MUSICRYPT INC

ANNUAL REPORT 2006

To Our Shareholders:

During the year ended December 31, 2006 Musicrypt made considerable progress. Revenues for fiscal 2006 were 45% higher than in 2005, with revenues in the fourth quarter alone growing by 64%. New customers and increased usage of Musicrypt's Digital Media Distribution System (DMDS) by existing customers contributed to this revenue growth.

The rapidly growing adoption of DMDS by the US record and radio industries was demonstrated when the number of US deliveries made via DMDS in the fourth quarter of 2006 increased to over five times the first quarter volume. An important milestone was attained during the year when Musicrypt signed its first revenue generating agreement with a US customer. In 2006 Musicrypt continued its program of expanding and enforcing its intellectual property rights for its patented technology, receiving the grant of its second patent and filing a $15 million patent infringement suit against a competitor. In the fourth quarter Musicrypt's geographic diversification in the US was augmented with the entry into the UK and European markets with partner Adstream Ltd. Shortly after the year end, in February 2007, Musicrypt was funded with a $10 million financing, the largest ever received by the company, which will provide resources for the company's continued growth.

I recommend that you read the enclosed Management Discussion and Analysis and the financial statements for a more detailed review of the extensive progress made and the financial results. The ongoing commitment of our employees, partners and shareholders provides the foundation for our current and future successes and we look to the future with great optimism.

John Heaven
President & Chief Executive Officer

Management Discussion and Analysis
For the Year Ended December 31, 2006

Musicrypt Inc. is listed on the TSX Venture Exchange under the symbol MCT and is traded in the USA on the OTCBB under the symbol MCYPF. Additional information on the company is available at www.musicrypt.comT and www.sedar.com.

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1) Date of MD&A April 10, 2006.

Note Regarding Forward Looking Statements

This document may contain or refer to certain forward-looking statements relating but not limited to Musicrypt's expectations, intentions, plans and beliefs. Forward-looking information can often be identified by forward-looking words such as "anticipate", "believe", "expect", "goal", "plan"," intend", "estimate", "may" and "will" or similar words suggesting future outcomes, or other expectations, beliefs, plans, objectives, assumptions, intentions or statements about future events or performance. Forward-looking information is based on current expectations that involve a number of business risks and uncertainties. Forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results to differ materially from expected results. Potential shareholders and prospective investors should be aware that these statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from those suggested by the forward-looking statements. Shareholders are cautioned not to place undue reliance on forward-looking information. By its nature, forward-looking information involves numerous assumptions, inherent risks and uncertainties, both general and specific, that contribute to the possibility that the predictions, forecasts, projections and various future events will not occur.

2) Description of Business

Musicrypt is focused on becoming the leading enabler of secure, user-friendly media distribution via the Internet. The principal business objective of Musicrypt is the development and marketing of its patented Digital Media Distribution System ("DMDS") technology solution.

DMDS is a web-based delivery system that pioneers secure digital file distribution by incorporating biometrics, high-value encryption and watermarking. DMDS replaces the physical distribution of musical recordings and advertising to radio, media, retailers and other authorized recipients with more accountable, effective and far less costly digital delivery of broadcast quality media via the Internet.

DMDS utilizes Musicrypt's patented Biometric Rights Management ("BRM") technology to authenticate the recipient of, and grant specified access rights to, the media being distributed. BRM is a unique combination of biometrics, high-value encryption and digital rights management. This biometric verification system identifies the recipient by his or her user name, password and distinctive personal characteristics. The biometric technology currently deployed in DMDS is keystroke dynamics, which identifies a user by their typing rhythm. BRM technology works to prevent unauthorized access and password sharing by verifying individual recipients, and requires no additional hardware for either the sender or the recipient, providing completely portable secure access to users.

Record labels have been delivering promotional releases to radio stations using primarily manual methods. In advance of the distribution of a new album to retailers, a single track (or song) is chosen from the album for release to radio. After the track has been selected, several hundred copies of a "radio only" compact disk single (known in the industry as a CD-PRO) are made. These CD-PRO's are individually packaged, labelled, and couriered or mailed to the radio stations that would potentially play this genre of music. This is time consuming, inefficient, expensive and very insecure.

In recent years leaks of new singles by Britney Spears and Lenny Kravitz, of the entire Radiohead album, the entire U2 album, and most recently, the leak in Europe of the new Madonna single, all before their planned public launch dates underscores the need for improved security for new releases. Also, increasing financial pressures in the record business are leading them to look for ways to reduce costs.

DMDS solves the problems with the current promotional distribution process used in the music industry and significantly reduce the costs of such distribution. The range of external parties that DMDS can distribute tracks to has grown beyond traditional radio to include consultants, managers, artists, satellite radio, internet radio, media and reviewers. DMDS is also used by record labels for securely distributing music internally.

3) Review of Operations

Musicrypt's business continued its strong advance through the fourth quarter of 2006. Revenues for the three month period ended December 31, 2006 were 64% higher than revenues for the fourth quarter of 2005. During the same period the loss decreased by 26%, or by $171,000, compared to last year's fourth quarter, reflecting the higher revenues as well as lower general and administration, royalties, marketing and travel, and salaries and benefits expenses.

The Company met the deferral criteria for development costs under generally accepted accounting principles as the Company is generating revenue from the product and technology it has developed. During the fourth quarter of 2006 $112,000 of product development costs were capitalized and $42,000 was amortized.

At the end of the fourth quarter of 2006, Musicrypt's DMDS was the de-facto standard for B2B (business to business) digital delivery of new music files for the record and radio industry in Canada. No competitor's system was in commercial use at any major record label in Canada to date in 2006. EMI, Sony BMG, Universal and Warner in Canada were all using DMDS commercially and the adoption of DMDS within the fast growing independent music sector was expanding.

Usage of DMDS in the US also continued to grow rapidly through the fourth quarter. Musicrypt's DMDS has delivered over 7,000 songs from more than 150 record labels to destinations which include radio stations representing over 35 US broadcast chains such as CBS/Infinity, Citadel, Clear Channel, Cox, Cumulus, Emmis, EntreVision, Entercom, Federated Media, Sirius, Journal, DMX, Jones Radio, AOL, Music Choice, Radio One, Salem Communications, Univision, Westwood One, Regent, Premiere Radio, Next Media, XM Satellite Radio, Waitt Media and many others. DMDS is the only system that can deliver music across both the US and Canada.

In March 2006 Musicrypt received the grant of its second patent, United States patent #7,003,670 entitled "Biometric Rights Management System" ("BRM"). The BRM patent is in force until 2023. The Biometric Rights Management System ("BRM") patent application relates to Musicrypt's innovative use of biometric security measures to implement digital rights management in the secure online distribution of music and other digital media. A patent application for BRM is pending in Canada, for which the grant in the US is a positive signal.

