

Diversinet

2006 Annual Report



To Our Shareholders:

2006 was a milestone year for Diversinet during which the company solidified its position as a leader in mobile based strong authentication and provisioning service, highlighted by the introduction of our flagship MobiSecure Strong Authentication product suite, the adoption of our soft token technology by leading security industry OEMs, our entry into the health care industry and the continued expansion of our distribution channels.

Our significant 2006 business and product achievements included:

- A consulting and licensing agreement valued at approximately U.S. \$1 million with Blue Cross of Northeastern Pennsylvania, a major United States health insurance provider, for Diversinet's MobiSecure Wallet and Vault to enable secure access and management of personal medical records by individuals and health care providers through mobile phones, handheld wireless devices and personal computers.
- A licensing agreement with RSA Security to integrate Diversinet's MobiSecure soft token suite and Diversinet's MobiSecure Authentication Service Center into RSA Security's products and services, enabling the downloading, provisioning and management of RSA Security's mobile and PC-based soft tokens.
- The release of Diversinet's next-generation MobiSecure soft token and MobiSecure Authentication Service Center (MASC), the first fully automated, self-service system capable of supporting consumer-scale strong authentication rollouts for online banking, remote online access and secure e-commerce applications.
- Albert E. Wahbe, a former senior executive at Scotiabank who successfully lead the bank's development of Internet banking, e-commerce, wireless, telephone banking and smart card technologies, joined the Diversinet board as chairman and is taking an active role in sales and business development. Ravi Chiruvolu, an MIT engineer, Harvard MBA and seasoned venture capitalist, also joined the board.
- The successful completion of \$5.0 million in new funding for working capital purposes and general operations through private placements in June and July. Of this funding, Diversinet's new chairman, Albert Wahbe, personally contributed U.S. \$2.76 million.
- A reseller agreement and initial customer order with b-connect, a Hong Kong based software developer and IT services provider, for the MobiSecure Strong Authentication product, including MobiSecure software tokens, to provide secure remote employee access to internal systems for a large international healthcare services client.
- The awarding of another new patent, now totaling 7 patents, with 17 more still pending, which improves Diversinet's ability to monetize its intellectual property through licensing opportunities.
- Diversinet continued to pursue new partnerships, enlisting Infosec Co., Ltd. ("SK Infosec") to distribute Diversinet's MobiSecure software tokens and MobiSecure Authentication Service Center provisioning service in Korea, ECONZ Wireless to integrate and extend the MobiSecure BREW client into current and future ECONZ Wireless applications for sale worldwide through ECONZ Wireless mobile carrier partners, and Oberthur Card Systems to develop a SIM-based solution that enables consumers and corporate users to employ strong authentication over the Internet using their GSM/UMTS mobile phones and networks worldwide.

As we head into 2007, we are excited by the many new opportunities being created by the rapid introduction of a broad range of powerful, connected mobile devices, including MobiSecure Wallet and Vault. We will continue to seek new distribution partnerships, forge alliances with technology leaders and develop exciting new products and services to meet the growing needs of consumers and businesses for security in a mobile world.

I would like to again thank our shareholders, our dedicated staff and our business partners for their support over this past year. I look forward to working together with you all to build upon on the significant gains we accomplished in 2006.

Regards,



Albert Wahbe
Chairman and 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, 2007.

Please find enclosed the Consolidated Balance Sheets as at December 31, 2006 and 2005, the Consolidated Statements of Earnings and Deficit and the Consolidated Statements of Cash Flows for the years ending December 31, 2006, 2005, and 2004, and the Notes to Consolidated Financial Statements for Diversinet Corp. Our financial statements have been prepared in accordance with Canadian generally accepted accounting principals (GAAP). These principles conform in all material respect with U.S. GAAP except as described in Note 13 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 for the year ending December 31, 2005. 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 scalable, 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 MobiSecure Wallet is a client-side secure container application, which can access or hold confidential personal information, such as user id and access information via fax, email and SMS. It operates in concert with the MobiSecure Vault, a server-side secure container application, and allows a user to access a host of personal information files. Personal health records, financial information, payment information, entertainment or loyalty information can be accessed in real time, directly from a user's mobile phone or other hand-held access device. The MobiSecure Vault provides large file storage and backup to the Wallet and is accessible through web service interfaces and adaptors.

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.

During the first quarter of 2006, RSA Security Inc. (the security division of EMC Corporation) entered into a license agreement under which Diversinet provided mobile device and PC-based software tokens and integrated provisioning services. The agreement includes licensing, development and revenue-sharing components that will result when launched by RSA Security in revenues of a minimum of \$2.2 million to Diversinet over three years. Under this commercial agreement, the Diversinet MobiSecure soft token suite and Diversinet's MobiSecure Authentication Service Center (MASC) will be integrated into RSA Security's products and services, enabling the downloading, provisioning, and management of RSA Security's mobile and PC-based soft tokens. Under GAAP, the revenue from this arrangement will be recognized over its term.

In December 2006 we entered into a consulting and licensing agreement with Blue Cross of Northeastern Pennsylvania (BCNEPA). The agreement will generate revenue of \$1,000,000 for consulting work and the delivery of the solution to the customer's first 100,000 users. BCNEPA will utilize our MobiSecure products, based on our MobiSecure soft token technology, to enable secure access to and management of personal medical records by individuals and health care providers through mobile phones, handheld wireless devices and personal computers. No revenue has been recorded in 2006 related to this contract, however \$900,000 was received prior to year end, and the \$900,000 is included in deferred revenues.

On June 30, 2006, we completed a private placement of 6,680,001 units, at \$0.60 per unit, for gross proceeds of \$4,008,000. Each unit is comprised of one common share and one common share purchase warrant. One half of the warrant will be exercisable to purchase one common share for each whole warrant at a price of \$0.75, the other half warrant at \$0.90, and will expire on June 30, 2008. 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 for working capital and general corporate purposes.

On July 26, 2006, we completed a private placement of 1,538,463 units, at \$0.65 per unit, for gross proceeds of \$1,000,000 and issued 96,154 units for consulting services related to the private placement. Each unit is comprised of one common share and one common share purchase warrant. The warrant will be exercisable to purchase one common share for each whole warrant at a price of \$1.00 and will expire on July 26, 2008. 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 for working capital and general corporate purposes.

