

# Covalon Technologies Ltd.

Consolidated Financial Statements

For the years ended

September 30, 2007 and 2006

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## Contents

<b>Auditors' Report</b>	2
<b>Consolidated Financial Statements</b>	
Balance Sheets	3
Statements of Deficit	4
Statements of Operations and Comprehensive Income	5
Statements of Cash Flows	6
Statements of Shareholders' Equity	7
<b>Summary of Significant Accounting Policies</b>	8-10
<b>Notes to Financial Statements</b>	11-17



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## Auditors' Report

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### **To the Shareholders of Covalon Technologies Ltd.**

We have audited the consolidated balance sheets of Covalon Technologies Ltd. as at September 30, 2007 and 2006 and the consolidated statements of deficit, operations and comprehensive income, cash flows and shareholders' equity for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) "BDO Dunwoody LLP"

Chartered Accountants, Licensed Public Accountants

Toronto, Ontario  
January 14, 2008

# Covalon Technologies Ltd.

## Consolidated Balance Sheets

September 30 2007 2006

### Assets

#### Current assets

Cash and cash equivalents	\$ 6,917,897	\$ 5,011,642
Short term investments	9,252,103	-
Accounts receivable	320,239	232,153
Refundable investment tax credits	-	65,400
Inventories	279,331	269,399
Prepaid expenses	204,512	61,971

**16,974,082** 5,640,565

#### Capital assets (Note 2)

580,661 440,611

#### Other assets (Note 3)

484,368 302,023

#### Deferred developments costs (Note 4)

2,205,350 2,410,189

**\$ 20,244,461** **\$ 8,793,388**

### Liabilities and Shareholders' Equity

#### Current liabilities

Accounts payable and accrued liabilities	\$ 673,357	\$ 506,720
Deferred revenue (Note 5)	1,977,904	20,715

**2,651,261** 527,435

#### Shareholders' Equity

Share Capital (Note 6 (b))	28,664,432	15,828,922
Contributed Surplus	329,004	340,297
Warrants (Note 6 (b))	-	927,479
Options (Note 6 (c))	925,625	418,739
Deficit	(12,325,861)	(9,249,484)

**17,593,200** 8,265,953

**\$ 20,244,461** **\$ 8,793,388**

On behalf on the Board

(signed) "Martin C. Bernholtz" Director

(signed) "Frank DiCosmo" Director

The accompanying summary of significant accounting policies and notes are an integral part of these consolidated financial statements.

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## Covalon Technologies Ltd.

### Consolidated Statements of Deficit

For the years ended September 30	2007	2006
Deficit, beginning of year	\$ (9,249,484)	\$ (7,044,494)
Loss for the year	<u>(3,076,377)</u>	<u>(2,204,990)</u>
Deficit, end of year	<u>\$ (12,325,861)</u>	<u>\$ (9,249,484)</u>

The accompanying summary of significant accounting policies and notes are an integral part of these consolidated financial statements.

# Covalon Technologies Ltd.

## Consolidated Statements of Operations and Comprehensive Income

For the years ended September 30	2007	2006
<b>Sales</b>	\$ 1,285,673	\$ 938,800
<b>Cost of goods sold</b>	<u>856,406</u>	<u>540,278</u>
	429,267	398,522
<b>Other revenue</b>		
Interest income	249,143	115,743
Licensing fee	<u>249,999</u>	<u>5,443</u>
	<u>928,409</u>	<u>519,708</u>
<b>Expenses</b>		
Amortization of capital assets	110,959	106,229
Amortization of patents and technology rights	28,714	21,966
Amortization of deferred development costs	113,315	115,401
Bank charges and interest	3,774	4,098
Consulting fees	2,400	112,312
Directors' fees	448,448	58,603
Foreign currency (gain) loss	53,269	(1,067)
Loss on disposal of equipment	9,218	-
Management fees	527,994	314,991
Marketing	220,046	235,141
Office and administrative	492,249	399,625
Patent maintenance	4,771	7,291
Professional fees	146,042	144,223
Property maintenance	7,620	8,783
Regulatory	588,833	353,043
Research and development	1,051,558	648,575
Training - professional development	14,464	5,476
Travel	81,968	96,693
Write-down of deferred development costs	91,524	78,710
Write-down of patents	<u>7,620</u>	<u>14,605</u>
	<u>4,004,786</u>	<u>2,724,698</u>
<b>Loss and comprehensive income for the year</b>	<u>\$ (3,076,377)</u>	<u>\$ (2,204,990)</u>
<b>Basic and fully diluted loss per share (Note 6 (d))</b>	<u>\$ (0.05)</u>	<u>\$ (0.05)</u>