The BRM patent augments Musicrypt's intellectual property assets that include the patent entitled "Content Distribution System and Method" that has been granted in Canada (#2,407,774) and its corresponding US patent application that is now undergoing examination. DMDS is the only patented secure digital delivery system available to the record and radio industries today.

In February 2006 the company entered into agreements with three new customers to use DMDS to securely distribute independent music to radio, press, music publishers, booking agents, promoters and other destinations including U.S. radio. Spincycle, a division of Frontside Promotions, based in Vancouver; Canada Disc and Tape, based in Calgary with offices in Edmonton and Saskatoon; and I2R, based in Montreal, will join with RDR Music Group and CIRPA to provide extensive access to DMDS for the vibrant and growing independent music sector in Canada and the US.

Also in February 2006, Nielsen Broadcast Data Systems (Nielsen BDS), the world's leading supplier of performance monitoring, expanded its strategic relationship with Musicrypt by offering secure song streams and downloads through DMDS directly from its BDSradio.com charts and station playlists. Radio programmers subscribing to Nielsen BDS, are able to access full songs distributed through Musicrypt's DMDS' secure digital system via BDSradio.com, and can listen to or download an entire song for on-air broadcasts by clicking on an icon directly within a format chart or station playlist. "We began our involvement with Musicrypt well over a year ago, when we recognized their DMDS system to be the pinnacle digital distribution system. It has always been our objective to further this association. This integration is the next logical step", said Rob Sisco, President of Nielsen Music. "Offering radio programmers direct and easy access to a music library under the most secure distribution system available is a win for both the record and radio industries."

In March 2006 Musicrypt launched Version 4.0 of DMDS. This latest version further advanced DMDS' sector defining capabilities with additional features and a new user interface. DMDS V4.0 key features include:

> **Patented Technology:** DMDS users can be assured that they are using the only patented secure digital delivery system available today. Musicrypt has already received allowance for two of its patents on DMDS and Biometric Rights Management in Canada and the US and has additional patents pending.
>
> **Watermarking:** DMDS is the only digital media distribution solution to employ an SDMI and ISO certified watermarking technology. The watermark has been

independently proven to persist through multiple digital and analog conversions and can be applied on a transactional basis. Combined with the biometrics employed by DMDS, the watermark provides a strong link to the individual (not the machine) that downloaded a track. This combination provides the most advanced system of personal accountability available to record labels and radio today.

Video Streaming: DMDS continues to provide record labels with the ability to send online video access along with tracks to radio and other recipients, and has provided this feature since 2004.

Linear/.WAV Files Delivery: DMDS has provided full delivery capability for linear or .wav format files since 2004 and V4.0 enhances this ability to deliver the highest quality files available. This feature continues to be appreciated by satellite and HD broadcasters.

Complete Control for Content Providers: Providers of content through DMDS have unrivalled flexibility over who has what type of access to their content and when. Only those individual recipients specified by the sender can have access to a track, whether directly through DMDS or Musicrypt's partners. Different release times and accessibility conditions can be set by the uploading user for each release, such as making a full track stream and download available to internal users a week in advance of external users, who may initially have access to a 30 second sample to stream and download, with the full track available to them for streaming and download a week later. Content providers can also withdraw access to content following its release.

TracPac: Record label users now have complete flexibility to group tracks as they wish, either as complete albums, compilations, custom albums or a variety of mixes. The TracPac feature provides labels with the ability to securely distribute these various configurations both internally and externally.

Real-Time Reporting: DMDS is the only digital media distribution system that provides content owners with online real-time access to reports on the distribution and usage of their files sent via DMDS.

iPod Integration: DMDS continues support of .wav and .wma formats that provides "click and drag" ease of use that is compatible with all portable players.

Flexible File formats: DMDS has been providing the highest quality files available plus user specified file formats since 2004 and V 4.0 further enhances this flexibility.

Highest Level of Accountability: DMDS is the only digital delivery system that provides secure digital file distribution by incorporating biometrics, high-value encryption and watermarking. DMDS prevents password sharing among users and enables the watermarking of downloaded tracks with the user's ID. DMDS has the world's first online watermark detector, enabling authorized users to check the watermark ID of tracks instantly on their desktop.

Portability: DMDS provides users with complete portability to manage the distribution and review of tracks from the convenience of any computer with an internet connection anywhere in the world. Users and content are never locked down to a machine.

Seamless Metadata Transfer: DMDS continues to provide users with the seamless transfer of track metadata to their programming or other systems through the use of an XML data interface.

National Borders Respected: DMDS provides users with the ability to control distribution of tracks on a per country basis. For example, DMDS allows the content owner to select which territories a song may be distributed to and what time it will be made available on a national basis.

In March 2006 Warner Music's superstar artist Pearl Jam's "World Wide Suicide" was delivered via DMDS across Canada and the US, making chart history when it became the first digitally delivered single in BDS chart history to debut at # 1 on the Rock Radio Audience chart on the same day as its' release. DMDS deliveries impact all of the selected destinations simultaneously, generating a nation-wide wall of promotion.

In May 2006 a major milestone was attained when Musicrypt signed its first revenue generating agreement in the US with Broadjam.com, one of the world's largest communities of independent music artists and labels. Broadjam boasts a membership of 50,000 and a database of more than 200,000 songs from artists representing all 50 US states and 110 different countries. "Broadjam is thrilled to offer Musicrypt's DMDS service to our rapidly growing membership of independent artists from around the globe," said Roy Elkins, founder and CEO of Broadjam.com. "DMDS has set a new standard for secure media distribution to radio professionals, and Broadjam is delighted to partner with an innovator like Musicrypt to open such channels to indie musicians." In September 2006 the new service called "Broadjam Radio Deliveries", powered by DMDS, was launched. The new service allows independent artists to deliver their music and promotional materials directly to radio stations across North America. The service gives independent musicians the opportunity to reach radio stations in the same manner as major label artists.

Also in May 2006 RCA Music Group selected DMDS to deliver the winning song from the new American Idol, Taylor Hicks, to radio across North America. Nearly 30 million viewers tuned in to see the American Idol season finale and nearly 50 million fans voted. "RCA Music Group chose DMDS to instantly deliver the eagerly anticipated American Idol winner to radio," said Adrian Moreira, VP Adult Format Promotion for RCA Music Group. "The fact that we can securely distribute music internally to our own staff, our sister company in Canada and externally to our radio and press partners at the moment the new Idol was chosen, demonstrates that DMDS is the premiere digital media distribution system available".