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 have incurred operating losses in each of the last ten 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, raising gross proceeds of \$2.65 million in December 2004, \$2.0 million in September 2005 and most recently raising \$5 million in June/July 2006. We cannot provide assurance that we will be able to raise sufficient funds in the future to sustain our operations.

In February 2005, the Company completed an asset sale agreement whereby it sold the majority of its subsidiary's (DSS) current assets, capital assets, current liabilities, and 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. For the two years ending February 2006 and 2007, the annual fee has been \$nil. 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.

As part of the June 2006 private placement, Albert Wahbe acquired 4,600,000 units. Albert Wahbe, our chairman as of July 2006, owns 4,700,000 common shares and 4,600,000 common share purchase warrants, representing as of December 31, 2006 approximately 24.5% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants. Mr. Wahbe also entered into a performance-based consulting agreement to provide sales and business development services for the Company. During 2005 and 2006 the Company completed two financings in which Lakefront Partners, LLC and James B. Wigdale, Jr. participated. After the completion of the financings, Lakefront beneficially owned 3,909,462 common shares and 666,667 common share purchase warrants, and Mr. Wigdale owned 380,000 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, 2006, a total of 4,289,462 common shares and 2,066,667 common share purchase warrants, together representing approximately 17.9% of the issued and outstanding common shares of the Company, presuming the exercise of such warrants.

Selected Annual Information

The selected annual information presented below is based on the audited consolidated financial statements as at December 31, 2006.

For the year ended December 31	2006	2005	2004
Revenue	\$1,666,965	\$1,101,104	\$2,602,894
Loss from continuing operations	(3,450,717)	(7,038,636)	(6,975,356)
Loss for the period	(3,450,717)	(7,109,496)	(7,516,842)
Loss per share	(0.12)	(0.35)	(0.62)
Weighted average number of common shares	28,740,174	20,578,427	12,144,565
Dividends declared per share	-	-	-
As at December 31	2006	2005	2004
Cash and short term investments	5,146,315	1,355,562	2,723,498
Total assets	5,830,228	2,013,122	7,307,634
Total long-term liabilities	-	-	-

Operating Results

Year ended December 31, 2006 compared to year ended December 31, 2005

For the years ending December 31, 2006 and 2005, we reported revenue of \$1,667,000 and \$1,101,000, respectively. We generated 84% (73% in 2005) of our revenues from the United States, 12% (18% in 2005) from the Asia Pacific region, 2% (9% in 2005) from Canada and 2% (nil in 2005) from other areas during the year ended December 31, 2006. During 2006, we generated 94% (100% in 2005) from consulting services and 6% (nil in 2005) from licensing. During 2006 we began and completed work on the RSA Security development product. We applied a zero gross margin percentage of completion method for this development agreement, providing us with \$845,000 in revenues and \$845,000 in cost of sales in fiscal 2006. During Q4 2006 we signed an agreement with BCNEPA under which we have invoiced \$900,000 included in 'deferred revenue' on the balance sheet. We expect to commence recognition of revenue related to this arrangement over the coming quarters as we deliver the MASC license and the associated 100,000 tokens to BCNEPA. 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. 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.

During 2006, 78% of our revenue came from three customers (67% in 2005 from two different 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 \$1,041,000 (gross margin of 38%) for the year ended December 31, 2006 compared to \$563,000 (gross margin of 49%) for 2005. This represents the direct costs associated with completing the software solutions and consulting services revenue. The lower margin for 2006 is the result of lower margins on a significant strategic customer (RSA Security) in 2006.

Research and development expenses were \$832,000 for the year ended December 31, 2006 compared to \$1,242,000 for 2005. Starting in Q1 2006, the development department focused a portion of their work effort towards completing modifications to our products for RSA Security. In the past, this department's time has been spent conducting research and developing our products for general availability. As a result, during 2006, product development costs of \$730,000 were reallocated from research and development to cost of sales. Costs were further reduced in 2006 by \$288,000 from the receipt of funds for our scientific research and experimental development (SRED) claim for the 2003, 2004 and 2005 fiscal years. The increase in development costs of \$608,000 (before the SRED credit and cost of sales allocation) over 2005 was largely due to an increase of 31% in the head count (from 16 to 21 people) in this department.

Sales and marketing expenses were \$701,000 for the year ended December 31, 2006 compared to \$1,290,000 for 2005. The decrease in costs in this department was due to a 38% reduction in the average head count (from 8 to 5). Further cost reductions included a decrease in travel costs of \$46,000, conferences by \$40,000 and memberships by \$28,000. Included in the December 31, 2006 sales and marketing expenses is \$33,000 (\$nil for 2005) relating to stock-based compensation expenses.

General and administrative expenses were \$2,485,000 for the year ended December 31, 2006 compared to \$2,301,000 for 2005. Included in the December 31, 2006 general and administrative expenses is \$874,000 (\$986,000 for 2005) relating to stock-based compensation expenses. The Company is required 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 and warrant grants. Professional fees increased by \$76,000 over 2005 due to greater spending in investor and public relations areas. We have also accrued Canadian \$250,000 with regards to litigation costs that we are currently involved in.

Depreciation and amortization expense was \$159,000 for the year ended December 31, 2006 compared to \$540,000 for 2005. The reduction in 2006 is primarily due to the sale of the DSS assets in February 2005, which led to reduced depreciation and amortization. This is consistent with the reduction in net capital assets.

Foreign exchange losses were \$18,000 for the year ended December 31, 2006 compared to \$11,000 for 2005. We earned interest and other income of \$118,000 during 2006 compared to \$32,000 for 2005 through investing our excess cash.

We reported a loss from discontinued operations of \$nil for the year ended December 31, 2006 compared to \$71,000 for 2005. 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, 2006 of \$3,451,000 compared to \$7,109,000 for 2005. These net losses include stock-based compensation expense relating to the issuance of options and warrants of \$906,000 and \$986,000 during 2006 and 2005, respectively, and a goodwill and customer asset impairment charge of \$nil and \$2,225,000 for 2006 and 2005, respectively.

