we increased our depreciation charge by \$145,000 for our joint venture assets in recognition that we were in the process of winding up the joint venture. With the sale of the DSS assets in February 2005, we expected to see reduced depreciation and amortization. These figures also include amortization of purchased technology and customer assets acquired on September 1, 2003 in the amount of \$126,000 (\$189,000 for 2004) and \$221,000 (\$331,000 for 2004), respectively.

During the third quarter of 2005, we received notice from one of our customers that they would not be renewing our contract to provide test lab services. Therefore, with there being no continuing customers from the September 2003 Caradas purchase and with our new strategy focused on the evolving protection and trust needs of mobile users, we determined that net customer assets were impaired under the fair value based methodology as prescribed under GAAP. We have recorded a customer asset impairment charge of \$331,000 (nil- 2004). In consideration of the adverse change noted above, we completed our goodwill impairment testing during the third quarter of 2005. As part of the purchase price calculation, and ultimately affecting the goodwill, the original value attributed to common shares provided in the Caradas acquisition was \$3.45 per common share. As the result of the above the fair value of our goodwill exceeded its carrying value which results in a \$1,895,000 impairment charge in the current year. As Caradas has been unable

to attract significant new customers in order to generate positive cash flows, we determined that the fair value of our goodwill exceeded its carrying value by \$1,895,000 as at September 30, 2005 (\$2,500,000 for 2004).

Foreign exchange losses were \$11,000 for the year ended December 31, 2005 compared to \$28,000 for 2004. We earned interest and other income of \$32,000 during 2005 compared to \$16,000 for 2004 through investing our excess cash.

We reported a loss from discontinued operations of \$71,000 for the year ended December 31, 2005 compared to \$542,000 for 2004. In February 2005 DSS completed an agreement whereby it sold the majority of its current assets, capital assets, current liabilities, consultant and customer accounts for \$250,000. With the sale of the DSS assets, we have included the results of DSS as a single line item ('discontinued operations') in the financial statements. During the first quarter of 2005, with the sale of DSS' assets, goodwill from the acquisition of DSS of \$392,000 has been included in determining the loss on disposition.

We reported a net loss for the year ended December 31, 2005 of \$7,109,000 compared to \$7,517,000 for 2004. These net losses include stock-based compensation expense relating to the issuance of options and warrants of \$986,000 and \$761,000 during 2005 and 2004 respectively and a goodwill and customer asset impairment charge of \$2,225,000 and \$2,500,000 for 2005 and 2004 respectively.

Unaudited quarter ended December 31, 2005 compared to the unaudited quarter ended December 31, 2004

For the quarter ending December 31, 2005, we reported revenue of \$159,000 compared to \$419,000 for the quarter ended December 31, 2004. During the quarter, we generated 100% (100% in 2004) from consulting services and nil (nil in 2004) from licensing. The lower revenue for the 2005 quarter was due to a reduction in the Caradas revenues of approximately \$254,000. During the fourth quarter of 2005, Caradas revenues were \$120,000 (2004 - \$374,000) of which \$47,000 was from deferred revenues.

Cost of sales were \$13,000 for the quarter ended December 31, 2005 compared to \$267,000 for the same quarter in 2004. During the fourth quarter of 2005, revenue included \$47,000 from deferred revenues for which the costs incurred were included in the 2004 cost of sales.

Research and development expenses were \$310,000 for the quarter ended December 31, 2005 compared to \$210,000 for the similar period of 2004. During the fourth quarter of 2004, we received a net amount of \$141,000 relating to investment tax credits for R&D work done in 2003 and the two month stub period in 2002. Sales and marketing expenses were \$354,000 for the quarter ended December 31, 2005 compared to \$138,000 for the similar period of 2004. The Q4 2005 results include severance costs as we realigned the sales and marketing team. Throughout the quarter the average number of employees in this department was greater by one. This resulted in remuneration, travel and human resource cost being greater by \$144,000. Public and media relations expenses were increased by \$34,000 over Q4 2004. General and administrative expenses were \$503,000 for the quarter ended December 31, 2005 compared to \$525,000 for the similar period of 2004. The 2005 quarter includes \$177,000 in stock-based compensation expense, compared to \$256,000 for the similar period in 2004.

Depreciation and amortization expense was \$48,000 for the quarter ended December 31, 2005 compared to \$332,000 for the similar period of 2004. During the fourth quarter of 2004, we increased our depreciation charge by \$145,000 for our joint venture assets. The expense for the fourth quarter of 2004 also included \$130,000 relating to amortization of customer assets and purchased technology. These assets were written off in the third quarter of 2005. The remaining variance is the result of applying our rates to a declining net asset balance.

We reported net income from discontinued operations of \$28,000 for the quarter ended December 31, 2005 compared to a loss of \$592,000 in the prior year's comparative period.

We reported a net loss of \$1,030,000 for the quarter ended December 31, 2005 and \$4,166,000 for the quarter ended December 31, 2004. The quarterly 2004 loss includes \$2,500,000 related to a goodwill impairment charge for Caradas. The loss per share was \$(0.05) for the quarter ended December 31, 2005 compared to \$(0.31) for the December quarter of 2004.

Year ended December 31, 2004 compared to year ended December 31, 2003

For the year ending December 31, 2004 and December 31, 2003, we reported revenue of \$2,603,000 and \$1,395,000 respectively. We generated 90% (78% in 2003) of our revenues from the United States, 2% (16% in 2003) from the Asia Pacific region, 4% (1% in 2003) from Canada and 4% (5% in 2003) from other areas during the period ended December 31, 2004. During this period, we generated 87% (76% in 2003) from consulting services and 13% (24% in 2003) from licensing. The higher revenue for 2004 was due to an increase in revenues of \$1.2 million through the acquisition of Caradas in September 2003. We are operating in an evolving and unpredictable market and accordingly have and may continue to experience wide fluctuations in our revenues.

During 2004, 64% (67% in 2003) of our revenue came from two customers. While we are endeavoring to increase our customer base, as the market that we operate in is still in an evolving stage and our revenue is still quite small, it is reasonable to expect that our revenue may continue to be concentrated among relatively few customers for the near future.

Cost of sales were \$1,427,000 (or gross margin of 45%) for the year ended December 31, 2004 compared to \$417,000 (or gross margin of 70%) for 2003. This represents the direct costs associated with completing the software solutions and consulting services revenue. With the addition of Caradas, licensing revenues (which have a higher gross margin than consulting services) as a percentage of total revenue decreased from 24% in 2003 to 12% in 2004.

Research and development expenses were \$1,154,000 for the year ended December 31, 2004 compared to \$1,276,000 for 2003. The decrease is due in part to further headcount cost reduction measures carried out in during 2004. During the year, we received a net amount of \$141,000 relating to investment tax credits for R&D work done in 2003 and the two month stub period in 2002. During 2003 we received \$289,000 for 2002 and 2001 and a rebate of retail sales taxes paid in excess in 2001.

Sales and marketing expenses were \$1,195,000 for the year ended December 31, 2004 compared to \$1,720,000 for 2003. The decrease in sales and marketing is largely due to the headcount cost cutting measures that we undertook in the second quarter of 2004. Included in the December 31, 2003 sales and marketing expenses is \$300,000 relating to stock-based compensation expenses. For 2004, all stock-based compensation has been included in general and administrative expenses.

General and administrative expenses were \$2,369,000 for the year ended December 31, 2004 compared to \$1,731,000 for 2003. Included in the December 31, 2004 general and administrative expenses is \$761,000 (\$525,000 for 2003) relating to stock-based compensation expenses.

Depreciation and amortization expense was \$920,000 for the year ended December 31, 2004 compared to \$663,000 for 2003. During the fourth quarter of 2004 we increased our depreciation charge by \$145,000 for our joint venture assets in recognition that we are in the process of winding up the joint venture. These figures also include amortization of purchased technology and customer assets acquired on September 1, 2003 in the amount of \$189,000 (\$63,000 for 2003) and \$331,000 (\$110,000 for 2003), respectively.

Foreign exchange losses for the year ended December 31, 2004 were \$28,000 compared to \$324,000 for the year ended December 31, 2003. The 2003 figures include unrealized foreign exchange losses of \$477,000 (2004 - \$0). Until October 1, 2003, we had historically prepared our consolidated financial statements in Canadian dollars and used the Canadian dollar as our measurement currency. We earned interest and other income of \$16,000 during for 2004 compared to \$23,000 for 2003 through investing our excess cash. Interest expenses were \$0 for the year ended December 31, 2004 compared to \$0 for 2003.

During the fourth quarter of 2004, we completed our goodwill impairment test and determined that goodwill of \$525,000 as at December 31, 2004 (nil for 2003) relating to DSS and \$2,500,000 (nil for 2003) relating to Caradas was impaired under the fair value based methodology as prescribed under GAAP. During fiscal 2004, Caradas was unable to attract significant new customers in order to generate the expected cash flows. DSS lost key management in the first quarter of 2004 and as a result DSS lost several customers over the course of the year. Furthermore, as part of the purchase price calculation, and ultimately affecting the goodwill, the original value attributed to common shares provided in the Caradas acquisition was \$3.45 per common share. As the result of the above the fair value of our goodwill exceeded its carrying value which results in an impairment charge in the current period.

We reported a loss from discontinued operations of \$541,000 for the year ended December 31, 2004 compared to \$246,000 for 2003. During the third quarter of 2004 we settled a dispute with a former shareholder of DSS and received 50,000 Diversinet common shares (with a fair value of \$21,000) and the elimination of the promissory note payable of \$150,000. This \$171,000 gain is offset by the inclusion of \$525,000 relating to a goodwill impairment charge for DSS in 2004.

We reported a net loss of \$7,517,000 for the year ended December 31, 2004 and \$4,959,000 for the year ended December 31, 2003. This net loss for 2004 and 2003 includes stock-based compensation expense relating to the issuance of options and warrants of \$761,000 and \$825,000 in 2004 and 2003 respectively and a goodwill impairment charge of \$2,500,000 and \$0 respectively. During the year, we started to report a fair value for stock-based compensation and are including this as an expense. During 2004, we revalued our goodwill from the DSS and Caradas acquisitions, discussed in further detail in this report.