At the end of May 2006 Musicrypt completed an agreement with Music Manufacturing Services (MMS), a leading CD, vinyl, DVD and cassette duplication and manufacturing company with offices in Toronto, New York, Nashville, Montreal, and Atlantic Canada. Lindsay Gillespie, President of Music Manufacturing Services said, "We're especially excited to introduce DMDS to the Nashville market. While most people think of Nashville as a country music centre, the city is also a major gospel music hub, and has thriving hiphop, urban and rock scenes. And for the first time, independent artists and labels will be able to access radio in both the US and Canada seamlessly."

In June 2006 the Company completed an oversubscribed $1.5 million financing through the sale of 7,500,000 units at $0.20 per unit. Each unit consists of one common share and one-half of a two-year warrant to purchase a common share for $0.30 per share.

Also in June, the Company filed a suit for $15 million in damages against Destiny Media Technologies Inc. (OTCBB:DSNY.OB), Destiny Software Productions, Inc. of Vancouver, Promo Only Inc. of Orlando, Florida and Promo Only CD's Inc. of Calgary, Alberta alleging patent infringement. In July 2005 Musicrypt's patent counsel faxed and delivered a registered letter to Destiny Media and Promo Only in the US and Canada advising them of Musicrypt's patent rights and demanding that they cease the alleged infringement of these. Musicrypt firmly believes that Destiny's and Promo Only's current system infringes Musicrypt's patent and that the validation for access purposes as claimed in Musicrypt's patent is not limited to biometrics.

In June 2006 Musicrypt and Billboard unveiled an exciting new product to be offered through their exclusive partnership. Called an "eNote," this custom electronic promotional tool combines secure digital delivery of songs with a digital advertisement that can include flash or video content, photos and album graphics and other promotional information to radio programmers and press throughout North America. eNotes present an incremental revenue opportunity for the company. Musicrypt and Billboard have successfully test marketed eNotes with key label partners which have included high profile releases such as American Idol winner, Taylor Hicks (RCA Music Group), the Goo Goo Dolls and Red Hot Chili Peppers (Warner Music Group), Neil Young (Reprise Records), Breaking Benjamin (Hollywood Records), and Corinne Bailey Rae (EMI Music). "Billboard is very excited to launch eNote into the music industry with such a dominant leader as Musicrypt," said John Kilcullen President and Publisher of Billboard. "eNote answers the desires of big and small record labels everywhere. Delivering the whole package to include the artist, images, videos, and marketing collateral, lays the foundation for the next generation of music delivery. We are looking forward to the success eNote will bring to our organization and to our strategic partnership with Musicrypt."

During June, Musicrypt launched the highly anticipated Mac version of DMDS. The new version of DMDS allows users to upload and download music and visual media to a Mac computer for use with any portable player, and deliver content to radio programmers in the U.S. and Canada. Musicrypt's DMDS Mac client provides the most comprehensive solution for every aspect of the creative community including musicians, recording studios, record labels, music publishers, post-production houses and all aspects of the advertising industry. The DMDS Mac client provides broadcast quality WAV files in any format, including AAC, and seamless support of iTunes with an instant download to iPod's Musicrypt is the only company to offer a complete Mac solution that encompasses uploading, downloading, and the conversion of files into any format.

In July 2006, Musicrypt announced a partnership with Pando Networks, Inc. based in New York City. Musicrypt will be the "Media Distribution Design Partner" for Pando, and this new relationship, combining Musicrypt's patented DMDS and Pando's revolutionary technology, will give users the ability to deliver large media files, including music videos and television commercials, quickly, securely and inexpensively to destinations worldwide using the internet. "We are excited about this new technology collaboration and partnership with Musicrypt. Their DMDS will provide media industry users with more security, faster file delivery and better quality, which are important when porting large files of this type," said Robert Levitan, CEO of Pando Networks, Inc. "Musicrypt's leadership in digital media distribution will provide the media industry with an advanced delivery system that's more effective, secure, and user friendly than present alternatives." Pando's expanded BitTorrent technology utilizes the best aspects of peer-to-peer technology. This technology is scalable and capable of delivering the HD quality files required by broadcast networks via the internet. By incorporating Pando's technology in DMDS, Musicrypt aims to provide the fastest secure digital delivery available for larger media such as music videos and television commercials via the Internet.

In October 2006 Musicrypt signed an exclusive deal with Atlanta Georgia based independent label Mogol Music. Mogol Music will be using DMDS to distribute its artists' hit songs to radio and broadcasters across North America. Mogol Music will be releasing the much anticipated "MySpace Girl", the first single by Bubble Boy, and anticipates many other hit singles to follow. Musicrypt created a unique custom-enhanced eNote specifically for this release.

Also in October 2006, Musicrypt signed an exclusive agreement with Music Allies, a leading US music industry marketing, consulting, and promotion firm. Music Allies provided backstage broadcast services for the 2006 Vegoose Music Festival, Oct 27 – 30 at Sam Boyd Stadium in Las Vegas, Nevada. Dozens of radio stations utilized the Music Allies broadcast studios and DMDS to record and then transmit exclusive interviews and acoustic performances directly from the live venue. Music Allies chose Musicrypt's patented DMDS to provide secure digital distribution of this exclusive live content.

In December 2006 Musicrypt joined forces with London based Adstream Ltd. (www.adstream.com) to market DMDS in the UK, Europe and Australia. Adstream is the leading provider of digital asset management and distribution services for the global advertising market, serving over 5,000 companies in 42 countries supported through 10 regional offices in the UK, USA, Singapore, India, Australia, South Africa, Malaysia, New Zealand, Ireland, and Germany. Adstream will provide its marketing team and customer base to market and support DMDS, initially to the music industry in the UK then on to continental Europe and Australia. "We looked at various competing technologies available to offer to our existing radio and music industry clients and chose Musicrypt's DMDS, because of its sector-leading features, ease of use and security advantages", said Andy Hopkinson, Managing Director of Adstream UK. "We believe DMDS will be the best choice for our customers and provide a substantial additional revenue opportunity for us."