Unaudited quarter ended December 31, 2006 compared to the unaudited quarter ended December 31, 2005

For the quarter ending December 31, 2006, we reported revenue of \$286,000 compared to \$159,000 for the quarter ended December 31, 2005. During the quarter, we generated 70% (100% in 2005) from consulting services and 30% (nil in 2005) from licensing. The higher revenue for the 2006 quarter was due to a large amount received for a license and professional services agreement entered into with a leading global identity authentication and protection company serving several million consumers. During Q4 2006 we signed an agreement with BCNEPA under which we have invoiced \$900,000 (and received \$900,000) which invoiced amount is included in 'deferred revenue' on the balance sheet.

Cost of sales were \$50,000 for the quarter ended December 31, 2006 compared to \$13,000 for the same quarter in 2005. The increase is due to a contract for professional services in which one employee's wages are charged to cost of sales. This contract started in November of 2005.

Research and development expenses were \$316,000 for the quarter ended December 31, 2006 compared to \$310,000 for the same period of 2005. Sales and marketing expenses were \$189,000 for the quarter ended December 31, 2006 compared to \$354,000 for the same period of 2005. 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 four less than the prior year. This resulted in remuneration, travel and human resource cost being reduced by \$138,000. Public and media relations expenses were decreased by \$23,000 over Q4 2005. General and administrative expenses were \$797,000 for the quarter ended December 31, 2006 compared to \$503,000 for the

same period in 2005. The 2006 quarter includes Canadian \$250,000 in litigation costs (2005 - \$nil) and \$90,000 in stock-based compensation expense, compared to \$177,000 for the same period in 2005.

Depreciation and amortization expense was \$38,000 for the quarter ended December 31, 2006 compared to \$48,000 for the same period of 2005. The variance is the result of applying our rates to a declining net asset balance.

We reported net income from discontinued operations of \$nil for the quarter ended December 31, 2006 compared to net income of \$28,000 in the prior year's comparative period.

We reported a net loss of \$1,050,000 for the quarter ended December 31, 2006 and \$1,030,000 for the quarter ended December 31, 2005. The loss per share was \$(0.03) for the quarter ended December 31, 2006 compared to \$(0.04) for the December quarter of 2005.

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 2005, 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 endeavouring to increase our customer base, the market that we operate in is still in an evolving stage and our revenue is still 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 with 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 focusing on 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 - \$nil). 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, which affects 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 2005. 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 \$541,000 for 2004. In February 2005 DSS completed an agreement whereby it sold the majority of its current assets, capital assets, current liabilities, and 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.

Liquidity and Capital Resources

Year ended December 31, 2006 compared to year ended December 31, 2005

Cash and cash equivalents at December 31, 2006 were \$5,146,000 compared with \$1,356,000 at December 31, 2005. The net change in cash and cash equivalents and short term investments for 2006 was \$3,791,000 compared to \$(1,368,000) for 2005. The fiscal 2006 increase was largely due to the June and July private placements in which gross proceeds of \$5,008,000 were raised. This was offset by operating activities which used cash in an amount of \$1,210,000 which includes the receipt from BCNEPA of \$900,000 included as part of the deferred revenues. The fiscal 2005 decrease is mainly due to continuing operations which used cash in an amount of \$3,291,000, offset by financing completed during 2005 for gross proceeds of \$2,000,000.

On July 26, 2006, we completed a private placement of 1,538,463 units, at \$0.65 per unit, for gross proceeds of \$1,000,000 and issued 96,154 units for consulting services related to the private placement. Each unit is comprised of one common share and one common share purchase warrant. The warrant will be exercisable to purchase one common share for each whole warrant at a price of \$1.00 and will expire on July 26, 2008.

On June 30, 2006, we completed a private placement of 6,680,001 units, at \$0.60 per unit, for gross proceeds of \$4,008,000. Each unit is comprised of one common share and one common share purchase warrant. One half of the warrant will be exercisable to purchase one common share for each whole warrant at a price of \$0.75, the other half warrant at \$0.90, and will expire on June 30, 2008.

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 starting 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.

As of December 31, 2006, we had commitments under non-cancellable operating leases for our facilities and equipment through 2012 in amounts of \$1,098,000.

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, 2006 of \$5,146,000 is sufficient to meet our short-term working capital requirements for the next twelve months. 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, 2006:

	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, 2006	285	1,050	-	1,050	0.03	0.03
September 30, 2006	432	932	-	932	0.03	0.03
June 30, 2006	477	747	-	747	0.03	0.03
March 31, 2006	473	722	-	722	0.03	0.03
December 31, 2005	159	1,057	(28)	1,029	0.03	0.03
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	142	1,299	0.06	0.07

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.

Quarter ended December 31, 2006 compared to quarter ended December 31, 2005

The net change in cash and cash equivalents and short term investments for the fourth quarter of 2006 was \$356,000 compared to \$(1,214,000) for the fourth quarter of 2005. The Q4 2006 increase is largely due cash receipts of \$900,000 received under the BCNEPA agreement. This amount is recorded in deferred revenue and will be recognized as revenue in future periods. The Q4 2005 decrease is mainly due to the continuing operating activities which used cash in an amount of \$1,191,000.

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), offset by financing completed in 2005 for gross proceeds of \$2,000,000 (in 2004 we completed two financings 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 starting 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 two later vestings will become immediate if any of a number of significant internal changes occurs. 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 starting December 20, 2004.

As of December 31, 2005, we had commitments under non-cancellable operating leases for our facilities and equipment through 2006 in amounts of \$380,000 for 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 were no changes in our internal control over financial reporting during the year ended December 31, 2006 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 \$1,098,000. The minimum payments due in each of the following years are as follows:

Contractual obligations	Total	Less than 1 year	2-3 years	4-5 years	More than 5 years
Operating lease obligations	1,097,764	214,570	410,734	404,966	67,494
Total	\$1,097,764	\$214,570	\$410,734	\$404,966	\$67,494

Transactions with Related Parties

As part of the June 2006 private placement, Albert Wahbe acquired 4,600,000 units. Albert Wahbe, one of our directors as of July 2006, owns 4,700,000 common shares and 4,600,000 common share purchase warrants, representing approximately 24.5% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants. Mr. Wahbe also entered into a performance based consulting agreement to provide sales and business development services for the Company, during 2006 he received \$10,000 relating to this agreement. As part of the June 2006 private placement, Lakefront Partners, LLC acquired 666,667 units. As well, during the September 2005 private placement, Lakefront Partners, LLC acquired 725,000 common shares. In 2004 we completed two financings in which Lakefront Partners, LLC and James B. Wigdale, Jr. participated. Mr. Wigdale, one of our directors, controls Lakefront Partners, LLC. As at December 31, 2006, Lakefront beneficially owns 3,909,462 common shares and 666,667 common share purchase warrants, and Mr. Wigdale owns 380,000 common shares and 1,400,000 common share purchase warrants, together representing approximately 17.9% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants.