Liquidity and Capital Resources

Year ended December 31, 2005 compared to year ended December 31, 2004

Cash and cash equivalents at December 31, 2005 were \$1,356,000 compared with \$723,000 at December 31, 2004. Short term investments, being corporate debt securities with a term of less than 90 days that could be converted into cash, at December 31, 2005 were nil compared to \$2,000,000 at December 31, 2004. The net change in cash and cash equivalents and short term investments for 2005 was (\$1,368,000) compared to \$932,000 for 2004. The fiscal 2005 decrease is mainly due to operating activities which used cash in an amount of \$3,291,000 (compared to 2004 when operating activities used cash in the amount of \$3,637,000) which was offset by a financing completed during 2005 for gross proceeds of \$2,000,000 (in 2004 we completed two financing for gross proceeds of \$2,000,000 in January 2004 and gross proceeds of \$2,650,000 in December 2004).

On September 26, 2005, we completed a private placement of 5,000,000 common shares for gross proceeds of \$2,000,000 and issued 71,250 common share purchase warrants to our placement agent. Each warrant entitles the holder to acquire one common share at a price of \$0.40 per common share for a period of three years from September 26, 2005. During 2005 the Board approved an incentive plan, based on achievement of certain milestones, for the entire management team and employees consisting of up to \$2,000,000 in cash and 2,000,000 nominal value warrants.

On January 20, 2004, we completed a private placement of 1,000,000 common shares and 1,100,000 common share purchase warrants for gross proceeds of \$2,000,000. All the warrants expire on January 15, 2007 with 500,000 vesting immediately and exercisable at \$2.00 per share, 350,000 vesting on January 15, 2005 and exercisable at a price of \$2.05 and the remaining 250,000 warrants vesting on July 15, 2004 and exercisable at a price of \$2.05 per share. The later two vestings will become immediate if any one of a number of significant changes occurs within us. During December 2004, we repriced the 350,000 warrants vesting on January 15, 2005 to \$0.60 as part of a revised agreement for 2005 services.

On December 20, 2004, we completed a private placement of 6,925,000 common shares and 300,000 common share purchase warrants for gross proceeds of \$2,650,000. Each warrant entitles the holder thereof to acquire one common share at a price of \$0.40 per common share for a period of up to three years from December 20, 2004.

As of December 31, 2005, we had commitments under non-cancelable operating leases for our facilities and equipment through 2006 in amounts of \$380,000 for fiscal 2006.

We are not subject to material market risk exposures, except for risks related to interest rate fluctuations and foreign currency exchange rates. Our exposure to market rate risk for changes in interest rates relates primarily to our cash equivalents and short term investments, created by our past financings. We have not used derivative financial instruments in our short term investments. We invest in high quality money market instruments and bonds with terms of less than 90 days. We are averse to principal loss and ensure the safety and preservation of our invested funds by limiting default, market and reinvestment risk. We do not make use of a bank line of credit and do not have any long-term debt. The impact of inflation has not been material to our business over the past five years.

We believe that our cash and cash equivalents as at December 31, 2005 of \$1,356,000 may be insufficient to meet our short-term working capital requirements for the next fiscal year. We may need to raise additional amounts to meet our working capital requirements through private or public financings, strategic relationships or other arrangements. However, additional funding may not be available on terms attractive to us, or at all. If we enter into strategic relationships to raise additional funds, we may be required to relinquish rights to certain of our technologies. Our failure to either raise capital when needed or to generate revenues would leave us with insufficient resources to continue our business.

The following table presents unaudited selected financial data for each of the last eight quarters ending December 31, 2005:

	Revenue for the period (\$000's)	Loss from continuing operations (\$000's)	Loss (income) from discontinued operations (\$000's)	Loss for the period (\$000's)	Loss per share from continuing operations (\$)	Loss per share (\$)
December 31, 2005	159	1,057	28	1,030	0.04	0.04
September 30, 2005	258	3,371	(48)	3,323	0.17	0.17
June 30, 2005	330	1,453	5	1,458	0.08	0.08
March 31, 2005	354	1,158	141	1,299	0.06	0.07
December 31, 2004	419	3,574	592	4,166	0.27	0.31
September 30, 2004	720	908	(247)	660	0.07	0.05
June 30, 2004	611	1,265	82	1,347	0.10	0.11
March 31, 2004	853	1,228	115	1,343	0.10	0.11

The September 30, 2005 quarterly loss is higher than previous quarters largely due to the inclusion of a goodwill impairment change of \$1,895,000 and a customer asset impairment charge of \$331,000. The December 31, 2004 quarterly loss is higher than previous quarters largely due to the inclusion of a goodwill impairment charge of \$2,500,000 and \$145,000 of depreciation and amortization charge relating to the joint venture.

Quarter ended December 31, 2005 compared to quarter ended December 31, 2004

The net change in cash and cash equivalents and short term investments for the fourth quarter of 2005 was \$(1,214,000) compared to \$1,901,000 for the fourth quarter of 2004. The Q4 2005 decrease is mainly due to the continuing operating activities which used cash in an amount of \$1,191,000. The Q4 2004 net change in cash and cash equivalents and short term investments of \$1,901,000 is due to continuing operating activities, which used cash in an amount of \$747,000 which was offset by the financing completed during December 2004 year for gross proceeds of \$2,650,000.

Year ended December 31, 2004 compared to year ended December 31, 2003

Cash and cash equivalents at December 31, 2004 were \$723,000 compared with \$548,000 at December 31, 2003. Short term investments, being marketable bonds with a term of less than 90 days that could be converted into cash, at December 31, 2004 were \$2,000,000 compared to \$1,244,000 at December 31, 2003. The net change in cash and cash equivalents and short term investments for 2004 was \$932,000 compared to \$318,000 for 2003. The fiscal 2004 increase is mainly due to operating activities which used cash in an amount of \$3,637,000 (compared to 2003 when operating activities used cash in the amount of \$2,264,000) which was offset by two financing completed during 2004, \$2,000,000 gross proceeds in January 2004 and \$2,650,000 gross proceeds in December 2004 (compared to \$3,100,000 gross proceeds in June 2003) and the repayment of \$50,000 of promissory notes payable. Included in the 2004 operating activities was \$225,000 paid to settle a legal fee dispute with our former attorneys on the Silva Run litigation.

The fiscal 2003 net change in cash and cash equivalents and short term investments of \$317,000 was due to operating activities, which used cash in an amount of \$984,000, the investment to acquire DSS and Caradas for net \$541,000, the repayment of DSS' bank indebtedness of \$240,000 and the repayment of notes payable related to the acquisition of DSS of \$873,000. These cash usages were offset by financings of net \$2,921,000 (being the June 2003 financing for gross proceeds of \$3,100,000 net of fees).

On January 20, 2004, we completed a private placement of 1,000,000 common shares and 1,100,000 common share purchase warrants for gross proceeds of \$2,000,000. All the warrants expire on January 15, 2007 with 500,000 vesting immediately and exercisable at \$2.00 per share, 350,000 vesting on January 15, 2005 and exercisable at a price of \$2.05 and the remaining 250,000 warrants vesting on July 15, 2004 and exercisable at a price of \$2.05 per share. The later two vestings will become immediate if any one of a number of significant changes occurs within us. During December 2004, we repriced the 350,000 warrants vesting on January 15, 2005 to \$0.60 as part of a revised agreement for 2005 services.

On December 20, 2004, we completed a private placement of 6,925,000 common shares and 300,000 common share purchase warrants for gross proceeds of \$2,650,000. Each warrant entitles the holder thereof to acquire one common share at a price of \$0.40 per common share for a period of up to three years from December 20, 2004.

On June 23, 2003, we completed a private placement of 5,000,000 common shares at a price of \$0.62 per common share for gross proceeds of \$3,100,000. The placement agent exercised its option to receive 500,000 common shares in lieu of its \$310,000 fee from this private placement. The placement agent also received 40,000 common shares in lieu of its \$24,000 retainer fee to act as placement agent. Further compensation was issued as a three-year broker cashless exercisable warrant terminating on June 20, 2006 to purchase up to 500,000 common shares at \$0.62 per share. The placement agent has exercised 440,000 in a cashless exercise to receive 304,037 common shares.

As of December 31, 2004, we had commitments under non-cancelable operating leases for our facilities and equipment through 2006 in amounts ranging from \$528,000 in fiscal 2005 declining to \$380,000 in fiscal 2006.

Controls and Procedures

We carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the fiscal year covered by this Annual Report. This evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective. There was no changes in our internal control over financial reporting during the year ended December 31, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Off-balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have had, or are reasonably likely to have, a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

Tabular Disclosure of Contractual Obligations

We are committed under operating leases for a total amount of approximately \$380,000. The minimum payments due in each of the following years are as follows:

Contractual obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating lease obligations	379,639	379,639	-	-	-
Total	\$379,639	\$379,639	\$-	\$-	\$-

Transactions with Related Parties

As part of the September 2005 private placement, Lakefront Partners, LLC acquired 725,000 common shares. As well, during 2004 we completed two financings in which Lakefront Partners, LLC and James B. Wigdale, Jr. participated. James Wigdale, Jr., one of our directors, controls Lakefront Partners, LLC. Currently, Lakefront beneficially owns 3,242,795 common shares and Mr. Wigdale owns 330,000 common shares and 1,400,000 common share purchase warrants, together representing approximately 19.35% of the issued and outstanding common shares of the Company, presuming the exercise of such warrants.

Diversinet's CEO is a member of the board of directors of the purchaser of the DSS asset agreement.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Significant estimates are used in determining the allowance for doubtful accounts, the useful lives of intangible assets, including customer assets and purchased technology, and goodwill impairment. In making such estimates and assumptions, management consults with employees knowledgeable in the area; gathers relevant information; where appropriate, seeks advice from qualified third parties; and, makes judgments, which in the opinion at that time, represent fair, balanced and appropriate conservative estimates and assumptions.

In the year ended December 31, 2005, we did not make any significant changes in, nor take any corrective actions regarding, our internal controls or other factors that could significantly affect these controls. We periodically review our internal controls for effectiveness and we plan to conduct an evaluation of our disclosure controls and procedures each quarter. Other important accounting policies are described in note 2 to our consolidated financial statements.

Risks and Uncertainties

Our Company is subject to a number of risks and uncertainties that could cause actual results to differ materially from those predicted or anticipated. These risks are described in our F-1 and annual Form 20-F filed with the SEC in the United States at www.sec.gov and filed on SEDAR in Canada at www.sedar.com. We encourage you to review these filings in order to evaluate an investment in our securities. Some key risks that could cause actual results to differ materially from those predicted or anticipated are listed below.