Also in December, Musicrypt completed a successful pilot for advertising delivery with The Gary Group, the leading advertising agency for the recording industry, based in Los Angeles, California. The intensive three-month program involved the secure digital delivery of radio spots to major market radio stations across the US via DMDS. The 30 and 60-second ad spots included Sheryl Crow's "Wildflower", Diamond Rio's "Greatest Hits II" and Indigo Girls' "Despite our Differences". This pilot confirmed that DMDS can deliver full broadcast quality advertising spots faster, more securely, and at far less cost than current distribution methods, as well as provide unrivalled online real-time reporting. Agencies and stations can securely access and fully utilize DMDS via the internet from any computer, Mac or PC, globally. “The pilot program just completed with Musicrypt’s DMDS has proved to us, that this patented technology can deliver our client’s advertising in a more timely, effective and efficient manner,” said Dick Gary, Chairman, The Gary Group. "We look forward to using DMDS to securely deliver broadcast quality radio and TV spots for our clients in a way that will no doubt revolutionize our industry. We will continue our work with Musicrypt to further enhance and refine DMDS for the advertising sector.”

Deliveries of music tracks via DMDS in the US increased over 500% from the first quarter of 2006 to over 219,000 deliveries in the fourth quarter of 2006. This rapid growth is attributed to the widespread adoption of DMDS by radio stations and major and independent labels throughout the US. In 2006 DMDS delivered songs from superstar artists such as American Idol winner Taylor Hicks, Beyonce, Neil Young, U2, Ludacris, Norah Jones, Dixie Chicks, Tony Bennett, Red Hot Chili Peppers, and hundreds more.

On February 6, 2007 Musicrypt completed a $10 million financing through Sprott Securities Inc. (now Cormark Securities Inc.) with the sale of 40,000,000 common shares at a price of $0.25 per share. As compensation to the Agent, the company paid an aggregate commission of $700,000 and issued 2,800,000 broker warrants, each exercisable at a price of $0.25 to acquire a common share until February 6, 2009. The common shares and the broker warrants may not be traded in Canada until June 7, 2007, except as permitted under applicable laws and stock exchange policies. This financing provides resources for Musicrypt’s European market expansion with Adstream, its US music delivery market growth, its radio and TV advertising delivery initiatives and the expansion and enforcement of its intellectual property rights.

4) Review of Results of Operations for the Year Ended December 31, 2006

Revenue for the fourth quarter of 2006 was $124,000, 64% higher than the revenue for the fourth quarter of 2005. For the fiscal year 2006, revenue was $430,000, a 45% increase over last year. This increase in revenue is primarily the result of new customers and the increasing use of DMDS by existing customers. Revenue is expected to continue to increase as these customers increase their usage of DMDS and US source revenues increase.

The loss for 2006 was $2,114,000, a 3% ($52,000) increase from last year. The increase in the loss was primarily the result of increased salaries and consulting expenses and higher amortization expense. For 2006 the loss per share was $0.07, compared to $0.09 per share for 2005.

The largest expense item increase in the year was in salaries and consulting expense of $197,000 (16%), which primarily reflects human resources deployed for the US music and advertising market programs that were not in place throughout the prior year. The second largest expense item increase for 2006 was in amortization of $113,000 (73%), mainly a result of higher investment in technology development. Royalty expense was $50,000 higher in 2006, as a result of the final minimum payment required under the technology license. General and administrative expense rose $41,000 (11%), because professional fees increased by $46,000, largely from costs incurred enforcing the company’s patent rights and for patent application costs. These increases were offset by the decrease in marketing and promotion expense of $213,000 (47%), which benefited from lower public relations, advertising and promotion costs.

The commercial acceptance of the company's product (DMDS) by the marketplace indicates that expenditures for product development should be recognized as an asset because these are expected to yield future economic benefits. Accordingly, $447,000 of development costs were capitalized in 2006 and $133,000 was amortized.

The company uses equity to compensate and motivate its staff and suppliers. In 2006 $202,000 of the expense recognized for salaries and consulting was for the non-cash expense recognized for options, compared to $290,000 last year. In 2006 the company issued 660,949 shares valued at $132,000 as payment for a royalty.

5) <u>Summary of Quarterly Results</u>

The following table sets out selected quarterly results of the Corporation for the eight quarters prior to the effective date of this report. The information contained herein is drawn from the interim and annual financial statements of the Corporation.

	Fiscal 2006 ($)				**Fiscal 2005 ($)**			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Sales	124,441	106,465	111,488	87,748	75,997	70,029	78,503	71,623
Loss for the period	489,405	524,314	569,753	530,115	660,847	604,515	352,930	443,681
Loss per share (basic & diluted)	.01	.02	.02	.02	.04	.02	.01	.02

These figures illustrate the successful development and ongoing marketing of DMDS in Canada and then the US, the obtaining of customers and the associated initial revenues, and the growth in usage resulting in increased revenues through 2006.

6) <u>Liquidity and Capital Resources</u>

Cash and cash equivalents at December 31, 2006 decreased to $72,000 from $642,000 at December 31, 2005. The main reason for this change was the use of funds in operations to carryout the Company's business plan. Cash flows used in operating activities during 2006 decreased by $233,000 (14%) compared to fiscal 2005. During the period the company also invested $30,000 in equipment, $23,000 in patents and $447,000 in product development.

In June 2006, the company completed a financing for gross proceeds of $1,500,000 through the sale of 7,500,000 Units at $0.20 per Unit. Each Unit consists of one common share and one-half of a two-year warrant to purchase a common share for $0.30 per share. The company issued 558,800 compensation warrants to the agents for the offering. These warrants entitle the holder to acquire a Unit at $0.20 for one year from the date of issue.

Subsequent to the year end, on February 6, 2007, Musicrypt completed a $10 million financing through Sprott Securities Inc. (now Cormark Securities Inc.) with the sale of 40,000,000 common shares at a price of $0.25 per share. As compensation to the Agent, the company paid an aggregate commission of $700,000 and issued 2,800,000 broker warrants, each exercisable at a price of $0.25 to acquire a common share until February 6, 2009. The common shares and the broker warrants may not be traded in Canada until June 7, 2007, except as permitted under applicable laws and stock exchange policies.

The company will continue to invest funds in building its business to achieve key market and growth targets. The company's operations are not yet generating positive cash flow, so it may need to source additional funds in order to carryout its business plan.

7) <u>Share Capital</u>

At December 31, 2006 Musicrypt had 34,766,815 common shares, 3,629,625 options, and 8,183,800 warrants outstanding. At December 31, 2005 Musicrypt had 26,605,866 common shares, 2,939,625 options and 4,475,000 warrants outstanding. 1,250,000 of the company's outstanding shares are not tradable currently as these are subject to the litigation described in note 13(d) of the financial statements.

D M C T LLP

Chartered Accountants

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AUDITORS' REPORT

To the Shareholders of
Musicrypt Inc.

We have audited the balance sheets of **Musicrypt Inc.** as at **December 31, 2006** and **2005** and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these 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 the years then ended in accordance with Canadian generally accepted accounting principles.