The accompanying summary of significant accounting policies and notes are an integral part of these consolidated financial statements.

# Covalon Technologies Ltd.

## Consolidated Statements of Cash Flows

For the years ended September 30

2007

2006

### Cash flows from operating activities

Loss for the year	\$	(3,076,377)	\$	(2,204,990)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities				
Amortization of capital assets		110,959		106,229
Amortization of patent and technology rights		28,714		21,966
Amortization of deferred development costs		113,315		115,401
Loss on disposal of capital assets		9,218		594
Write-down of deferred development costs		91,524		78,710
Write-down of patents		7,620		14,605
Stock compensation expense		566,880		35,244
Foreign exchange (gain) loss		53,269		(1,067)
Changes in non-cash working capital balances				
Accounts receivable		(88,086)		(173,385)
Inventories		(9,932)		(140,974)
Prepaid expenses		(142,541)		5,247
Accounts payable and accrued liabilities		166,638		(201,112)
Deferred revenue		1,957,189		20,715
Refundable tax credits		65,400		206,011
		<u>(146,210)</u>		<u>(2,116,806)</u>

### Cash flows from investing activities

Purchase of capital assets (net of disposals and investment tax credits)		(260,227)		(54,808)
Purchase of patents and technology rights		(218,679)		(104,862)
Purchase of short term investments		(9,252,103)		-
		<u>(9,731,009)</u>		<u>(159,670)</u>

### Cash flows from financing activities

Net proceeds on issuance of share capital		<u>11,836,743</u>		<u>6,643,047</u>
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### Foreign exchange gain (loss) on cash held

		<u>(53,269)</u>		<u>1,067</u>
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### Increase in cash and cash equivalents during the year

		<u>1,906,255</u>		<u>4,367,638</u>
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### Cash and cash equivalents, beginning of year

		<u>5,011,642</u>		<u>644,004</u>
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### Cash and cash equivalents, end of year

	\$	<u>6,917,897</u>	\$	<u>5,011,642</u>
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The accompanying summary of significant accounting policies and notes are an integral part of these consolidated financial statements.

**Covalon Technologies Ltd.**  
**Consolidated Statements of Shareholders' Equity**

**For the years ended September 30, 2007 and 2006**

	Share Capital		Contributed Surplus	Warrants	Options	Deficit	Total
	Number of Shares	Amount					
<b>Balance, September 30, 2005</b>	41,221,323	\$ 9,872,463	\$ 37,137	\$ 333,930	\$ 593,616	\$ (7,044,494)	\$ 3,792,652
Issuance of common shares and warrants for cash pursuant to a private placement	13,696,600	5,989,523		858,777			6,848,300
Issue of common shares for cash pursuant to the exercise of warrants	1,043,861	528,632		(149,043)			379,589
Issue of common shares for cash pursuant to the exercise of stock options	361,000	207,393			(91,848)		115,545
Expired warrants and options			303,160	(184,887)	(118,273)		-
Stock based compensation					35,244		35,244
Share issuance cost		(769,089)		68,702			(700,387)
Net loss						(2,204,990)	(2,204,990)
<b>Balance, September 30, 2006</b>	56,322,784	15,828,922	340,297	927,479	418,739	(9,249,484)	8,265,953
Issue of warrants pursuant to the exercise of broker compensation warrants		(2,338,229)		2,338,229			-
Issue of common shares for cash pursuant to the exercise of warrants	15,888,056	14,907,819		(3,265,708)			11,642,111
Issue of common shares for cash pursuant to the exercise of stock options	501,194	265,920			(71,287)		194,633
Options reinstated to consultant			(23,693)		23,693		-
Stock based compensation					566,880		566,880
Expired stock options			12,400		(12,400)		-
Net loss						(3,076,377)	(3,076,377)
<b>Balance, September 30, 2007</b>	72,712,034	\$ 28,664,432	\$ 329,004	\$ -	\$ 925,625	\$ (12,325,861)	\$ 17,593,200

The accompanying summary of significant accounting policies and notes are an integral part of these consolidated financial statements.