Financial resources: The attached consolidated financial statements are prepared on a going concern basis that assumes that the Company will continue in operation in the foreseeable future and be able to realize its assets and discharge its liabilities in the normal course of business. The projected cash flows for the Company are based upon assumptions that include, amongst others, a revenue stream from our

wireless security and identity management solutions and the success of future external financing initiatives. Should these projects be delayed then the present working capital would not be sufficient for the Company to continue in the normal course of operations. In recognition of these concerns, management is considering various revenue and cost management alternatives and may consider raising additional cash through external financing activities. It is not possible at this time to predict with any assurance the success of these initiatives.

Our ability to continue operations may be dependent on our ability to obtain additional financing. Although we have made progress in developing our solutions and have completed initial consumer deployments, our revenue from operations is not sufficient to cover our operating expenses at present and may be unlikely to be sufficient within fiscal 2006. We have obtained funding for operations from private placements in the past, but there is no assurance we will be able to do so again in the near future despite the progress of the business. Our failure to either raise capital when needed or to generate revenues would leave us with insufficient resources to continue our business.

Our quarterly and annual operating results have varied substantially in the past and are likely to vary substantially from quarter to quarter and year to year in the future due to a variety of factors. In particular, our period-to-period operating results are significantly dependent upon the sale of license agreements and the continued success in providing professional services. In this regard, the purchase of our solutions often requires our customers to make a significant capital investment, which customers may view as a discretionary cost and, therefore, a purchase that can be deferred or cancelled due to budgetary or other business reasons. Furthermore, our ability to continue providing professional services is dependent upon being able to provide value added resources at reasonable rates. Estimating future revenues is also difficult because we ship our products upon receipt of a signed license agreement and, therefore, we do not have a backlog. Thus, quarterly and annual license revenues are heavily dependent upon agreements finalized and software shipped within the same quarter or year. We expect these revenue patterns to continue for the foreseeable future, until recurring revenue becomes a significant portion of total revenue. Despite the uncertainties in our revenue patterns, our operating expenses are based upon anticipated revenue levels and such expenses are incurred on an approximately rateable basis throughout the quarter. As a result, if expected revenues are delayed or otherwise not realized in a quarter for any reason, our business, operating results and financial condition would be adversely affected in a significant way.

If our common shares should become ineligible for continued quotation on the OTC BB or a public trading market does not continue for any reason, holders of our common shares may have difficulty selling their shares. Our common shares became ineligible for continued quotation on the NASDAQ SmallCap Market and are now trading on the Over the Counter Bulletin Board; therefore holders of our common shares will have difficulty selling their shares. Our common shares were quoted on the NASDAQ SmallCap Market from June 1995 through late April 2003.

Our common shares may continue to be penny stock, which may adversely affect the liquidity of our common shares. The United States Securities and Exchange Commission has adopted regulations that define a penny stock to be any equity security that has a market price, as defined in those regulations, of less than \$5.00 per share, subject to certain exceptions. Our common shares are currently penny stock.

Commercial deployment: The ability of the Company to continue operations is also dependent on the acceptance of its security and identity management solutions and the adoption of transaction-based applications over wireless networks as an accepted method of commerce in sufficient volume for us to generate enough revenues to fund our expenses and capital requirements. The wireless mobile commerce market is in a very early stage and it may not develop to a sufficient level to support our business.

Dependence on key customers; concentration of credit: The loss of any key customer and our inability to replace revenues provided by a key customer may have a material adverse effect on our business and financial condition. Our customer base includes large financial institutions. As a result, we maintain individually significant receivable balances due from them. If these customers fail to meet their payment obligations, our operating results and financial condition could be adversely affected. For the year ending December 31, 2005, three customers accounted for 38%, 29%, and 18% of our total sales. As at December 31, 2005, one customer accounted for 90% of our total accounts receivable.

Foreign exchange: Our functional currency is the U.S. dollar. Sales generated outside Canada are generally denominated in U.S. dollars. During fiscal 2004 and 2005, we incurred a portion of our expenses in U.S. dollars, but we also incurred a portion of our expenses in other currencies including Canadian dollars, Pound Sterling and Hong Kong dollars. Changes in the value of these currencies relative to the U.S. dollar may result in currency losses that may have an adverse effect on our operating results. With the completion of our financings in September 2005, we have a portion of our cash resources in U.S. dollars and in Canadian dollars. During fiscal 2004 and 2005 we maintained a portion of our cash resources in both U.S. and Canadian dollar term deposits.

Litigation: Our Company has been named as a defendant in various proceedings arising in the course of our Company's activities and arising from transactions relating to a previous business operated by our Company. Litigation arising from these matters may be time consuming, distracting and expensive. An adverse resolution to any of these proceedings may have a material adverse impact on our business and financial condition. During 2005, one of our wholly owned subsidiaries settled an outstanding suit from October 2002 for \$7,500. The plaintiff was seeking to receive \$328,000, alleging the subsidiary received preferential payments. During 2004, the Silva Run Worldwide Ltd. lawsuit that was started in May 1996 was settled and the Company also settled an outstanding legal fee dispute with our former attorneys. Also during 2004, we settled a former employee lawsuit that was started in January 2004 and we settled two former employee lawsuits that were started in July 2003.

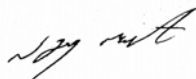
MANAGEMENT'S REPORT

The accompanying consolidated financial statements and all information in the Annual Report have been prepared by management and have been reviewed and approved by the Board of Directors of the Company. The consolidated financial statements were prepared in accordance with accounting principles generally accepted in Canada and, where appropriate, reflect management's best estimates and judgments. Management is responsible for the accuracy, integrity and objectivity of the consolidated financial statements within reasonable limits of materiality and for the consistency of financial data included in the text of the Annual Report with that contained in the consolidated financial statements.

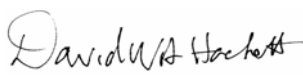
To assist management in the discharge of these responsibilities, the Company maintains a system of internal controls and systems designed to provide reasonable assurance that its assets are safeguarded, that only valid and authorized transactions are executed and that accurate, timely and comprehensive financial information is prepared and disclosed. The internal control systems and financial records are subject to reviews by external auditors during the examination of the financial statements. Management recognizes its responsibility for conducting the Company's affairs to comply with the requirements of applicable laws and established financial standards and principles, and for maintaining proper standards of conduct in its activities.

The Company's Audit Committee is appointed by the Board of Directors annually and is comprised of three non-management directors. The Audit Committee meets with management as well as with the independent auditors to satisfy itself that management is properly discharging its financial reporting responsibilities and to review the consolidated financial statements and the independent auditors' report. The Audit Committee reports its findings to the Board of Directors for consideration in approving the consolidated financial statements for presentation to the shareholders. The Audit Committee has responsibility for engaging or re-appointing the Company's independent auditors. The independent auditors have direct and unrestricted access to the Audit Committee to discuss their audit and related findings as to the integrity of the Company's financial reporting.

The consolidated financial statements have been audited by KPMG LLP, Chartered Accountants, on behalf of the shareholders, in accordance with generally accepted auditing standards. Their report outlines the scope of their audit and expresses their opinion on the consolidated financial statements of the Company.



Nagy Moustafa, *Chief Executive Officer*
February 22, 2006



David Hackett, *Chief Financial Officer*

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Diversinet Corp. as at December 31, 2005 and December 31, 2004 and the consolidated statements of earnings and deficit and cash flows for each of the years ended December 31, 2005, December 31, 2004 and December 31, 2003. 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 and the standards of the Public Company Accounting Oversight Board (United States). 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.

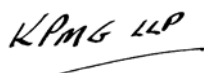
In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and December 31, 2004 and the results of its operations and its cash flows for each of the years ended December 31, 2005, December 31, 2004, and December 31, 2003 in accordance with Canadian generally accepted accounting principles.



Chartered Accountants, Toronto, Canada, February 22, 2006

COMMENTS BY AUDITORS FOR U.S. READERS ON CANADA - U.S. REPORTING DIFFERENCE

In the United States, reporting standards for auditors require the addition of an explanatory paragraph (following the opinion paragraph) when the financial statements are affected by conditions and events that cast substantial doubt on the Company's ability to continue as a going concern, such as those described in note 1 to the financial statements. Our report to the shareholders dated February 22, 2006, is expressed in accordance with Canadian reporting standards which do not permit a reference to such events and conditions in the auditors' report when these are adequately disclosed in the financial statements.



Chartered Accountants, Toronto, Canada, February 22, 2006

DIVERSINET CORP.

Consolidated Balance Sheets
(In United States dollars)

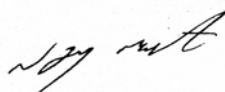
As at December 31	2005	2004
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,355,562	\$ 723,498
Short-term investments	–	2,000,000
Accounts receivable	66,039	290,239
Other receivables	1,266	35,700
Prepaid expenses	117,245	187,653
Current assets of discontinued operations (note 3)	–	512,992
Total current assets	1,540,112	3,750,082
Capital assets, net (note 4)	473,010	593,673
Purchased technology, net of accumulated amortization of \$nil, (2004-\$251,333)	–	125,667
Customer assets net of accumulated amortization of \$nil, (2004-\$441,024)	–	551,280
Goodwill (notes 2b)	–	2,286,932
Total assets	\$ 2,013,122	\$ 7,307,634
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 153,100	\$ 147,084
Accrued liabilities (note 5)	226,679	478,781
Notes payable	–	4,611
Deferred revenue	79,000	165,343
Current liabilities of discontinued operations (note 3)	–	676,414
Total current liabilities	458,779	1,472,233
Shareholders' equity:		
Share capital (note 6):		
Authorized:		
Unlimited common shares		
Issued and outstanding:		
24,316,691 (19,157,941 – 2004) common shares	54,347,652	52,445,135
Contributed surplus	2,521,422	1,265,549
Cumulative translation adjustment	(1,520,721)	(1,520,721)
Share purchase warrants (note 6)	2,500,977	2,830,929
Deficit	(56,294,987)	(49,185,491)
Total shareholders' equity	1,554,343	5,835,401
Future operations (note 1)		
Commitments and contingencies (note 10)		
Total liabilities and shareholders' equity	\$ 2,013,122	\$ 7,307,634

See accompanying notes to consolidated financial statements.

On behalf of the Board:



Mark Steinman, Chairman



Nagy Moustafa, Director

DIVERSINET CORP.