DMCT, LLP

DMCT, LLP, Licensed Public Accountants

March 6, 2007
Toronto, Ontario

Musicrypt Inc.
Balance Sheets
As at December 31

	Note		2006		2005
## Assets					
Current					
Cash and cash equivalents		**$**	**72,447**	$	641,541
Amounts receivable			**90,732**		51,260
Prepaids and sundry assets			**47,283**		18,963
			210,462		711,764
Capital assets	3		**59,655**		73,284
Patents			**22,994**		-
Investment in technology	4		**611,271**		703,808
Deferred development costs	5		**736,049**		422,836
		$	**1,640,431**	$	1,911,692
## Liabilities					
Current					
Operating loan	6	**$**	**15,000**	$	-
Accounts payable and accrued liabilities			**263,168**		102,898
			278,168		102,898
## Shareholders' Equity					
Capital stock	7		**12,322,261**		10,856,920
Contributed surplus	9		**645,844**		444,129
Deficit			**(11,605,842)**		(9,492,255)
			1,362,263		1,808,794
		$	**1,640,431**	$	1,911,692

Commitments and Contingencies (Note 13)

Subsequent Event (Note 15)

Approved by the Board **"Cliff Hunt"** Director **"John Heaven"** Director
(Signed) (Signed)

See accompanying notes.

Musicrypt Inc.

Statements of Operations and Deficit
For the Years Ended December 31

	Note	2006	2005
Revenue		**$ 430,142**	$ 296,152
Expenses			
Salaries and consulting		**1,437,196**	1,240,203
Marketing and promotion		**236,379**	449,264
General and administrative		**412,677**	371,873
Technology development		**40,122**	42,191
Royalties		**150,000**	100,000
Amortization		**267,355**	154,597
		2,543,729	2,358,128
Loss for the year		**(2,113,587)**	(2,061,976)
Deficit at beginning of year		**(9,492,255)**	(7,430,279)
Deficit at end of year		**$(11,605,842)**	$ (9,492,255)
Basic and diluted loss per share	11	**$ (0.07)**	$ (0.09)

See accompanying notes.

Musicrypt Inc.

Statements of Cash Flows
For the Years Ended December 31

	2006	2005
Cash flows from (used in) operating activities		
Loss for the year	**$ (2,113,587)**	$ (2,061,976)
Add items not affecting cash		
Amortization	**267,355**	154,597
Loss on disposal of property, plant and equipment	**1,947**	-
Issuance of shares for services	**-**	28,515
Issuance of shares pursuant to equity compensation plan	**-**	398,590
Issuance of shares for royalty payment	**132,190**	-
Stock-based compensation	**201,715**	290,276
	(1,510,380)	(1,189,998)
Changes in non-cash working capital items		
Amounts receivable	**(39,471)**	10,759
Prepaids and sundry assets	**(28,320)**	(915)
Accounts payable and accrued liabilities	**160,270**	(457,851)
Deferred revenue	**-**	(12,500)
	(1,417,901)	(1,650,505)
Cash flows from (used in) investing activities		
Purchase of capital assets	**(29,694)**	(72,233)
Patents	**(22,994)**	-
Investment in technology	**-**	(80,235)
Deferred development costs	**(446,656)**	(448,554)
	(499,344)	(601,022)
Cash flows from financing activities		
Issuance of common shares, net of issue costs	**1,333,151**	2,767,025
Operating loan	**15,000**	-
	1,348,151	2,767,025
Increase (decrease) in cash during the year	**(569,094)**	515,498
Cash and cash equivalents at beginning of year	**641,541**	126,043
Cash and cash equivalents at end of year	**$ 72,447**	$ 641,541

See accompanying notes.

1. BASIS OF PRESENTATION

Musicrypt Inc. ("Musicrypt" or the "Company") is a technology company that is targeted to become the leading enabler of user-friendly and secure distribution of media via the internet. The Company was incorporated on July 28, 1999 under the laws of Ontario as Musicrypt.com Inc. and changed to its present name on December 22, 2000.

2. SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles within the framework of the significant accounting policies summarized below.

Use of Estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenue and expenses during the year. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents consists of cash in the bank and highly liquid investments with maturities of three months or less at the time of purchase.

Capital Assets

Capital assets are recorded at cost less accumulated amortization. Amortization is calculated on a straight-line basis over the estimated useful lives of the assets as follows:

Office furniture and equipment	- 5 years
Computer equipment	- 3 years
Computer software	- 3 years
Leasehold improvements	- over the term of the lease
Website	- 3 years

Patents

Costs to obtain patents are capitalized and are amortized to operations on a straight-line basis over the underlying term of the patents upon the registration of the patent. The patent relates to the use of the technology under license described in Note 5.

2. SIGNIFICANT ACCOUNTING POLICIES (Cont'd)

Investment in Technology

The investment in technology consists of consideration paid for the acquisition of a license to use technology. Such costs are amortized to operations on a straight-line basis over the remaining term of the license. The license agreement expires in 2013.

Research and Development Costs

Research costs are charged to operations when incurred. Development costs are expensed in the year incurred unless they meet the criteria under Canadian generally accepted accounting principles for deferral and amortization. Amortization commences with the successful commercial production or use of the product or process. These costs are being amortized over a period of four years from commencement of commercial use.

Impairment of Long-lived Assets

Long-lived assets consists of capital assets, patents, deferred development costs and investment in technology. Long-lived assets are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable. When the carrying value is not recoverable from future cash flows on an undiscounted basis and the carrying value exceeds the assets' fair value, an impairment loss is recorded for the excess of carrying value over fair value.

Share Issuance Costs

Costs incurred in connection with the issuance of capital stock are netted against the proceeds received.

Accounting for Stock-Based Compensation and Other Stock-Based Payments

The Company applies a fair value based method of accounting to all stock-based payments. Accordingly, stock-based payments are measured at the fair value of the consideration received or the fair value of the equity instruments issued or liabilities incurred, whichever is more reliably measurable. Stock-based compensation is charged to operations over the vesting period and the offset is credited to contributed surplus. Consideration received upon the exercise of stock options is credited to share capital and the related contributed surplus is transferred to share capital.

2. SIGNIFICANT ACCOUNTING POLICIES (Cont'd)

Revenue Recognition

The Company's revenue is derived through the secure distribution of media via its patented Digital Media Distribution System. The Company recognizes revenue at the time persuasive evidence of an agreement exists, price is fixed and determinable, the distribution of the media has occurred and collectibility is reasonably assured.

Loss Per Share

Basic loss per share is calculated based on the weighted average number of shares outstanding. The treasury stock method is used to compute the dilutive effect of options, warrants and similar instruments.