A former member of our Board of Directors received consideration (while a Director) relating to services performed during the 2006 year of 100,000 share purchase warrants (exercisable at \$0.63 per common share) valued at \$4,717 relating to consulting services performed for the company.

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

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 their opinion at the time, represent fair, balanced and appropriate conservative estimates and assumptions.

In the year ended December 31, 2006, 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 1 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-3 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, security solution providers and health care providers. 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, 2006, one customer accounted for 56%, and two customers accounted for 11% of our total sales. As at December 31, 2006, three customers accounted for 33%, 16%, and 15% 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 2006 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 June and July 2006, we have a portion of our cash resources in U.S. dollars and in Canadian dollars. During fiscal 2005 and 2006 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 fiscal 2000, the Company and its wholly owned Barbados subsidiary, The Instant Publisher Ltd., were sued by a company that alleged 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. Management believes that a loss arising from this matter is probable and that the amount can be reasonably estimated. The Company has recorded an amount for the liability based on its current estimate of the settlement amount. As additional information becomes available, any potential liability related to this matter is assessed and the estimates will be revised accordingly. Based on the currently available information, management believes that the ultimate outcome of this matter will not have a material adverse effect on our financial position or overall trends in results of operations.

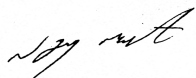
MANAGEMENT'S REPORT

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, 2007



David Hackett, *Chief Financial Officer*

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Diversinet Corp. as at December 31, 2006 and 2005 and the consolidated statements of earnings and deficit and cash flows for each of the years in the three year period ended December 31, 2006. 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, 2006 and 2005 and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2006 in accordance with Canadian generally accepted accounting principles.

Canadian generally accepted accounting principles vary in certain significant respects from US generally accepted accounting principles. Information relating to the nature and effect of such differences is presented in Note 13 to the consolidated financial statements.



Chartered Accountants, Toronto, Canada, February 22, 2007

DIVERSINET CORP.

Consolidated Balance Sheets
(In United States dollars)

As at December 31	2006	2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 5,146,315	\$ 1,355,562
Accounts receivable	154,109	67,305
Prepaid expenses	141,081	117,245
Total current assets	5,441,505	1,540,112
Capital assets, net (note 3)	388,723	473,010
Total assets	\$ 5,830,228	\$ 2,013,122

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable	\$ 172,291	\$ 153,100
Accrued liabilities (note 4)	633,661	226,679
Deferred revenue	938,550	79,000
Total current liabilities	1,744,502	458,779

Shareholders' equity:

Share capital (note 5):		
Authorized:		
Unlimited common shares		
Issued and outstanding:		
33,413,005 (24,316,691 – 2005) common shares	58,414,036	54,347,652
Contributed surplus	3,646,283	2,521,422
Cumulative translation adjustment	(1,520,721)	(1,520,721)
Share purchase warrants (note 5)	3,291,832	2,500,977
Deficit	(59,745,704)	(56,294,987)
Total shareholders' equity	4,085,726	1,554,343

Commitments and contingencies (note 9)

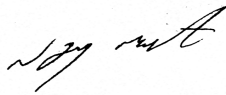
Total liabilities and shareholders' equity	\$ 5,830,228	\$ 2,013,122
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See accompanying notes to consolidated financial statements.

On behalf of the Board:



Albert Wahbe, Chairman



Nagy Moustafa, Director

DIVERSINET CORP.

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

Year ended December 31	2006	2005	2004
Revenue	\$ 1,666,965	\$ 1,101,104	\$ 2,602,894
Cost of sales	1,041,096	562,987	1,426,922
Gross margin	625,869	538,117	1,175,972
Expenses:			
Research and development	831,925	1,241,599	1,153,758
Sales and marketing	700,870	1,289,940	1,195,434
General and administrative	2,484,556	2,301,032	2,369,025
Depreciation and amortization	159,048	539,770	920,323
Goodwill impairment charge (note 1b)	-	1,894,690	2,500,000
Customer asset impairment charge	-	330,768	-
	4,176,399	7,597,799	8,138,540
Loss before the following	(3,550,530)	(7,059,682)	(6,962,568)
Foreign exchange loss	18,291	10,586	28,386
Interest income and other income	(118,104)	(31,632)	(15,598)
Loss from continuing operations	(3,450,717)	(7,038,636)	(6,975,356)
Loss from discontinued operations (note 2)	-	(70,860)	(541,486)
Loss for the year	(3,450,717)	(7,109,496)	(7,516,842)
Deficit, beginning of year	(56,294,987)	(49,185,491)	(41,668,649)
Deficit, end of year	\$(59,745,704)	\$(56,294,987)	\$(49,185,491)
Basic and diluted loss per share from continuing operations	\$ (0.12)	\$ (0.34)	\$ (0.57)
Basic and diluted loss per share	\$ (0.12)	\$ (0.35)	\$ (0.62)
Weighted average number of common shares	28,740,174	20,578,427	12,144,565

See accompanying notes to consolidated financial statements.

DIVERSINET CORP.

Consolidated Statements of Cash Flows
(In United States dollars)