Consolidated Statements of Earnings and Deficit
(In United States dollars)

Year ended December 31	2005	2004	2003
Revenue	\$ 1,101,104	\$ 2,602,894	\$ 1,394,630
Cost of sales	562,987	1,426,922	416,776
Gross margin	538,117	1,175,972	977,854
Expenses:			
Research and development	1,241,599	1,153,758	1,275,598
Sales and marketing	1,289,940	1,195,434	1,720,459
General and administrative	2,301,032	2,369,025	1,731,345
Depreciation and amortization	539,770	920,323	662,762
Goodwill impairment charge (note 2b)	1,894,690	2,500,000	–
Customer asset impairment charge	330,768	–	–
	7,597,799	8,138,540	5,390,164
Loss before the following	(7,059,682)	(6,962,568)	(4,412,310)
Foreign exchange loss	10,586	28,386	324,365
Interest income and other income	(31,632)	(15,598)	(23,493)
Loss from continuing operations	(7,038,636)	(6,975,356)	(4,713,182)
Loss from discontinued operations (note 3)	(70,860)	(541,486)	(245,569)
Loss for the year	(7,109,496)	(7,516,842)	(4,958,751)
Deficit, beginning of year	(49,185,491)	(41,481,762)	(36,523,011)
Adjustment for cumulative effect of change in accounting for stock based compensation (note 2o)	–	(186,887)	–
Deficit, end of year	\$(56,294,987)	\$(49,185,491)	\$(41,481,762)
Basic and diluted loss per share from continuing operations	\$ (0.34)	\$ (0.57)	\$ (0.67)
Basic and diluted loss per share	\$ (0.35)	\$ (0.62)	\$ (0.71)
Weighted average number of common shares	20,578,427	12,144,565	7,022,447

See accompanying notes to consolidated financial statements.

DIVERSINET CORP.

Consolidated Statements of Cash Flows
(In United States dollars)

For the year ended December 31	2005	2004	2003
Cash provided by (used in):			
Operating activities:			
Loss for the year from continuing operations	\$ (7,038,636)	\$ (6,975,356)	\$ (4,713,182)
Items not involving cash:			
Depreciation and amortization	539,770	920,323	662,762
Goodwill impairment charge (note 2b)	1,894,690	2,500,000	—
Customer asset impairment charge	330,768	—	—
Stock-based compensation expense	986,257	760,916	825,010
Unrealized foreign exchange loss	—	—	477,210
Change in non-cash operating working capital:			
Accounts receivable	224,200	15,615	1,645,298
Other receivables	34,434	23,777	(82,028)
Prepaid expenses	70,408	184,554	10,655
Accounts payable	6,016	(182,896)	(1,766,591)
Accrued liabilities	(252,102)	(571,658)	829,068
Deferred revenue	(86,343)	(312,106)	(152,162)
Cash used in continuing operations	(3,290,538)	(3,636,831)	(2,263,960)
Cash provided by discontinued operations	(92,042)	94,858	1,280,081
Cash used in operations	(3,382,580)	(3,541,973)	(983,879)
Financing activities:			
Issue of common shares, common share purchase options and warrants for cash	1,842,183	4,565,503	2,920,746
Notes payable	(4,611)	(17,456)	(879,448)
Proceeds from sale of discontinued operations	250,000	—	—
Repayment of promissory notes payable	—	(50,000)	—
Bank indebtedness	—	—	(240,979)
Cash provided by financing activities	2,087,572	4,498,047	1,800,319
Investing activities:			
Proceeds of disposition of short-term investments	2,000,000	(756,040)	(269,777)
Acquisitions, net of cash received	—	—	(541,084)
Net (addition) disposal of capital assets	(72,928)	(24,070)	42,085
Cash provided by (used in) investing activities	1,927,072	(780,110)	(768,776)
Increase in cash and cash equivalents	632,064	175,964	47,664
Cash and cash equivalents, beginning of year	723,498	547,534	499,869
Cash and cash equivalents, end of year	\$ 1,355,562	\$ 723,498	\$ 547,533
Supplementary non-cash financing and investing activities:			
Issue of warrants on acquisitions	\$ —	\$ —	\$ 1,044,640
Issue of common shares on acquisitions	—	—	4,959,875
Issuance of shares in settlement of debt	—	400,000	—

See accompanying notes to consolidated financial statements.

DIVERSINET CORP.

Notes to Consolidated Financial Statements
(In United States dollars)

Years ended December 31, 2005 and 2004

Diversinet Corp. (the "Company"), an Ontario corporation, develops, markets and distributes wireless security infrastructure solutions and identity management solutions and professional services to the enterprise, financial services, government and gaming and wagering marketplaces.

1. Future operations:

These consolidated financial statements have been prepared on a going concern basis, which assumes the Company will continue in operation for the foreseeable future and be able to realize assets and satisfy liabilities in its normal course of business. Certain conditions and events exist that cast substantial doubt on the Company's ability to continue as a going concern.

The Company has incurred significant losses and used significant amounts of cash in operating activities in recent years.

Continued operations depend upon the Company's ability to generate future profitable operations and/or obtain additional financing to fund future operations and, ultimately, to generate positive cash flows from operating activities. There can be no assurance that the Company will be successful in obtaining additional financing or generating positive cash flows from operations.

Should the Company be unable to generate positive cash flows from operations or secure additional financing in the foreseeable future, the application of the going concern principle for financial statement reporting purposes may no longer be appropriate. These financial statements do not include any adjustments related to the valuation or classification of recorded asset amounts or the amounts or classification of liabilities that may be necessary should the Company be unable to continue as a going concern.

2. Significant accounting policies:

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada, which, except as described in note 16, conform in all material respects with accounting principles generally accepted in the United States. Significant accounting policies adopted by the Company are as follows:

(a) Basis of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany transactions and balances have been eliminated.

(b) Goodwill and customer assets:

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the sum of the amounts allocated to the identifiable tangible and intangible assets acquired, less liabilities assumed, based on their fair values. When the Company enters into a business combination, the purchase method of accounting is used. Goodwill is assigned as of the date of the business combination to reporting units that are expected to benefit from the business combination. Goodwill is not amortized but instead is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test is carried out in two steps. In the first step, the carrying amount of the reporting unit, including goodwill, is compared with its fair value. When the fair value of the reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered to be impaired and the second step of the impairment test is unnecessary. The second step is carried out when the carrying amount of reporting unit exceeds its fair value, in which case, the implied fair value of the reporting unit's goodwill, determined in the same manner as the value of goodwill is determined in a business combination, is compared with its carrying amount to measure the amount of the impairment loss, if any.

During the third quarter of 2005, a Caradas customer contract expired and accordingly a goodwill and customer asset impairment analysis was performed for the Caradas reporting unit. The impairment analysis indicated that the fair values of goodwill and customer assets were nil, and the Company recorded a goodwill write down of \$1,894,690 and a customer assets write down of \$330,768. The impairment analysis for DSS indicated that the fair value of goodwill was nil and accordingly recorded an impairment charge of \$392,242. Application of the goodwill impairment test requires judgment, including assignment of assets and liabilities and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology. This requires significant judgments including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, the useful life over which cash flows will occur, and determination of discount rate and terminal asset value. The Company believes goodwill is recorded at its fair value as at December 31, 2005.

During fiscal 2004, Caradas was unable to attract significant new customers in order to generate expected cash flows, and DSS lost key management which resulted in the loss of several customers over the course of the year. The Company completed a goodwill impairment test as at December 31, 2004 and determined that goodwill of \$2,500,000

relating to Caradas and \$525,000 relating to DSS was impaired under the fair value methodology as prescribed under GAAP. Goodwill impairment charges for DSS have been included in the results from discontinued operations for all periods presented.

The changes in the carrying amount of goodwill for the years ended December 31, 2005 and 2004 are as follows:

Balance December 31, 2003	\$ 5,311,932
<u>Goodwill impairment charge</u>	<u>(3,025,000)</u>
Balance December 31, 2004	2,286,932
<u>Goodwill impairment charge</u>	<u>(2,286,932)</u>
<u>Balance December 31, 2005</u>	<u>\$ —</u>

(c) Impairment or disposal of long-lived assets:

The Company reviews capital and intangible assets (long-lived assets) for impairment on an annual basis or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Absent any triggering factors during the year, the Company conducts its long-lived asset assessment in the fourth quarter to correspond with its planning cycle. An impairment loss is recognized when the carrying amount of an asset that is held and used exceeds the projected undiscounted future cash flows expected from its use and disposal, and is measured as the amount by which the carrying amount of the asset exceeds its fair value which is measured by discounted cash flows when quoted market prices are not available. For assets available-for-sale, an impairment loss is recognized when the carrying amount exceeds the fair value less costs to sell.

(d) Revenue recognition:

The majority of our revenues are derived from consulting services delivered on a stand alone basis. We also provide technical consulting services relating to smart card based application security systems. We also derive revenues from products and services for mobile commerce over wireless networks.

Consulting revenues are recognized on a time and materials basis, or on a percentage of completion basis, depending on the specifics of the contract, as employees and subcontractors provide services. Revenue from time and materials service contracts are recognized as the services are provided. Revenue from long term contracts is recognized based on actual hours incurred as specific deliverables are achieved, consistent with the Company's proportional performance under the contractual arrangement. Losses on contracts are recognized during the period in which the loss first becomes probable and reasonably estimable. Contract losses are determined to be the amount by which the estimated direct and indirect costs of the contract exceed the estimated total revenues that will be generated by the contract. Revenue recognized in excess of billings is recorded as unbilled services. Billings in excess of revenue recognized are recorded as deferred revenue until the above revenue recognition criteria are met. Reimbursements, including those relating to travel and other out-of-pocket expenses, and other similar third-party costs, are included in revenues.

Revenue from software license agreements is recognized in accordance with CICA 3400 "Revenue" and Statement of Position 97-2 "Software Revenue Recognition" as amended upon execution of a license agreement and the shipment of the software, as long as all vendor obligations have been satisfied, the license fee is fixed and determinable and collection of the license fees is probable. We consider fees related to arrangements with significant payments due beyond our normal trading terms not to be fixed or determinable. If the fee is not fixed or determinable, revenue is recognized as the payments become due from the customer. If collectibility is not considered probable, revenue is recognized when the fee is collected. Revenue from the sale of additional software products is recognized as software is delivered.