Income Taxes

The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on temporary differences between financial reporting and tax bases of assets and liabilities, as well as for the benefit of losses available to be carried forward to future years for tax purposes. Future income tax assets and liabilities are measured using enacted or substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Future income tax assets are recorded in the financial statements if realization is considered more likely than not.

Foreign Currency Translation

Monetary assets and liabilities denominated in foreign currencies are translated to Canadian dollars at exchange rates in effect at the balance sheet date. Non-monetary assets and liabilities are translated at rates of exchange at each transaction date. Revenue and expenses are translated at the rate of exchange at each transaction date. Gains or losses on translation are included in income.

3. CAPITAL ASSETS

December 31, 2006

	Cost	Accumulated Amortization	Net
Office furniture and equipment	**$ 21,617**	**$ 13,635**	**$ 7,982**
Computer equipment	**156,350**	**112,037**	**44,313**
Computer software	**10,917**	**9,472**	**1,445**
Leasehold improvements	**7,768**	**6,473**	**1,295**
Website	**10,456**	**5,836**	**4,620**
	$ 207,108	**$ 147,453**	**$ 59,655**

December 31, 2005

	Cost	Accumulated Amortization	Net
Office furniture and equipment	$ 20,413	$ 9,850	$ 10,563
Computer equipment	133,376	81,703	51,673
Computer software	9,801	8,680	1,121
Leasehold improvements	7,768	3,884	3,884
Website	8,394	2,351	6,043
	$ 179,752	$ 106,468	$ 73,284

4. INVESTMENT IN TECHNOLOGY

	2006	2005
Balance at beginning of year	**$ 703,808**	$ 625,285
Additions	**-**	162,735
Less: Amortization	**(92,537)**	(84,212)
Balance at end of year	**$ 611,271**	$ 703,808

The deferred amounts relate to the technology license agreement described in Note 13 (c). In the current year, $NIL (2005 - $80,235) of additions were paid in cash and $NIL (2005 - $82,500) was satisfied through the issuance of common shares. The Company is also committed to other payments under the licensing agreement as disclosed in Note 13 (c).

5. DEFERRED DEVELOPMENT COSTS

	2006	2005
Opening balance	**$ 422,836**	$ -
Additions	**446,656**	448,554
Less: Amortization	**(133,443)**	(25,718)
Ending balance	**$ 736,049**	$ 422,836

Costs associated with the development of the Company's various digital media distribution systems ("DMDS") have been recorded as a deferred development costs. When the product begins to generate revenues, management ceases to defer the associated costs and begins to amortize the asset over the estimated benefit period.

6. OPERATING LOAN

The Company has available an operating line of credit of $25,000. Borrowings under the operating line of credit are due on demand and bear interest at prime plus 2.5% per annum and are secured by a general security agreement. As at December 31, 2006, the Company had drawn $15,000 on this line of credit.

7. CAPITAL STOCK

Authorized
An unlimited number of common shares.

Issued and outstanding

	Number of Shares	Value
Balance, January 1, 2005	**17,166,591**	**$ 7,580,290**
Issued pursuant to equity compensation plan (i)	720,000	360,000
Issued for cash (ii)	769,411	205,117
Issued for licensing technology (iii)	187,500	82,500
Issued for services (iv)	54,546	30,000
Issued for services (v)	21,818	12,000
Issued for cash (vi)	7,500,000	2,531,908
Issued pursuant to equity compensation plan (vii)	91,000	38,590
Issued for services (viii)	95,000	16,515
Balance, December 31, 2005	**26,605,866**	**$ 10,856,920**
Issued for cash (ix)	7,500,000	1,333,151
Issued for royalty payment (x)	660,949	132,190
Balance, December 31, 2006	**34,766,815**	**$ 12,322,261**

(i) 720,000 common shares valued at $360,000 were issued pursuant to the equity compensation plan.

(ii) The Company issued 769,411 common shares for gross proceeds of $230,823 by way of a private placement. Each unit consisted of one common share and one-half of a warrant to purchase one common share at a price of $0.45 per share for six months. The warrants expired prior to the end of the year. Share issuance costs of $25,706 have been netted against the proceeds.

(iii) The Company issued 187,500 common shares valued at $82,500 as consideration for a technology license (Note 13 (c)).

(iv) The Company issued 54,546 common shares for services rendered during the year valued at $30,000. The services relate to arranging the private placement disclosed in Note 7(vi). The costs has been recorded as a share issuance costs and has been netted against the gross proceeds of the private placement.

(v) The Company issued 21,818 common shares for services rendered during the year valued at $12,000.

7. CAPITAL STOCK (Cont'd)

(vi) The Company issued 7,500,000 units for gross proceeds of $3,000,000 by way of a private placement. Each unit consisted of one common share and one-half of a warrant to purchase one common share at a price of $0.80 per share for a period of twelve months thereafter. The warrant price increases to $0.90 per common share for the subsequent twelve month period. Share issuance costs of $468,092 have been netted against the proceeds.

(vii) The Company issued 91,000 common shares pursuant to the equity compensation plan.

(viii) The Company issued 95,000 common shares for consulting services.

(ix) The Company issued 7,500,000 units for gross proceeds of $1,500,000 by way of a private placement. Each unit consisted of one common share and one-half of a warrant to purchase one common share at a price of $0.30 per share for a period of twenty four months thereafter. Share issuance costs of $166,849 have been netted against the proceeds.

(x) The Company issued 660,949 common shares to its licensor in satisfaction of the balance of the minimum royalty due under the license agreement, in the amount of $132,190.

8. STOCK OPTIONS AND WARRANTS

(i) Stock Options

The Company has an Incentive Stock Option Plan (the "Plan"). The Plan provides for options to be granted to the benefit of employees, directors and third parties. The maximum number of shares allocated to and made available to be issued under the Plan is 4,500,000. The exercise price of options granted under the Stock Option Plan will be determined by the directors, but will be at least equal to the closing trading price for the common shares for the last trading day prior to the grant and otherwise the fair market price as determined by the Board of Directors. The term of any option granted shall not exceed the maximum permitted time period under applicable regulations. Except as otherwise provided elsewhere in the Stock Option Plan, the options shall be cumulatively exercisable in installments over the option period at a rate to be fixed by the Board of Directors. The Company will not provide financial assistance to any optionee in connection with the exercise of options.

Agent's options were granted with respect to the initial public offering and were not issued under the Plan.