For the year ended December 31	2006	2005	2004
Cash provided by (used in):			
Operating activities:			
Loss for the year from continuing operations	\$ (3,450,717)	\$ (7,038,636)	\$ (6,975,356)
Items not involving cash:			
Depreciation and amortization	159,048	539,770	920,323
Goodwill impairment charge (note 1b)	—	1,894,690	2,500,000
Customer asset impairment charge	—	330,768	—
Stock-based compensation expense	906,444	986,257	760,916
Change in non-cash operating working capital:			
Accounts receivable	(86,804)	258,634	39,392
Prepaid expenses	(23,836)	70,408	184,554
Accounts payable	19,191	6,016	(182,896)
Accrued liabilities	406,982	(252,102)	(571,658)
Deferred revenue	859,550	(86,343)	(312,106)
Cash used in continuing operations	(1,210,142)	(3,290,538)	(3,636,831)
Cash provided by discontinued operations	—	(92,042)	94,858
Cash used in operations	(1,210,142)	(3,382,580)	(3,541,973)
Financing activities:			
Issue of common shares, common share purchase options and warrants for cash	5,075,656	1,842,183	4,565,503
Notes payable	—	(4,611)	(17,456)
Proceeds from sale of discontinued operations	—	250,000	—
Repayment of promissory notes payable	—	—	(50,000)
Cash provided by financing activities	5,075,656	2,087,572	4,498,047
Investing activities:			
Proceeds of disposition of short-term investments	—	2,000,000	(756,040)
Capital assets additions	(74,761)	(72,928)	(24,070)
Cash provided by (used in) investing activities	(74,761)	1,927,072	(780,110)
Increase in cash and cash equivalents	3,790,753	632,064	175,964
Cash and cash equivalents, beginning of year	1,355,562	723,498	547,534
Cash and cash equivalents, end of year	\$ 5,146,315	\$ 1,355,562	\$ 723,498
Supplementary non-cash financing and investing activities:			
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, 2006, 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 health services, financial services, software security, storage and memory manufacturers, entertainment and gaming and telecommunications marketplaces.

1. 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 13, 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 customer contract related to the Company's Caradas reporting unit 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 Technologies (DSS) indicated that the fair value of goodwill was nil and accordingly recorded an impairment charge of \$392,242, which is included in discontinued operations (note 2). 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.

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 charges</u>	<u>(2,286,932)</u>
<u>Balance December 31, 2005 and 2006</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 Company recognizes revenue in accordance with Statement of Position ("SOP") 97-2, Software Revenue Recognition, issued by the American Institute of Certified Public Accountants ("AICPA") in October 1997 as amended by SOP 98-9 issued in December 1998. The Company derives revenue from licensing its products and providing related services, including installation, integration, and maintenance.

(i) License revenue:

The Company recognizes product revenue when it has an executed license agreement with the customer, the software product has been delivered, the amount of the fees to be paid by the customer is fixed and determinable, and collection of these fees is deemed probable. The Company considers fees related to arrangements with significant payments due beyond its 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.

The Company enters into software license agreements that provide for future license payments to be made based on the number of users. Customers who exceed their licensed fixed level of users are required to pay additional license fees. Revenue associated with additional users is recognized when the amount becomes determinable, and when the requirements of revenue recognition as set out above have been met.

(ii) Service revenue:

Typically, software license agreements are multiple element arrangements as they also include consulting, related maintenance and/or implementation services fees. Arrangements that include consulting services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangements. The Company's software products are generally fully functional upon delivery and implementation and do not require any significant modification or alteration for customer use, however, for larger customers, customization services may be significant. Customers generally purchase consulting services to facilitate the adoption of the Company's technology and may contract with the Company to have dedicated personnel to participate in the services being performed, but the customer may also decide to use their own resources or appoint other professional service organizations to provide these services.

In determining whether the services are essential to the functionality of its software, the Company applies the criteria in SOP 97-2. When the services are considered essential to the functionality of the software, the Company recognizes both the software product revenue and services revenue under the percentage of completion method using the input method based on the ratio of direct labour hours incurred to date to total projected labour hours. When services are not considered essential, the entire arrangement fee is allocated to each element in the arrangement based on the respective vendor specific objective evidence ("VSOE") of the fair value of each element. VSOE used in determining the fair value of license revenue is based on the price charged by the Company when the same element is sold in similar quantities to a customer of similar size and nature. VSOE used in determining 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. The revenue allocable to the software license is recognized when the product revenue criteria are met. The revenue allocable to the consulting services is recognized as the services are performed. In instances where VSOE exists for undelivered elements but does not exist for delivered elements of a software arrangement, the Company uses the residual method of allocation of the arrangement fees for revenue recognition purposes. For arrangements containing multiple elements wherein VSOE of fair value does not exist for all undelivered elements, revenue for the delivered and undelivered elements is deferred until VSOE of fair value exists or all elements have been delivered.

Consulting, implementation and training revenues are recognized as the services are performed, generally on a time and materials basis. Consulting revenues attributed to fixed price arrangements are recognized using the proportional performance method based on direct labour costs incurred to date as a percentage of total estimated direct labour costs to complete the project as this better reflects the pattern in which the Company's obligations to its customers are fulfilled and revenue is earned. When total cost estimates exceed revenues in a fixed price arrangement, the estimated losses are recognized immediately based upon an average fully burdened daily cost rate applicable to the consulting individuals delivering the services.

(iii) Maintenance revenue:

Maintenance and support revenues paid in advance are non-refundable and are recognized ratably over the term of the agreement, which typically is twelve months.

The Company provides upgrade rights only as part of Post-contract Customer Support (“PCS” or “maintenance”) arrangements. Maintenance generally includes the right to receive unspecified updates and upgrades, determined solely by the Company, after the software license period begins. These unspecified update and upgrade rights generally provide for the customer to receive bug fixes and future enhancements, respectively, to the existing software. The Company does not enter into arrangements that provide for “specified” upgrade rights. “Unspecified” updates and upgrades are included in maintenance revenue. Maintenance revenue is recognized ratably over the term of the maintenance contract.

(iv) Deferred revenue:

Product and services revenues that have been prepaid but do not yet qualify for recognition as revenue under the Company’s revenue recognition policy are reflected as deferred revenue on the consolidated balance sheets.

(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) 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 the refund is received. In 2006, the Company reduced research and development expenses by \$288,000 (2005 - \$nil, 2004 - \$135,000) for refunds received during the year in relation to the 2003, 2004 and 2005 fiscal year’s scientific research and development claims. Assistance related to the acquisition of capital assets used for research and development is credited against the related capital assets.

(g) 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.

(h) Purchased and acquired technology:

The Company capitalizes purchased technology and amortizes such costs over its estimated useful life. The carrying value is assessed on a periodic basis to determine if a write-down is required.

(i) Customer assets:

Customer relationships acquired through business combinations are amortized over their estimated useful life. Acquired customer contract assets are amortized over the related contract terms as services are performed. The carrying value is assessed on a periodic basis to determine if a write-down is required.

(j) Foreign currency translation:

The Company uses the U.S. dollar as its measurement and reporting currency in the preparation of its consolidated financial statements.

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 the loss for the period.

(k) 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

(l) 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.