Revenue earned on software arrangements involving multiple elements (i.e., software products, upgrades/enhancements, post contract customer support, installation, training, et cetera) is allocated to each element based on vendor specific objective evidence (VSOE) of relative fair value of the elements. When arrangements contain multiple elements and VSOE only exists for all undelivered elements, the Company recognizes revenue for the delivered elements using the residual method, whereby the total arrangement fee is assigned to the undelivered elements based on their fair value, with the residual assigned to the delivered elements and recognized. VSOE used in determining the fair value for installation, integration and training is based on the standard daily rates for the type of service being provided multiplied by the estimated time to complete the task. VSOE used in determining the fair value of maintenance and technical support is based on annual renewal rates. For arrangements containing multiple elements where VSOE does not exist for all undelivered elements, revenue for the delivered and undelivered elements is deferred until either VSOE exists for the remaining undelivered elements or all elements have been delivered. The revenue allocated to post contract customer support is recognized ratably over the term of the support and revenue allocated to service elements (such as training and installation) is recognized as the services are performed.

The Company's sales arrangements generally include standard payment terms ranging up to 90 days. The Company provides a limited product warranty, the costs of which have historically been insignificant. The Company's products are not subject to rights of return, stock rotation rights or price protection.

(e) Cash and cash equivalents:

Cash and cash equivalents include cash on account and short-term investments in money market instruments with original maturities of 90 days or less when acquired.

(f) Short-term investments:

Short-term investments consist of corporate debt securities having a term of 90 days but less than one year when acquired which are recorded at cost plus accrued interest.

(g) Investment tax credits:

Investment tax credits are accrued when qualifying expenditures are made and there is reasonable assurance that the credits will be realized. Investment tax credits earned with respect to current expenditures for qualified research and development activities are included in the consolidated statements of earnings and deficit as a reduction of related expenses in the year incurred. Assistance related to the acquisition of capital assets used for research and development is credited against the related capital assets. The Company has recorded no investment tax credits in 2005 (\$141,000 - 2004).

(h) Research and development costs:

Research costs are expensed as incurred. Software development costs are deferred once costs meet the criteria under Canadian generally accepted accounting principles for deferral and amortization. Such deferred costs are amortized, commencing when the product is commercially released, on a straight-line basis over two years. The recoverability of any unamortized deferred development costs is reviewed on an ongoing basis.

(i) Purchased and acquired technology:

The Company capitalizes purchased technology and amortizes such costs over two years. The carrying value is assessed on a periodic basis to determine if a write-down is required. During the year, the Company recorded amortization of purchased technology and customer assets in the amount of \$126,000 (\$189,000 for 2004) and \$221,000 (\$331,000 for 2004), respectively.

(j) Customer assets:

Customer relationships are amortized over three years. Customer contracts are amortized as services are performed. The carrying value is accessed on a periodic basis to determine if a write-down is required.

(k) Foreign currency translation:

Monetary assets and liabilities denominated in foreign currencies are translated into United States dollars at the exchange rates prevailing at the consolidated balance sheet dates. Non-monetary assets and liabilities are translated at historical rates. Transactions in foreign currencies are translated into United States dollars at the approximate rates prevailing at the dates of the transactions. Foreign exchange gains and losses are included in loss for the period.

As a result of a number of circumstances, including the financing activities during fiscal 2003, the acquisition of DSS Software Technologies and Caradas, Inc. and the U.S. dollar becoming the measurement currency in which most of the Company's business is transacted, effective October 1, 2003, the Company adopted the U.S. dollar as its measurement and reporting currency for preparation of its consolidated financial statements

Under this method, share capital was translated at the exchange rate in effect at the time of the transaction. Deficit was translated at the approximate rates prevailing at the dates of the transactions and monetary assets and liabilities were translated into United States dollars at the exchange rates prevailing at the consolidated balance sheet dates. The resulting difference has been classified as a cumulative translation adjustment on the balance sheet.

(l) Capital assets:

Capital assets are stated at cost less accumulated depreciation and amortization. Depreciation and amortization is provided over the estimated useful lives of the assets at the following annual rates and bases:

Asset	Basis	Rate
Computer hardware	Declining balance	30%
Computer software	Declining balance	30%
Furniture and fixtures	Declining balance	20%
Leasehold improvements	Straight-line	Over term of lease

(m) Income taxes:

The Company accounts for income taxes using the asset and liability method. Under this method, future income taxes are recognized at the enacted or substantively enacted tax rate expected to be applicable at the date of reversal for all significant temporary differences between the tax and accounting bases of assets and liabilities and for certain tax carry forward items. Future income tax assets are recognized only to the extent that, in the opinion of management, it is more likely than not that the future income tax assets will be realized. Future income tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of the substantive enactment of the change.

(n) Earnings per share:

Basic earnings per share is computed using the weighted average number of common shares that are outstanding during the year. Diluted earnings per share is computed using the weighted average number of common and potential common shares outstanding during the year. Potential common shares consist of the incremental number of common shares issuable upon the exercise of stock options and warrants and are calculated using the treasury stock method.

(o) Stock-based compensation:

Effective January 1, 2004, Canadian GAAP requires the Company to estimate the fair value of stock-based compensation granted to employees and to expense the fair value over the estimated vesting period of the stock options. In accordance with the transition rules, the Company has retroactively adopted this change without re-statement of prior years and has determined the fair value of stock options granted to employees since November 1, 2002 in the amount of \$186,887, representing the expense for the 2003 fiscal year. This amount has been charged to deficit with an offsetting increase to the contributed surplus. During the year ended December 31, 2005, the Company recorded compensation expense for Canadian GAAP of \$439,250 (2004 - \$577,549) relating to employee stock options for which there was no corresponding expense under US GAAP (note 14).

(p) Use of estimates:

The preparation of these consolidated financial statements in conformity with 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 at the date of these consolidated financial statements and the reported amounts of revenue and expenses during the year. Actual results could differ from those estimates.

3. Acquisitions and discontinued operations:

(a) In January 2003, the Company acquired 100% of the outstanding shares of DSS Software Technologies ("DSS"), a consulting services provider. The aggregate purchase price of \$1,301,038 was allocated as follows:

Fair value of net capital assets acquired	\$ 93,374
Working capital	290,422
Goodwill	917,242
<hr/>	
Purchase price	\$ 1,301,038

Final consideration for this acquisition consisted of \$350,000 in cash, \$26,998 in costs associated with the acquisition, the issuance of 200,000 Diversinet shares, 120,000 warrants with a value of \$374,040, and a promissory note of \$150,000.

The Company completed a goodwill impairment test as at December 31, 2004 and recorded an impairment charge of \$525,000, as disclosed in note 2(b). An additional impairment charge of \$392,242 was recorded when the majority of assets and liabilities held by DSS were sold in February 2005, as disclosed in note 4.

(b) In September 2003, the Company acquired 100% of the outstanding shares of Caradas, Inc., a credential management provider. The aggregate purchase price was \$5,630,475, consisting of 1,417,500 common shares with a value of \$4,895,310, \$64,565 of costs associated with the acquisition and 200,000 common share purchase warrants with a value of \$670,600. All purchase warrants have subsequently been cancelled unexercised, and their value reclassified to contributed surplus. The acquisition was accounted for using the purchase method and the purchase price was allocated as follows:

Fair value of net capital assets acquired	\$ 186,853
Working capital	(320,372)
Purchased technology	377,000
Customer assets	992,304
Goodwill	4,394,690
<hr/>	
Purchase price	\$ 5,630,475

The customer assets of \$992,304 were comprised of customer relationships and other customer contracts. The customer relationships were assigned a useful life of three years and amortized on a straight-line basis, while the customer contracts were amortized as services were performed. The purchased technology of \$377,000 was assigned a useful life of two years and is fully amortized as at December 31, 2005.

During the fourth quarter of 2004, the Company completed a goodwill impairment test and recorded an impairment charge of \$2,500,000. An additional impairment charge of \$1,894,690 for goodwill, and \$330,768 for customer assets, was recorded in 2005, as disclosed in note 2(b).

In February 2005, the Company's subsidiary DSS Software Technologies (DSS) completed an agreement whereby it sold the majority of its current assets, capital assets, current liabilities, consultant and customer accounts for \$250,000. Diversinet is

entitled to a five-year annual fee of up to \$120,000 per year based on the purchaser meeting certain gross profit and net profit criteria. These amounts will be recorded as income from discontinued operations, if and when received.

The results of DSS have been excluded from continuing operations in the statements of operations and deficit for all periods presented. The following summarises the impact of discontinued operations on the balance sheet and statement of operations and deficit for all periods presented.

As at December 31	2005	2004	
Balance sheet	\$	\$	
Current assets	–	512,992	
Current liabilities	–	676,414	
Net liabilities of discontinued operations	–	(163,422)	

For the year ended December 31:	2005	2004	2003
Income Statement	\$	\$	\$
Revenue	453,361	4,441,994	7,126,886
Expenses	820,772	4,983,480	7,372,455
Income (loss) from discontinued operations	(367,411)	(541,486)	(245,569)
Gain on disposition of discontinued operations	296,551	–	–
Loss from discontinued operations	(70,860)	(541,486)	(245,569)
Loss per share from discontinued operations	0.00	(0.04)	(0.03)

Expenses in the loss on disposition of discontinued operations includes the elimination of the related goodwill of \$392,242 (2004 - \$525,000; 2003 - nil).

During the third quarter of 2004, the Company settled a dispute with a former shareholder of DSS and received 50,000 Diversinet common shares (with a fair value of \$21,000) and the elimination of the promissory note payable of \$150,000, which was recorded as a reduction of discontinued expenses in the table above. Additional future cash consideration of \$800,000 receivable based on achievement of certain financial targets was also eliminated.

4. Capital assets:

December 31, 2005	Cost	Accumulated depreciation and amortization	Net book value
Computer hardware	\$ 1,214,614	\$ 928,857	\$ 285,757
Computer software	506,783	420,786	85,997
Furniture and fixtures	269,717	182,390	87,327
Leasehold improvements	158,713	144,784	13,929
	\$ 2,149,827	\$ 1,676,817	\$ 473,010

In the year ended December 31, 2005, depreciation expense and amortization on capital assets amounted to \$192,701.