8. STOCK OPTIONS AND WARRANTS (Cont'd)

(i) Stock Options (Cont'd)

The Company had issued stock options to acquire common shares as follows:

	2006		2005	
	Number of Options	**Weighted Average Exercise Price**	Number of Options	Weighted Average Exercise Price
Outstanding, beginning of year	**2,939,625**	**$ 0.48**	1,717,645	$ 0.58
Granted	**735,000**	**$ 0.26**	1,385,000	$ 0.41
Cancelled	**(7,500)**	**$ (0.42)**	-	$ -
Expired	**(37,500)**	**$ (0.60)**	(163,020)	$ (0.75)
Outstanding, end of year	**3,629,625**	**$ 0.46**	2,939,625	$ 0.48
Exercisable	**3,065,625**	**$ 0.48**	2,170,625	$ 0.51

The Company had the following stock options outstanding at December 31, 2006:

Number of Options	**Exercise Price**	**Expiry Date**
50,000	$ 0.75	June 7, 2007
175,000	$ 0.10	June 7, 2007
249,625	$ 0.75	June 12, 2007
210,000	$ 0.75	May 7, 2008
75,000	$ 0.10	May 7, 2008
15,000	$ 0.88	May 28, 2008
25,000	$ 0.47	September 24, 2008
50,000	$ 1.04	January 1, 2009
400,000	$ 0.47	January 1, 2009
100,000	$ 0.86	August 9, 2009
25,000	$ 0.47	August 25, 2009
25,000	$ 0.52	September 14, 2009
135,000	$ 0.47	November 24, 2009
60,000	$ 0.44	February 3, 2010
500,000	$ 0.44	March 7, 2010
665,000	$ 0.42	May 19, 2010
110,000	$ 0.42	October 3, 2010
125,000	$ 0.25	November 22, 2010
450,000 (i)	$ 0.25	April 11, 2011
65,000	$ 0.20	August 16, 2011
120,000	$ 0.24	November 21, 2011
3,629,625		

(i) As disclosed in Note 13 (a) these are performance options that vest based on certain performance targets being met.

8. STOCK OPTIONS AND WARRANTS (Cont'd)

(ii) Warrants

The Company had issued warrants to acquire common shares as follows:

	2006		2005	
	Number of Warrants	**Weighted Average Exercise Price**	Number of Warrants	Weighted Average Exercise Price
Outstanding, beginning of year	**4,475,000**	**$ 0.74**	1,223,011	$ 0.69
Granted	**4,308,800**	**$ 0.29**	4,859,703	$ 0.72
Expired	**(600,000)**	**$ (0.40)**	(1,607,714)	$ (0.63)
Outstanding, end of year	**8,183,800**	**$ 0.53**	4,475,000	$ 0.74

The Company had the following warrants outstanding at December 31, 2006:

Number of Warrants	**Purchase Price**	**Expiry Date**
125,000 [a]	$ 0.50	March 1, 2007
3,750,000 [b]	$ 0.90	April 21, 2007
1,630,000 [c]	$ 0.30	May 12, 2008
75,000 [c]	$ 0.30	May 25, 2008
2,045,000 [c]	$ 0.30	June 7, 2008
340,800 [d]	$ 0.20	May 12, 2007
8,000 [d]	$ 0.20	May 25, 2007
210,000 [d]	$ 0.20	June 7, 2007
8,183,800		

(a) Pursuant to an agreement with a service provider, additional warrants to a maximum of 375,000 will be issued subject to the successful completion of certain marketing targets. The exercise price of any warrants issued under the agreement will be the closing price of the Company's shares immediately prior to the date upon which the warrants are issuable under the agreement. These expired unexercised subsequent to the year-end.

(b) These warrants were issued in connection with the private placement disclosed in Note 7(vi). Each warrant entitles the holder to acquire one common share at a price of $0.80 per share for a period of twelve months from issuance (April 21, 2005) and increasing to $0.90 per share for twelve months thereafter.

(c) These are issued in connection with the private placement of units disclosed in Note 7(ix). Each warrant entitles the holder to acquire one common share at a price of $0.30 per share for a period of twenty four months from issuance.

8. STOCK OPTIONS AND WARRANTS (Cont'd)

(d) These warrants were issued to agents in connection with the private placement of units disclosed in Note 7(ix). Each warrant entitles the holder to acquire one unit at a price of $0.20 per unit for a period of twelve months from issuance. Each unit consists of one common share and one-half of a warrant to purchase one common share at a price of $0.30 per share for a period of twenty four months from issuance of the original warrant.

9. CONTRIBUTED SURPLUS

	2006	2005
Contributed surplus beginning of year	**$ 444,129**	$ 153,853
Stock-based compensation expense (Note 10)	**201,715**	290,276
	$ 645,844	$ 444,129

10. STOCK-BASED COMPENSATION

The total stock compensation expense relating to options recognized in the year was $201,715 (2005 - $290,276).

The fair value of each option granted in the year ended December 31, 2006 has been estimated at the date of grant or the date when it became measurable using the Black-Scholes option pricing model with the following weighted-average assumptions: (i) dividend yield of 0%; (ii) expected volatility of 87% (2005 - 79%); (iii) risk-free interest rate of 4.1% (2005 - 3.5%) and; (iv) expected life of 5 (2005 - 5) years. The Company has assumed no forfeiture rate (except on performance based options) as adjustments for actual forfeitures are made in the period they occur. The total grant date fair values of options issued in the year ended December 31, 2006 was $68,279 (2005 - $388,094).

11. LOSS PER SHARE

Loss per share has been calculated based on the weighted average number of common shares outstanding at December 31, 2006 of 31,369,104 (2005 - 23,928,974).

For the above-mentioned years, the Company had securities outstanding which could potentially dilute basic earnings per share in the future, but were excluded from the computation of dilutive net loss per share in the periods presented, as their effect would have been anti-dilutive. Such outstanding securities consist of the following:

	2006	2005
Options	**3,629,625**	2,939,625
Warrants	**8,183,800**	4,475,000

12. INCOME TAXES

(i) Income Tax Expense

The following table reconciles income taxes calculated at combined Canadian federal/provincial tax rates with the income tax expense in these financial statements:

	2006	2005
Loss before income taxes	**$(2,113,587)**	$(2,061,976)
Statutory rate	**36.1%**	36.1%
Expected income tax recovery	**$ (763,005)**	$ (744,373)
Change in temporary timing differences relating to:		
Equipment and intangible assets	**89,700**	55,800
Unutilized tax losses relating to operations	**590,600**	581,173
Amounts not deductible for tax and other	**82,705**	107,400
Income tax expense	**$ -**	$ -

(ii) Future Income Taxes

The temporary differences that give rise to future income tax assets and future income tax liabilities are presented below:

	2006	2005
Amounts related to tax loss and credit carryforwards	**$ 3,584,100**	$ 2,957,700
Share issuance costs	**160,000**	228,300
Equipment and intangible assets	**299,200**	209,500
Net future tax asset	**4,043,300**	3,395,500
Less: Valuation allowance	**(4,043,300)**	(3,395,500)
	$ -	$ -

(iii) The Company has non-capital losses of approximately $9,928,000 available to apply against future taxable income. If not utilized, the non-capital losses will expire as follows:

2007	$ 872,000
2008	936,000
2009	470,000
2010	1,770,000
2014	2,630,000
2015	1,389,000
2026	1,861,000
	$ 9,928,000

The potential tax benefit relating to these losses has not been reflected in these financial statements.