(m) 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.

(n) Stock-based compensation:

The Company estimates the fair value of stock-based compensation granted to employees since November 1, 2002 and expenses the fair value over the estimated vesting period of the stock options.

(o) 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.

2. Acquisitions and discontinued operations:

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.

For the year ended December 31:	2006	2005	2004
Income Statement	\$	\$	\$
Revenue	–	453,361	4,441,994
Expenses	–	820,772	4,983,480
Income (loss) from discontinued operations	–	(367,411)	(541,486)
Gain on disposition of discontinued operations	–	296,551	–
Loss from discontinued operations	–	(70,860)	(541,486)
Loss per share from discontinued operations	–	0.00	(0.04)

Expenses in the loss on disposition of discontinued operations includes the elimination of the related goodwill of \$nil (2005 - \$392,242, 2004 – \$525,000).

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 cancellation of a promissory note payable by the Company 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.

3. Capital assets:

December 31, 2006			
	Cost	Accumulated depreciation and amortization	Net book value
Computer hardware	\$ 1,236,368	\$ 1,017,847	\$ 218,521
Computer software	513,518	447,595	65,923
Furniture and fixtures	280,867	200,971	79,896
Leasehold improvements	26,821	2,438	24,383
	\$ 2,057,574	\$ 1,668,851	\$ 388,723
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
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4. Accrued liabilities:

	2006	2005
Compensation	\$ 252,928	\$ 42,256
Professional fees	335,731	101,973
Miscellaneous	45,002	82,450
	<u>\$ 633,661</u>	<u>\$ 226,679</u>

5. 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, 2003	1,020,404	\$ 1,331,652	11,043,027	\$ 49,191,482
Stock options exercised (a)	–	–	189,914	358,458
Private Placement (b)	1,100,000	1,593,710	1,000,000	364,571
Private Placement (c)	300,000	97,140	6,925,000	2,530,624
Acquisition of Caradas (d)	(100,000)	(335,300)	–	–
Professional services (e)	288,000	183,366	–	–
Warrants cancelled and expired (h)	(40,000)	(39,639)	–	–
Balance December 31, 2004	2,568,404	2,830,929	19,157,941	52,445,135
Private Placement (f)	71,250	25,066	5,000,000	1,800,117
Acquisition of Caradas (d)	(100,000)	(335,300)	–	–
Professional services (g)	375,000	72,353	–	–
Warrants cancelled and expired (h)	(701,404)	(92,071)	–	–
Board compensation (l)			130,000	85,400
Stock options exercised (a)	–	–	28,750	17,000
Balance December 31, 2005	2,213,250	2,500,977	24,316,691	54,347,652
Private Placement (i)	6,680,001	1,139,741	6,680,001	2,848,259
Private Placement (j)	1,634,617	266,616	1,634,617	722,670
Professional services (k)	113,179	25,254	95,179	61,457
Board compensation (l)			300,000	186,000
Warrants cancelled and expired (h)	(597,000)	(640,756)	–	–
Employee bonus (m)			159,642	84,543
Stock options and warrants exercised (a)	–	–	226,875	163,455
Balance December 31, 2006	10,044,047	\$ 3,291,832	33,413,005	\$ 58,414,036

Shares issued for other than cash consideration are valued at their market price at the date of agreement for issuance.

- (a) During 2004, 2005, and 2006 the Company granted options to certain employees, officers and directors under a share option plan (note 10), enabling them to purchase common shares of the Company.
- (b) 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. During December 2004, the Company repriced the 350,000 warrants vesting on January 15, 2005 to \$0.60 in connection with the financing in (c) below.

- (c) 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 starting December 20, 2004.
- (d) 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.
- (e) 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
	<u>288,000</u>	<u>\$ 183,366</u>

- (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. These warrants expired unexercised.
- (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. These warrants expired unexercised.
- (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. These warrants expired unexercised.
- (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. These warrants expired unexercised.
- (vi) On September 20, 2004, the Company entered into an agreement for sales strategy consulting. 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. These warrants expired unexercised.
- (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. These warrants expired unexercised.

- (f) 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 starting September 26, 2005.
- (g) Professional services:

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

Compensation options and warrants		
	Number	Amount
Advisory board consulting services (i)	125,000	\$ 32,119
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
	375,000	\$ 72,353

- (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. During 2006, 25,000 warrants were exercised and the remainder expired unexercised.
- (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 was exercisable from November 20, 2005 to March 20, 2006 to purchase up to 30,000 of our common shares at \$0.80 per share. These warrants expired unexercised.
- (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 was exercisable from April 20, 2006 to July 20, 2006 to purchase up to 15,000 of our common shares at \$0.62 per share. These warrants expired unexercised.
- (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 was exercisable from May 15, 2006 to September 15, 2006 to purchase up to 25,000 of our common shares at \$0.40 per share. These warrants expired unexercised.
- (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 was exercisable from July 30, 2005 to July 30, 2006 to purchase up to 100,000 of our common shares at \$0.63 per share. These warrants expired unexercised.
- (h) 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.
- (i) On June 30, 2006, the Company completed a private placement of 6,680,001 units, at \$0.60 per unit, for gross proceeds of \$4,008,000. Each unit is comprised of one common share, one-half common share purchase warrant at \$0.75 and one-half common share purchase warrant at \$0.90. Each whole warrant will be exercisable to purchase one common share and will expire on June 30, 2008. The Company allocated \$1,139,741 of the net proceeds to the warrants and \$2,868,000 less costs of 19,741 to share capital based on their estimated relative fair value.
- (j) On July 26, 2006, the Company completed a private placement of 1,538,463 units, at \$0.65 per unit, for gross proceeds of \$1,000,000 and issued 96,154 units for consulting services related to the private placement. Each unit is comprised of one common share and one common share purchase warrant. The warrant will be exercisable to purchase one common share for each whole warrant at a price of \$1.00 and will expire on July 26, 2008. The Company allocated \$266,616 of

the net proceeds to the warrants and \$754,000, less costs of \$31,330, to share capital based on their estimated relative fair value.