December 31, 2004	Cost †	Accumulated depreciation and amortization	Net book value
Computer hardware	\$ 1,147,777	\$ 841,425	\$ 306,352
Computer software	508,163	385,197	122,966
Furniture and fixtures	290,789	171,249	119,540
Leasehold improvements	170,825	126,010	44,815
	\$ 2,117,554	\$ 1,523,881	\$ 593,673

In the year ended December 31, 2004, depreciation expense and amortization on capital assets amounted to \$416,712.

5. Accrued liabilities:

	2005	2004
Compensation	\$ 42,256	\$ 151,633
Professional fees	101,973	97,611
Miscellaneous	82,450	229,537
	\$ 226,679	\$ 478,781

6. Share capital, warrants and common share purchase options:

There are an unlimited number of authorized common shares with no par value.

The following details the changes in issued and outstanding shares, compensation options and warrants:

	Compensation options and warrants		Common shares	
	Number	Amount	Number	Amount
Balance, December 31, 2002	535,404	\$ 47,348	3,222,308	\$ 40,677,545
Reverse stock split (b)	–	–	–	(5,246)
Private placement (c)	60,000	68,304	5,844,037	2,932,587
Stock options exercised and shares issued (a)	–	–	83	52
Acquisition of DSS (d)	120,000	374,040	–	–
Acquisition of Caradas (e)	200,000	670,600	1,417,500	4,895,310
Professional services (f)	105,000	171,360	559,099	701,620
Private placement (c)	–	–	–	(10,386)
Balance, December 31, 2003	1,020,404	1,331,652	11,043,027	49,191,482
Stock options exercised and shares issued (a)	–	–	189,914	358,458
Private Placement (g)	1,100,000	1,593,710	1,000,000	364,571
Private Placement (h)	300,000	97,140	6,925,000	2,530,624
Acquisition of Caradas (e)	(100,000)	(335,300)	–	–
Professional services (i)	288,000	183,366	–	–
Warrants cancelled and expired (l)	(40,000)	(39,639)	–	–
Balance December 31, 2004	2,568,404	2,830,929	19,157,941	52,445,135
Private Placement (j)	71,250	25,066	5,000,000	1,800,117
Acquisition of Caradas (e)	(100,000)	(335,300)	–	–
Professional services (k)	375,000	72,353	130,000	85,400
Warrants cancelled and expired (l)	(701,404)	(92,071)	–	–
Stock options exercised and shares issued (a)	–	–	28,750	17,000
Balance December 31, 2005	2,213,250	\$ 2,500,977	24,316,691	\$ 54,347,652

- (a) During 2003, 2004, and 2005, the Company granted options to certain employees, officers and directors under a share option plan (note 13), enabling them to purchase common shares of the Company.
- (b) On January 28, 2003 the Company completed a reverse stock split of its issued and outstanding common shares whereby every ten shares of common stock were exchanged for one share of common stock. All common share amounts in the financial statements have been restated to give effect to the stock split.
- (c) On June 23, 2003, the Company completed a private placement of 5,000,000 common shares at a price of \$0.62 per common share for gross proceeds of \$3,100,000.
- The placement agent exercised its option to receive 500,000 common shares in lieu of its \$310,000 fee from the private placement. The placement agent also received 40,000 common shares in lieu of its \$24,000 retainer fee to act as placement agent. Further compensation was issued as a three-year broker cashless exercisable warrant terminating on June 20, 2006 to purchase up to 500,000 common shares of Diversinet at \$0.62 per share. The placement agent has exercised 440,000 in a cashless exercise to receive 304,037 common shares.
- (d) In January 2003, the Company acquired 100% of the outstanding shares of DSS Software Technologies. The purchase price included 120,000 share purchase warrants with a value of \$374,040. The share purchase warrants became fully vested on January 1, 2005 and expires on December 31, 2006.
- (e) On September 1, 2003, Diversinet acquired 100% of the outstanding shares of Caradas, Inc. The aggregate consideration was 1,417,500 Diversinet common shares and 200,000 share purchase warrants. The share purchase warrants are exercisable at \$2.45 per share for five years. During 2004, 100,000 share purchase warrants were cancelled and the remaining warrants were repriced to \$0.40. During 2005, the remaining 100,000 share purchase warrants were cancelled and the value transferred to contributed surplus.

(f) Professional services:

The following chart summarizes the activity during the year ended December 31, 2003:

	Compensation options and warrants		Common shares	
	Number	Amount	Number	Amount
Business development services (i)	–	\$ –	250,000	\$ 300,000
Public relations services (ii)	100,000	57,620	200,000	240,000
Warrants exercised (ii)	(100,000)	(57,620)	69,099	57,620
Advisory board consulting services (iii)	50,000	59,260	–	–
Consulting services (iv)	–	–	40,000	104,000
Consulting services (v)	25,000	39,640	–	–
Advisory board consulting services (vi)	25,000	52,508	–	–
Consulting services (vii)	5,000	19,952	–	–
	105,000	\$ 171,360	559,099	\$ 701,620

- (i) On May 14, 2003, the Company entered into an agreement for business development services. This agreement is subject to certain milestones that if not met may allow Diversinet to terminate the retainer portion of the agreement and /or the entire agreement. In consideration for the services to be rendered Diversinet will pay a retainer equal to \$25,000 per month, which at our discretion may be paid as follows: (i) \$25,000 per month in cash, or (ii) \$25,000 per month by the issuance of 41,667 common shares per month, or (iii) \$20,000 per month in cash and issuance of 8,333 common shares per month. The Company elected to pay the first six months by way of 250,000 common shares.
- (ii) On May 14, 2003, the Company entered into an agreement for public relations services. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a three-year cashless exercisable warrant terminating on May 12, 2006 to purchase up to 100,000 of our common shares at \$0.60 per share and 200,000 common shares, being 16,667 common shares per month for 12 months in regards to the compensation payable by us for these services. The consultant opted to have a cashless exercise and received 69,099 common shares.
- (iii) On July 1, 2003, the Company entered into an agreement for advisory board consulting services. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a three-year warrant terminating on June 30, 2006 to purchase up to 50,000 of our common shares at \$0.62 per share.
- (iv) On July 17, 2003, the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued 40,000 of our common shares.
- (v) On August 20, 2003 the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a one-year warrant terminating on August 20, 2004 to purchase up to 25,000 of our common shares at \$3.40 per share.
- (vi) On July 1, 2003, the Company entered into an agreement for advisory board consulting services. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a five-year warrant terminating on August 1, 2008, vesting equally on a quarterly basis over three years, to purchase up to 25,000 of our common shares at \$0.62 per share in regards to the compensation payable by us for these services.
- (vii) On September 1, 2003 the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a two-year warrant terminating on September 30, 2005 to purchase up to 5,000 of our common shares at \$2.50 per share.
- (g) On January 20, 2004, the Company completed a private placement of 1,000,000 common shares and 1,100,000 common share purchase warrants for gross proceeds of \$2,000,000. All the warrants expire on January 15, 2007 with 500,000 vesting immediately and exercisable at \$2.00 per share, 350,000 vesting on January 15, 2005 and exercisable at a price of \$2.05 and the remaining 250,000 warrants vesting on July 15, 2004 and exercisable at a price of \$2.05 per share. The later two vestings will become immediate if any one of a number of significant changes occurs within the Company. During December 2004, the Company repriced the 350,000 warrants vesting on January 15, 2005 to \$0.60 in connection with the financing in (h) below.
- (h) On December 20, 2004, the Company completed a private placement of 6,925,000 common shares and 300,000 common share purchase warrants for gross proceeds of \$2,650,000. Each warrant entitles the holder thereof to acquire one common share at a price of \$0.40 per common share for a period of up to three years from December 20, 2004.
- (i) Professional services:

The following chart summarizes the activity during the year ended December 31, 2004:

Compensation options and warrants		
	Number	Amount
Advisory board consulting services (i)	25,000	\$ 45,930
Consulting services (ii)	72,000	100,574
Consulting services (iii)	15,000	5,464
Consulting services (iv)	18,000	22,360
Consulting services (v)	38,000	3,027
Consulting services (vi)	100,000	4,810
Consulting services (vii)	20,000	1,201
	288,000	\$ 183,366

- (i) On January 16, 2004, the Company entered into an agreement for advisory board consulting services. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a three-year warrant terminating on January 30, 2006 to purchase up to 25,000 of our common shares at \$2.50 per share in regards to the compensation payable by us for these services.
- (ii) On January 31, 2004, the Company entered into an agreement for public relations services. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a two-year warrant terminating on January 30, 2006 to purchase up to 72,000 of our common shares at \$2.50 per share in regards to partial compensation payable by us for these services.
- (iii) On April 11, 2004 the Company amended an agreement for consulting services dated August 20, 2003. As additional consideration for the services to be rendered in accordance with the agreement, Diversinet issued a five-year warrant terminating on April 11, 2009 to purchase up to 15,000 of our common shares at \$1.90 per share in regards to the compensation payable by us for these services.
- (iv) On May 1, 2004 the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a two-year warrant terminating on May 17, 2006 to purchase up to 18,000 of our common shares at \$1.65 per share in regards to the compensation payable by us for these services.
- (v) On September 20, 2004, the Company entered into an agreement for corporate marketing. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a share purchase warrant terminating on December 31, 2005 to purchase up to 38,000 of our common shares at \$0.50 per share in regards to the compensation payable by us for these services.
- (vi) On September 20, 2004, the Company entered into an agreement for internal corporate sales providing development and support for the sales message and strategy. In consideration for the services to be rendered in accordance with the agreement, Diversinet issued a share purchase warrant terminating on December 31, 2005 to purchase up to 100,000 of our common shares at \$0.50 per share in regards to the compensation payable by us for these services
- (vii) On September 22, 2004, the Company entered into an agreement for internal legal services. In part consideration for the services to be rendered in accordance with the agreement, Diversinet issued a share purchase warrant terminating on January 31, 2006 to purchase up to 20,000 of our common shares at \$0.50 per share in regards to the compensation payable by us for these services.
- (j) On September 26, 2005, the Company completed a private placement of 5,000,000 common shares and 71,250 common share purchase warrants for gross proceeds of \$2,000,000. Each warrant entitles the holder thereof to acquire one common share at a price of \$0.40 per common share for a period of up to three years from September 26, 2005.
- (k) Professional services:

The following chart summarizes the activity during the year ended December 31, 2005:

	Compensation options and warrants		Common shares	
	Number	Amount	Number	Amount
Advisory board consulting services (i)	125,000	\$ 32,119	130,000	\$ 85,400
Consulting services (ii)	30,000	7,023	—	—
Consulting services (iii)	15,000	3,959	—	—