13. COMMITMENTS AND CONTINGENCIES

(a) Equity Compensation Plan

Pursuant to the equity compensation plan for 2006, 450,000 options were granted as potential performance bonuses for two participating executives in 2006. These options vest subject to certain performance targets being met. The Company expects the performance targets for 225,000 options will not be met and have accordingly not recorded an expense for these items.

(b) Warrants

The Company is committed to issue up to 375,000 warrants as described in Note 8(ii)(a). Subsequent to year-end, this commitment expired.

(c) Technology License Agreement

The Company acquired a license (the "License") to use a patented biometric technology (the "Intellectual Property"). The License gives the Company an exclusive worldwide license for the Intellectual Property until July 31, 2006, and a non-exclusive licence until July 31, 2013, thereafter automatically renewing for successive one year terms subject to termination on 180 days notice prior to the renewal date by either the Licensor or the Company. The non-exclusive licence continues for a two year transition period from the date of expiry or termination (other than from default by the Company or Licensor).

The Licence provides Musicrypt with the exclusive worldwide rights to use the Intellectual Property in connection with the communication of digitized audio content (including musical recordings, advertising, dialogue, sound effects and other audio recordings) within, to and among entities engaged in the creation, production and broadcast of music content, such as record companies, music producers, recording studios and radio broadcasters. The License also provides non-exclusive worldwide rights to use the Intellectual Property as described in the preceding sentence, in connection with the communication of content associated with digitized audio content (such as track title, artist name, and album covers), music videos and advertising, within, to and among entities involved in the review and/or approval of digitized audio content (including critics, journalists, charting companies, concert promoters and consultants, music video television stations, advertising agencies and their clients, and other advertisers).

Consideration for the License includes 750,000 common shares of the Company and a royalty of 5% of gross revenues received in connection with use of the Intellectual Property. 375,000 of the common shares were issued in December 2003, 187,500 were issued on March 29, 2004 and 187,500 were issued on March 24, 2005. After June 15, 2004, the Licensor may not sell more than 50,000 shares in any 30 day period. The Licensor may offer no more than 10,000 shares for sale in any one day.

Minimum royalties of $50,000, $100,000 and $150,000 are payable respectively at the end of each of the first three years of the agreement. The Company has paid all of the minimum royalties.

13. COMMITMENTS AND CONTINGENCIES (Cont'd)

(d) Litigation

On November 14, 2000, the Company filed a claim against a former employee and shareholder, and related shareholders, seeking a rescission of their 1,250,000 common shares and damages in the amount of $100,000. A counterclaim was brought against the Company by these defendants for various relief including damages of approximately $850,000, a declaration that the defendants are shareholders and orders that they be bought out or the Company be wound up. In May 2001, the Company successfully defeated a motion by the defendants that sought interim costs and security for costs. The Company was awarded its costs for this motion. The Company continues to vigorously defend the action. The outcome is not determinable and therefore no provision is recorded.

In the ordinary course of business activities, the Company may be contingently liable for litigation and claims with customers, suppliers and former employees. Management believes that adequate provisions have been recorded in the accounts where required.

(e) Patent Infringement

On July 25, 2005, the Company sent a letter to a competitor and its partners demanding that they cease infringement of the Company's Content Distribution System and Method patent number 2,407,774 in Canada. On March 7, 2006, the competitor filed a claim with the Federal Court of Canada requesting a ruling that the technology of the competitor and its partners does not infringe on this patent and that the patent was invalid. In June 2006, the Company filed with the Federal Court a statement of defence and counterclaim seeking $15 million in damages for infringement from the competitor and its partners.

(f) Leases

Total future minimum annual lease payments for premises and equipment are as follows:

2007	$	21,500
2008		900
	$	**22,400**

(g) Consulting Agreement

In 2006 the Company entered into a consulting services agreement relating to strategic business opportunities. Pursuant to the agreement, the Company is required to pay a fee of 10% of the gross profit generated from business transactions resulting from the arrangement for five years from the date of such transaction. The Company entered into such a transaction in 2006 and no revenues have been generated from the transaction to date. The consulting services agreement was terminated in February 2007.

14. FINANCIAL INSTRUMENTS

Fair Value

The carrying values of cash and cash equivalents, amounts receivable, accounts payable and accrued liabilities, and operating loan approximate fair values due to the relatively short term maturities of these instruments.

Credit Risk

The Company is subject to risk of non-payment of accounts receivable. The Company mitigates this risk by monitoring the credit worthiness of its customers.

Interest Rate Risk

The Company has bank borrowings that carry interest at a floating rate and therefore, is subject to cash flow interest rate risk.

15. SUBSEQUENT EVENT

On February 6, 2007, the Company issued 40,000,000 common shares by way of a private placement for gross proceeds of $10,000,000. The Company paid commissions of $700,000 and issued 2,800,000 broker warrants that are exercisable at $0.25 per warrant and expire two years from issuance.

CORPORATE INFORMATION

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John C. Heaven	*President & Chief Executive Officer*
Germain (Gerry) R. Lacoursiere	*Member of Audit Committee and Compensation Committee*
Justin D. C. LaFayette	*Member of Audit Committee and Compensation Committee*
Gary Moss	*Member of Audit Committee and Compensation Committee*

Officers

John C. Heaven	*President & Chief Executive Officer*
Clifford G. Hunt	*Chairman & Chief Operating Officer*
J. Christopher Montgomery	*Executive Vice President, Global Marketing*
Wojtek A. Hoch	*Vice President, Technology*
Jon Klein	*Vice President, Sales*

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MUSICRYPT INC

EMI Music Canada

Sony BMG Music Canada

Universal Music Canada

Warner Music Canada

The Canadian Independent record Production Association (CIRPA)

Frontside Promotions Group

RDR Music Group

Koch Entertainment

Maple Music Recording

Broadjam

Independent Online Distribution Alliance (IODA)

Music Allies

Adstream

Astral Media

CHUM Radio

Clear Channel Radio

Corus Radio

GoldenWest Broadcasting

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