(k) Professional services:

The following chart summarizes the activity during the year ended December 31, 2006:

	Compensation options and warrants		Common shares	
	Number	Amount	Number	Amount
Consulting services (i)	95,179	\$ 20,873	95,179	\$ 61,457
Consulting services (ii)	18,000	4,381	–	–
	113,179	\$ 25,254	95,179	\$ 61,457

(i) On January 1, 2006, the Company entered into an agreement for public relations services. In consideration for the services to be rendered in accordance with the agreement, a combination of common shares and common share purchase warrants were issued each quarter. Of the common share purchase warrants issued, 30,000 are exercisable at \$1.00 and vested on March 30, 2006, 25,000 are exercisable at \$1.20 and vested on June 30, 2006, 21,429 are exercisable at \$1.40 and vested on September 30, 2006 and the remaining 18,750 are exercisable at \$1.60 and vested on December 31, 2006. These common share purchase warrants expire on December 31, 2007.

(ii) On September 6, 2006, the Company entered into an agreement for marketing consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant to purchase 25,000 common shares at \$0.56 was issued with equal vesting on each of October 6, November 6 and December 6, 2006. During 2006, 7,000 warrants were exercised. These warrants expire on September 6, 2007.

(l) On May 12, 2005 and on July 31, 2006, the Company issued common shares to each non-management board member in lieu of cash compensation.

(m) During 2006 common shares were issued to some employees in lieu of cash bonuses.

6. 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 2,174,349 at December 31, 2006, 2,409,873 at December 31, 2005 and 1,178,486 at December 31, 2004. Anti-dilutive warrants amounted to 10,044,047 at December 31, 2006, 2,213,250 at December 31, 2005 and 2,568,404 at December 31, 2004 respectively.

7. Income taxes:

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

	2006	2005
Future tax assets:		
Operating loss carryforwards	\$10,429,483	\$11,577,330
Capital loss carryforwards	747,058	818,264
Share issue costs	118,643	155,117
Research and development costs	3,382,463	3,612,437
Capital assets, accounting basis less than tax basis	5,886,872	6,384,259
	20,564,518	22,547,407
Valuation allowance	(20,564,518)	(22,547,407)
Net future tax assets	\$ –	\$ –

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, 2006, the Company has non-capital losses available for carryforward for Canadian income tax purposes amounting to \$28,292,000. These losses expire in the following fiscal years:

2007	12,084,000
2008	3,620,000
2009	411,000

2010	4,401,000
2014	2,708,000
2015	3,460,000
2026	1,608,000
	<u>\$ 28,292,000</u>

The Company also has non-capital losses available for carryforward for United States income tax purposes amounting to \$2,803,000, expiring between 2018 and 2026.

8. 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, 2006, 100% (2005 - 100%, 2004 - 75%) of the capital assets were located in Canada and nil% (2005 - nil%, 2004 - 25%) were located in the United States.

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, 2006 are as follows:

	Sales			Accounts Receivable	
	2006	2005	2004	2006	2005
Customer 1	56%	0%	0%	–	–
Customer 2	11%	0%	0%	\$50,000	–
Customer 3	11%	18%	0%	–	–
Customer 4	0%	29%	18%	–	–
Customer 5	0%	38%	46%	–	–

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, 2006 are as follows:

	2006	2005	2004
Sales:			
United States	\$ 1,396,543	\$ 801,700	\$ 2,334,510
Canada	33,872	99,680	116,526
Asia	203,550	199,724	41,858
Other	33,000	–	110,000
	<u>\$ 1,666,965</u>	<u>\$ 1,101,104</u>	<u>\$ 2,602,894</u>

During each of the years in the three-year period ended December 31, 2006 revenue is attributable to products as follows:

	2006	2005	2004
Sales:			
Consulting services	\$ 1,576,965	\$ 1,101,104	\$ 2,274,007
Licensing	90,000	–	328,887
	<u>\$ 1,666,965</u>	<u>\$ 1,101,104</u>	<u>\$ 2,602,894</u>

9. 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. Management believes that a loss arising from this matter is probable and that the amount can reasonably be estimated. The Company has recorded an amount for the liability based on its current estimate of the settlement amount. As additional information becomes available, any potential liability related to this matter will be assessed and the estimates revised accordingly. Based on the currently available information, management believes that the ultimate outcome of this matter will not have a material adverse effect on our financial position or overall trends in results of operations.

(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:

2007	214,570
2008	208,251
2009	202,483
2010	202,483
2011	202,483
2012	67,494
	\$ 1,097,764

Rental expense was \$155,000 for the year ended December 31, 2006 (2005 - \$158,000, 2004 - \$153,000).

10. 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 3,705,127 common shares (being 4,148,538 options reserved for issuance less 443,411 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, 2006, the number of common shares reserved for future issues of stock options amounts to 1,530,778.

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 4% (2005 – 3%, 2004 – 3%), estimated life of five years, expected dividend yield of 0% and average volatility of 120% (2005 – 150%, 2004 – 150%).

The following table summarizes information about stock options outstanding at December 31, 2006:

Range of exercise price	Options outstanding			Options vested	
	Number outstanding	Weighted average remaining contractual life – years	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$0.37 – \$0.60	1,582,414	3.27	\$ 0.40	1,221,348	\$ 0.40
\$0.62 – \$1.50	180,297	0.87	0.31	151,050	0.25
\$1.51 – \$6.10	411,638	1.66	2.52	411,638	2.52
	2,174,349	2.86	\$ 0.83	1,784,036	\$ 0.91

Changes for the employee stock option plan during the year ended December 31, 2006 were as follows:

	Year ended 2006		Year ended 2005	
	Number of shares	Weighted average exercise price	Number of shares	Weighted average exercise price
Options outstanding, beginning of year	2,409,873	\$ 0.98	1,178,486	\$ 2.37
Options granted	740,661	0.43	1,647,500	0.41
Options exercised	(194,875)	0.40	(28,750)	0.59
Options cancelled	(781,310)	1.03	(387,363)	2.80
Options outstanding, end of year	2,174,349	0.83	2,409,873	0.98
Options exercisable, end of year	1,784,036	0.91	1,383,591	1.24

Weighted average fair value of options granted during the year	\$ 0.39	\$ 0.63
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11. 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, 2006 and 2005.