Consulting services (iv)	30,000	17,946	–	–
Consulting services (v)	50,000	2,528	–	–
Consulting services (vi)	25,000	4,061	–	–
Consulting services (vii)	100,000	4,717	–	–
	<u>375,000</u>	<u>\$ 72,353</u>	<u>130,000</u>	<u>\$ 85,400</u>

- (i) On April 1, 2005, the Company issued common share purchase warrants to each of the members of our advisory board. These warrants vest at a rate of 8.3% per month over a one-year period and expire on December 31, 2006. Each holder of these warrants is entitled to purchase common shares at \$0.66 per share.
- (ii) On March 15, 2005, the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that is exercisable from November 20, 2005 to March 20, 2006 to purchase up to 30,000 of our common shares at \$0.80 per share.
- (iii) On July 21, 2005, the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that is exercisable from April 20, 2006 to July 20, 2006 to purchase up to 15,000 of our common shares at \$0.62 per share.
- (iv) On July 21, 2005, the Company entered into a consulting agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that is exercisable from February 28, 2008 to May 31, 2008 to purchase up to 30,000 of our common shares at \$0.71 per share.
- (v) On September 8, 2005, the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that is exercisable from September 7, 2006 to September 7, 2008 to purchase up to 50,000 of our common shares at \$0.40 per share.
- (vi) On September 15, 2005, the Company entered into an agreement for professional services of a technical consultant. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that is exercisable from May 15, 2006 to September 15, 2006 to purchase up to 25,000 of our common shares at \$0.40 per share.
- (vii) On July 30, 2005 the Company entered into an agreement for professional services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that is exercisable from July 30, 2005 to July 30, 2006 to purchase up to 100,000 of our common shares at \$0.63 per share.
- (l) Amount related to warrants expiring during the period unexercised. The value of warrants that have vested prior to the cancellation or expiration date has been reclassified to contributed surplus.
- (m) During the third quarter of the current year, the Board approved an incentive plan, based on achievement of certain milestones, for the entire management team and employees consisting of up to \$2,000,000 in cash and 2,000,000 nominal value warrants.

7. Basic and diluted loss per share:

Common shares issuable upon the exercise of options and warrants that could dilute basic loss per share in the future were not included in the computation of diluted loss per share because to do so would have been anti-dilutive for all periods presented. Anti-dilutive options amounted to 2,409,873 at December 31, 2005, 1,178,486 at December 31, 2004 and 1,118,846 at December 31, 2003. Anti-dilutive warrants amounted to 2,213,250 at December 31, 2005, 2,568,404 at December 31, 2004 and 1,020,404 at December 31, 2003 respectively.

8. Income taxes:

The tax effects of significant temporary differences representing future tax assets is as follows:

	2005	2004
Future tax assets:		
Operating loss carryforwards	\$11,577,330	\$12,145,083
Capital loss carryforwards	818,264	754,249
Share issue costs	155,117	246,021
Research and development costs	3,612,437	3,256,230
Capital assets, accounting basis less than tax basis	6,384,259	6,308,767
	<u>22,547,407</u>	<u>22,710,350</u>
Valuation allowance	(22,547,407)	(22,710,350)
Net future tax assets	<u>\$ –</u>	<u>\$ –</u>

In assessing the realizability of future tax assets, management considers whether it is more likely than not that some portion or all of the future tax assets will not be realized. The ultimate realization of future tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers projected future taxable income, uncertainties related to the industry in which the Company operates and tax planning strategies in making this assessment.

At December 31, 2005, the Company has non-capital losses available for carryforward for Canadian income tax purposes amounting to \$29,123,000. These losses expire in the following fiscal years:

2006	\$4,614,000
2007	12,100,000
2008	3,625,000
2009	411,000
2010	4,407,000
2014	1,864,000
2015	2,102,000
	<u>\$ 29,123,000</u>

The Company also has non-capital losses available for carryforward for United States income tax purposes amounting to \$2,727,000, expiring between 2018 and 2025.

9. Segmented information:

The Company operates in a single reportable operating segment. This segment derives its revenue from the sale of secured wireless and identity management solutions and related products and services. As at December 31, 2005 – 100%, December 31, 2004 - 75% and December 31, 2003 - 60% of the capital assets were located in Canada, 0% (25% - December 31, 2004; 22% December 31, 2002) were located in the United States and 0% (0% December 31, 2004 and 18% - December 31, 2003) in Hong Kong.

A summary of sales to major customers that exceeded 10% of total sales and the approximate amount due from these customers during each of the years in the three-year period ended December 31, 2005 are as follows:

	Sales			Accounts Receivable	
	2005	2004	2003	2005	2004
Customer 1	38%	46%	49%	–	178,417
Customer 2	29%	18%	18%	–	79,000
Customer 3	18%	0%	0%	–	–

The Company does not consider itself to be economically dependent on any single customer or supplier.

Revenue is attributable to geographic location based on the location of the customer during each of the years in the three-year period ended December 31, 2005 are as follows:

	2005	2004	2003
Sales:			
United States	\$ 801,700	\$ 2,334,510	\$ 1,093,932
Canada	99,680	116,526	9,665
Other	–	110,000	70,000
Asia	199,724	41,858	221,033
	<u>\$ 1,101,104</u>	<u>\$ 2,602,894</u>	<u>\$ 1,394,630</u>

During each of the years in the three-year period ended December 31, 2005 revenue is attributable as follows:

	2005	2004	2003
Sales:			
Consulting services	\$ 1,101,104	\$ 2,274,007	\$ 1,065,870
Licensing	–	328,887	328,760
	<u>\$ 1,101,104</u>	<u>\$ 2,602,894</u>	<u>\$ 1,394,630</u>

10. Commitments and contingencies:

(a) Litigation:

Management is of the opinion that the claims listed below are without merit and will not materially impact the Company. As a result, no provision for loss has been made in these consolidated financial statements.

- (i) During fiscal 2000, the Company and its wholly owned Barbados subsidiary, The Instant Publisher Ltd., were sued by a company that alleged that the Company breached a dealer agreement entered into in 1995 by the Company's former printing business and is seeking damages of \$1,533,950 and damages of \$25,000,000 for loss of reputation and loss of opportunity, pre-judgment and post-judgment interest, and costs.
- (ii) In addition to the above, in the ordinary course of business, the Company and its subsidiaries have legal proceedings brought against them.

(b) Lease commitments:

Total future minimum lease payments including operating costs are as follows:

2006	379,639
	\$ 379,639

11. Share option plan:

The Company grants options to certain employees, officers, directors and consultants under a share option plan (the "Plan"), enabling them to purchase common shares of the Company. The exercise price of an option under the Plan may not be less than the current market price of common shares on the day immediately proceeding the day the share option was granted. The Plan provides that the number of common shares reserved for issuance under the Plan shall not exceed 2,896,250 common shares (being 3,144,788 options reserved for issuance less 248,538 exercised to date). During 2005, the Company reduced the stock option vesting period from three years to two years (which has correspondingly shortened the expense amortization period) and also started to compensate Directors with stock grants or cash and option grants. This has increased compensation expense. As at December 31, 2005, the number of common shares reserved for future issues of stock options amounts to 486,379.

Assumptions used when valuing the options and warrants at their date of grant using the Black-Scholes option pricing model include: risk-free interest rate of 3.092%, estimated life of three years, expected dividend yield of 0% and volatility of 150%.

The following table summarizes information about stock options outstanding at December 31, 2005:

Options outstanding				Options vested	
Range of exercise price	Number outstanding	Weighted average remaining contractual life – years	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$0.37 – \$0.63	1,887,800	3.90	\$ 0.43	984,268	\$ 0.43
\$1.50 – \$24.06	522,073	2.51	3.00	399,323	3.25
	2,409,873	3.60	\$ 0.98	1,383,591	\$ 1.24

Changes for the employee stock option plan during the year ended December 31, 2005 were as follows:

	Year ended 2005		Year ended 2004	
	Number of shares	Weighted average exercise price	Number of shares	Weighted average exercise price
Options outstanding, beginning of year	1,178,486	\$ 2.37	1,118,846	\$ 5.45
Options granted	1,647,500	0.41	451,300	0.37
Options exercised	(28,750)	0.59	(4,914)	0.63
Options cancelled	(387,363)	2.80	(386,746)	9.61
Options outstanding, end of year	2,409,873	0.98	1,178,486	2.37
Options exercisable, end of year	1,383,591	1.24	730,271	2.71
Weighted average fair value of options granted during the year		\$ 0.63		\$ 0.76

12. Financial instruments and risk management:

The Company is exposed to the following risks related to financial assets and liabilities:

(a) Currency risk:

The Company is subject to currency risk through its activities in Canada, United Kingdom, Europe and Asia. Unfavourable changes in the exchange rate may affect the operating results of the Company.

The Company does not actively use derivative instruments to reduce its exposure to foreign currency risk. However, dependent on the nature, amount and timing of foreign currency receipts and payments, the Company may enter into forward exchange contracts to mitigate the associated risks. The Company has not entered into such contracts at December 31, 2005 and 2004.

(b) Fair values:

The fair values of the Company's financial instruments approximate their carrying amounts due to their short-term nature.

(c) Credit risk:

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash equivalents, short-term investments and accounts receivable. Cash equivalents and short-term investments are maintained at high-quality financial institutions.

The Company generally does not require collateral for sales on credit. The Company closely monitors extensions of credit. Management assesses the need for allowances for potential credit losses by considering the credit risk of specific customers, historical trends and other information.

Valuation Accounts and Reserves:

	2005	2004	2003
Allowance for Doubtful Accounts			
Opening balance	\$ 218,500	\$ 132,500	\$ -
Additions (deductions)	(218,500)	86,000	132,500
Closing balance	\$ -	\$ 218,500	\$ 132,500

Additions (deductions) to the allowance to doubtful accounts are charged to the income statement through the bad debt expense as part of the general and administrative account.

13. Related party transactions:

Related party transactions are in the normal course of operations and are measured at the exchange amount, which is the amount established and agreed to by the related parties.

As part of the September 2005 private placement, Lakefront Partners, LLC acquired 725,000 common shares. As well, during 2004 the Company completed two financings in which Lakefront Partners, LLC and James B. Wigdale, Jr. participated. James Wigdale, Jr., one of our directors, controls Lakefront Partners, LLC. Currently, Lakefront beneficially owns 3,242,795 common shares and Mr. Wigdale owns 330,000 common shares and 1,400,000 common share purchase warrants, together representing approximately 19.35% of the issued and outstanding common shares of the Company, presuming the exercise of such warrants.