(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:

	2006	2005	2004
<u>Allowance for Doubtful Accounts</u>			
Opening balance	\$ -	\$ 218,500	\$ 132,500
Write offs	-	(218,500)	-
Additions	20,000	-	86,000
<u>Closing balance</u>	<u>\$ 20,000</u>	<u>\$ -</u>	<u>\$ 218,500</u>

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

12. 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 June 2006 private placement, Albert Wahbe acquired 4,600,000 units. Albert Wahbe, one of our directors as of July 2006, owns 4,700,000 common shares and 4,600,000 common share purchase warrants, representing approximately 24% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants. Mr. Wahbe also entered into a performance based consulting agreement to provide sales and business development services for the Company, during 2006 he received \$10,000 relating to this agreement.

As part of the June 2006 private placement, Lakefront Partners, LLC acquired 666,667 units. As well, during the September 2005 private placement, Lakefront Partners, LLC acquired 725,000 common shares. In 2004 we completed two financings in which Lakefront Partners, LLC and James B. Wigdale, Jr. participated. These units were acquired at the same price and terms as unrelated investors. Mr. Wigdale, one of our directors, controls Lakefront Partners, LLC. As at December 31, 2006, Lakefront beneficially owns 3,909,462 common shares and 666,667 common share purchase warrants, and Mr. Wigdale owns 380,000 common shares and 1,400,000 common share purchase warrants, together representing approximately 18% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants.

A former member of our Board of Directors received consideration (while a Director) relating to services performed during the 2006 year of 100,000 share purchase warrants (exercisable at \$0.63 per common share) valued at \$4,717 relating to consulting services performed for the company.

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

13. 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.

	2006	2005	2004
Share capital:			
Canadian GAAP	\$58,414,036	\$54,347,652	\$52,445,135
Elimination of reduction of share capital (a)	30,089,054	30,089,054	30,089,054
U.S. GAAP	\$88,503,090	\$84,436,706	\$82,534,189
Deficit and comprehensive loss:			
Canadian GAAP	\$(59,745,704)	\$(56,294,987)	\$(49,185,491)
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	1,016,799	577,549
U.S. GAAP	\$(89,809,655)	\$(86,358,938)	\$(79,688,692)
Consolidated statements of loss:			
Loss under Canadian GAAP	\$(3,450,717)	\$(7,109,496)	\$(7,516,842)
Compensation expense (b)(ii)	-	439,250	577,549
Loss under U.S. GAAP	\$(3,450,717)	\$(6,670,246)	\$(6,939,293)
Basic and diluted loss per share under U.S. GAAP	\$(0.12)	\$(0.32)	\$(0.57)
Comprehensive loss under U.S. GAAP	\$(3,450,717)	\$(6,670,246)	\$(6,939,293)

(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:

Effective January 1, 2006, the Company is required to apply the provisions of FASB Statement No. 123R ("SFAS 123R"), which requires all share based payments to be recognized in the financial statements based on their fair values using either a modified – prospective or modified – retrospective transition method. The company has adopted this standard using the modified - prospective method and, therefore recognizes share-based compensation for any new share-based awards and awards modified, repurchased or cancelled after the required effective date, January 1, 2006. Under SFAS 123R, the company is required to determine the grant date fair value of the stock-based awards granted to employees. The company is continuing to use the Black-Scholes option pricing model to value these options. The related grant date fair value is subsequently recognized as stock-based compensation expense over the requisite service period. As a result, stock-based compensation expense recognized under U.S. GAAP after December 31, 2005 equals the amount recognized under Canadian GAAP when the fair value method has been applied since 2003. Previously, the Company adjusted compensation cost for actual forfeitures at the time forfeitures occurred. SFAS 123R requires the company to estimate forfeitures as part of the initial measure of the grant date fair value of the award. The cumulative effect of the change in accounting policy for the adjustment related to the forfeitures for the prior periods is not material at January 1, 2006.

(c) Notes to consolidated financial statements:

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

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

Albert Wahbe, Chairman & Chief Executive Officer has served as a Director and Chairman since July 2006 and CEO since April 2007. Mr. Wahbe was previously Executive Vice President and Group Head, Global Transaction Banking at Scotiabank, where he led the evolution of e-commerce and e-banking to provide Global Business solutions. Mr. Wahbe was also CEO of e-Scotia, where he developed Scotiabank's Internet banking, e-commerce, wireless, telephone banking and smart card technologies for consumers. Prior to Scotiabank, Mr. Wahbe held senior management positions in marketing and technology operations at I.B.M. Canada. Mr. Wahbe graduated from the Harvard University Graduate School of Business in 1998, completing the Advanced Management Program and International Senior Management Program.

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

Albert Wahbe has served as Diversinet's Chief Executive Officer since April 2007.

Ravi Chiruvolu has served as a director since July 2006. Mr. Chiruvolu runs Top Shelf Capital, a venture fund focused on increasing shareholder value for small cap public companies. Prior to this, Mr. Chiruvolu was a managing director at Charter Venture Capital, where he ran a \$150m early stage fund. He holds an MBA from Harvard Business School and a Bachelor of Science and a Master of Science in Engineering from MIT. Mr. Chiruvolu is a leader in the venture capital industry as well as PIPE investing, and has written numerous articles in the Venture Capital Journal and spoken at several conferences on the topics.

Gregory Milavsky has served as a Director since April 2007. Mr. Milavsky has over 20 years of corporate finance, investment banking and private equity experience in Toronto, London, New York and Tokyo. He was Associate Director of Corporate Finance with CIBC Limited, an Investment Banker with James D. Wolfensohn Incorporated, Senior Vice President and Director with Rothschild Canada, Chief Executive of Rothschild Quantico Capital, Managing Director and Group Head of Scotiabank Private Equity Investments and is currently Senior Managing Director of Canterbury Park Capital.

Philippe Tardif has served as a Director since March 2007. Mr. Tardif is a partner at the law firm Borden Ladner Gervais LLP and specializes in securities law and capital markets transactions. He also advises on corporate governance matters and acts as advisor to special committees and boards of directors. A past member of the Securities Advisory Committee to the Ontario Securities Commission and a member of the Securities Law Subcommittee of the Ontario Bar Association, Mr. Tardif was called to the Ontario Bar in 1987.

James ('Jay') Wigdale has served as a Director since January, 2005. Mr. Wigdale founded Lakefront Partners, LLC, a money-management firm, in 1998 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. Mr. Wigdale was also the VP of Corporate Banking from 1984 to 1990 at Barnett Bank, Inc. (now Bank of America). He holds a Bachelor of Science (Marketing) degree from Miami University of Ohio.

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