Diversinet's CEO is a member of the board of directors of the purchaser of the DSS asset agreement.

14. Reconciliation of Canadian and United States generally accepted accounting principles ("GAAP"):

The consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles. Material differences between Canadian and United States generally accepted accounting principles are described below.

	2005	2004	2003
Share capital:			
Canadian GAAP	\$54,347,652	\$52,445,135	\$49,191,482
Elimination of reduction of share capital (a)	30,089,054	30,089,054	30,089,054
U.S. GAAP	\$84,436,706	\$82,534,189	\$79,280,536
Deficit and comprehensive loss:			
Canadian GAAP	\$(56,294,987)	\$(49,185,491)	\$(41,481,762)
Elimination of reduction of share capital (a)	(30,089,054)	(30,089,054)	(30,089,054)
Compensation expense (b)(i)	(991,696)	(991,696)	(991,696)
Compensation expense (b)(ii)	1,016,799	577,549	-
U.S. GAAP	\$(86,358,938)	\$(79,688,692)	\$(72,562,512)
Consolidated statements of loss:			
Loss under Canadian GAAP	\$(7,109,496)	\$(7,516,842)	\$(4,958,751)
Compensation expense (b)(ii)	439,250	577,549	-

Loss under U.S. GAAP	\$(6,670,246)	\$ (6,939,293)	\$ (4,958,751)
Basic and diluted loss per share under U.S. GAAP	\$(0.32)	\$(0.57)	\$(0.71)
Loss under U.S. GAAP	\$(6,670,246)	\$ (6,939,293)	\$ (4,958,751)
Other comprehensive loss (income) being cumulative translation adjustment (c)	–	–	(477,210)
Comprehensive loss under U.S. GAAP	\$(6,670,246)	\$ (6,939,293)	\$ (5,435,961)

(a) Share capital and deficit:

On March 1, 1999, the shareholders approved a resolution to reduce the stated capital of the Company by \$30,089,054 to eliminate the deficit as at October 31, 1999. Under Canadian GAAP, a reduction of the carrying amount of share capital of outstanding common shares is allowed with a corresponding offset to deficit. This reclassification, which the Company made in 2000 to eliminate the deficit that existed at October 31, 1999, did not meet the criteria specified by U.S. GAAP and results in an increase to share capital with a corresponding increase in deficit of \$30,089,054.

(b) Compensation expense:

- (i) Effective November 1, 2002, the Company adopted the new CICA Handbook section 3870, "Stock-Based compensation and Other Stock Based Payments". As a result, the Company has recognized compensation expense on options issued to consultants subsequent to November 1, 2002. As the Company has always recognized compensation expense for options issued to consultants for US GAAP purposes, this resulted in no U.S. GAAP differences in 2005 and 2004. Prior to the adoption of 3870, the company did not recognize compensation expense for Canadian GAAP purposes when stock or stock options were issued to consultants. Any consideration paid on exercise of stock options or purchase of stock was credited to share capital.
- (ii) Effective January 1, 2004 Canadian GAAP requires the Company to estimate the fair value of stock-based compensation granted to employees and to expense this amount over the estimated vesting period of stock options. For US GAAP purposes, the Company follows the intrinsic value method and no stock based compensation is recorded when the exercise price of stock options granted to employees is the same as the market price at the date of grant. If the Company issues options with an exercise price that is less than the market price, for US GAAP purposes the resulting compensation expense is charged to earnings over the vesting period. During the year ended December 31, 2005, the Company recorded compensation expense for Canadian GAAP of \$439,250 (2004 - \$577,549) relating to employee stock options in excess of the amount recorded under US GAAP.

(c) Other comprehensive loss (income):

FASB Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" (SFAS 130") requires disclosure of comprehensive income, which includes reported net income as adjusted for other comprehensive income. Other comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources.

(e) Short-term investments:

Short-term investments consist of corporate debt securities. For U.S. GAAP purposes, the Company classifies its debt securities as available-for-sale, which are recorded at fair value.

Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific identification basis. During the periods presented, there have been no unrealized holding gains or losses on short-term investments.

A decline in the market value of any available-for-sale security below cost that is deemed to be other than temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established.

(f) Notes to consolidated financial statements:

In order to comply with U.S. GAAP, the following notes to the consolidated financial statements would need to be added:

(i) Stock-based compensation plan:

SFAS No. 123, Accounting for Stock-Based Compensation, requires pro forma disclosures of net income and earnings per share, as if the fair value-based method as opposed to the intrinsic value-based method of accounting for employee stock options had been applied. The disclosures in the following table show the Company's loss for the year and loss per share on a pro forma basis using the fair value method as determined by using the Black-Scholes option-pricing model. Assumptions used when valuing the options at their date of grant using in the Black-Scholes option pricing model include: risk-free interest rate of 3.092%, estimated life of three years, expected divided yield of 0% and volatility of 150%.

	2005	2004	2003
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Loss under U.S. GAAP	\$ (6,670,246)	\$ (6,939,293)	\$ (4,958,751)
Compensation expense	804,158	673,513	1,281,680
Pro forma loss under U.S. GAAP	(7,474,404)	(7,612,806)	(6,240,431)
Pro forma loss per common share:			
Basic and diluted	(0.36)	(0.63)	(0.89)
Weighted average number of common shares	20,578,427	12,144,565	7,022,447

(ii) Recent accounting pronouncements:

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), which replaces Accounting Principles Board Opinion No. 20, "Accounting Changes", and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS 154 provides guidance on the accounting for and reporting of changes in accounting principles and error corrections. SFAS 154 requires retrospective application to prior period's financial statements of voluntary changes in accounting principle and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. Certain disclosures are also required for restatements due to correction of an error. SFAS 154 is effective for accounting changes and corrections of errors, made in fiscal years beginning after December 15, 2005. The impact that the adoption of SFAS 154 will have on the Company's results of operations and financial condition will depend on the nature of future accounting changes and the nature of transitional guidance provided in future accounting pronouncements.

Executive Officers

Nagy Moustafa, Chief Executive Officer

In 1997, it was Nagy Moustafa's vision to take identity management into the wireless market, thus making Diversinet a leading innovator in the wireless industry. Mr. Moustafa was the founder of CIT Canada Inc., an IT consulting firm, and its chief visionary since its inception. Prior to CIT Canada Inc., Mr. Moustafa was Director of Information Technology with Rogers Communications and held senior positions at IBM, Computerland and the Canadian Ministry of Treasury and Economics.

David Hackett, Chief Financial Officer and Corporate Secretary

David Hackett joined Diversinet in 2002 having most recently been the Chief Financial Officer and Corporate Secretary of Aucxis Corp. Prior to that Mr. Hackett was Chief Financial Officer, Director and Corporate Secretary of EveryWare Development Inc. Mr. Hackett was instrumental in raising numerous financing rounds and acquisitions including the eventual sale of EveryWare to Pervasive Software Inc. Mr. Hackett began his professional career at as a Chartered Accountant at Ernst & Young.

Board of Directors

Brian Barry has served as a Director since March 2005. Mr. Barry currently is an independent consultant and in January 2005 Mr. Barry completed a merger and acquisition activity with sale of Cilyx to Openwave. From May 2002 to May 2004 Mr. Barry was Chief Executive Officer of Hyperchip and from January 1998 to March 2002 he was Chief Executive Officer of Ericsson Canada.

Nagy Moustafa has served as Diversinet's Chief Executive Officer since November 1997 and President from November 1997 to December 2004.

Keith Powell has served as one of Diversinet's Directors since July 2002. Mr. Powell was previously the Senior Vice-President, Information Services and Chief Information Officer at Nortel Networks. Mr. Powell is currently a Partner at XPV Capital Corporation, a early stage venture capital company. In addition he holds seats on a number of technology company boards.

Mark Steinman has served as one of Diversinet's Directors since June 1998 and Chairman since September 2002. Mr. Steinman has thirty years of corporate finance experience and is currently an independent consultant. Until 2003, Mr. Steinman was Executive Vice President and Chief Financial Officer of Stelco Inc. and prior to 1999 as Chief Financial Officer of Spar Aerospace and Chief Financial Officer of Rogers Cablesystems.

James ('Jay') Wigdale has served as one of Diversinet's Directors since January 2005. Mr. Wigdale founded Lakefront Partners, LLC, a money-management firm, in 1988 and is the firm's Chief Investment Officer. Prior to founding Lakefront, he was senior VP of Institutional Sales and Regional Manager for Robert W. Baird & Co.

Advisory Board

Richard Clarke has served the last three U.S. Presidents as a senior White House advisor, where he held the titles of special assistant to the President for global affairs, national coordinator for security and counter-terrorism, and special advisor to the President for cyber-security. He is presently an on-air global terrorism consultant for ABC Television, and chairman of Good Harbor Consulting LLC.

Roger Cressey served as chief of staff to the U.S. President's Critical Infrastructure Protection Board from November 2001 to September 2002. Between November 1999 and November 2001, he served as director for transnational threats on the U.S. National Security Council staff. Mr. Cressey is the president of Good Harbor Consulting and an adjunct professor at Georgetown University.

Dr. Taher Elgamal is the chairman of Securify, Inc. and former chief scientist at Netscape Communications. He is a renowned expert on information security.

Patrick Gauthier is senior vice president, New Product Development, for Visa U.S.A. Over the past 5 years Patrick has led the team that created "smart Visa" for the US market. Before joining Visa, Patrick was North American Sales Manager with Schlumberger Smart Card & Systems. Patrick holds a Master's degree in Telecommunications Engineering from the Institut Supérieur des Télécommunications in France.

Howard Schmidt is chief information security officer for eBay and a founding member of the Global Council of CSOs (Chief Security Officers), a security think tank. In December 2001, Mr. Schmidt was appointed as the vice chair of the President's Critical Infrastructure Protection Board. Previously, Mr. Schmidt was chief security officer for Microsoft Corp.

Steve Sigmund is a Venture Partner at BlueStream Ventures, where he leads the firm's investment activities in the information security sector. Previously, he was a Managing Director in Equity Research at RBC Capital Markets and its predecessor firms Dain Rauscher Wessels and Wessels, Arnold & Henderson.

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