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**Covalon Technologies Ltd.**  
**Summary of Significant Accounting Policies**

**September 30, 2007 and 2006**

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Nature of Business	<p>The Company is incorporated under the laws of Ontario and is engaged in the business of developing medical products. In prior years, up to and including the year ending September 30, 2005, the Company focused its efforts on research and development and the raising of capital to fund the development of medical products. Accordingly, the Company was considered to be in the development stage. The Company has now received regulatory approval on numerous products and is currently generating revenue. The Company's main business function has changed to manufacturing and sales; accordingly the Company is no longer considered a Development Stage Company. All research and development costs subsequent to September 30, 2005 are now expensed as incurred.</p>						
Basis of Consolidation	<p>These financial statements have been prepared using the purchase method of consolidation. The assets and liabilities of the acquired companies are initially recorded at cost. The results of operations of the acquired companies are included from the dates of acquisition. All significant intercompany transactions and balances have been eliminated on consolidation.</p>						
Revenue Recognition	<p>Revenue is recognized on an accrual basis as follows:</p> <ul style="list-style-type: none"><li>a) Revenue arising from product sales is recognized once the product has been shipped to the customer.</li><li>b) Revenue arising from licensing fees and royalties is initially recorded as deferred revenue and recognized over the period of the relevant agreements.</li><li>c) Revenue arising from interest is recognized as earned.</li></ul>						
Cash and Cash Equivalents	<p>Cash and cash equivalents are defined as highly liquid investments and consist of cash and money market instruments.</p>						
Inventories	<p>Raw materials and supplies are stated at the lower of average cost and replacement cost. Cost is generally determined on the first-in, first-out basis. Work in process and finished goods are stated at the lower average cost and net realizable value.</p>						
Capital Assets	<p>Capital assets are recorded at cost less related investment tax credits. Amortization is based on the estimated useful life of the asset and is calculated as follows:</p> <table><tr><td>Furniture and fixtures</td><td>- 20% diminishing balance basis</td></tr><tr><td>Lab equipment</td><td>- 20% diminishing balance basis</td></tr><tr><td>Leasehold improvements</td><td>- straight-line basis over 5 years</td></tr></table>	Furniture and fixtures	- 20% diminishing balance basis	Lab equipment	- 20% diminishing balance basis	Leasehold improvements	- straight-line basis over 5 years
Furniture and fixtures	- 20% diminishing balance basis						
Lab equipment	- 20% diminishing balance basis						
Leasehold improvements	- straight-line basis over 5 years						

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**Covalon Technologies Ltd.**  
**Summary of Significant Accounting Policies**

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**September 30, 2007 and 2006**

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Other Assets	Other assets include expenditures related to obtaining patents and technology rights and are stated at cost less accumulated amortization. Amortization is being provided on a straight-line basis over the remaining life of the patent being 20 years less the number of years since application for the patent.
Deferred Development Costs / Research Development	<p>During the development stage, research costs were expensed as incurred. Development costs which meet generally accepted criteria, including reasonable assurance regarding recoverability, are deferred and amortized from the beginning of commercial production and sales. Annually the Company reviews the recoverability of deferred development costs through evaluation of the expected future cash inflows from commercialization of the associated products to determine if there is an impairment in the recoverable amount.</p> <p>Development costs for each product (project) are amortized when the product regulatory approval to sell the product is received, on a straight-line basis over the years remaining on the patent.</p>
Investment Tax Credits	Investment tax credits arising from qualifying research and experimental development costs are recorded as a reduction of deferred development costs or capital asset purchases in the period in which these tax credits are considered reasonably assured to be recovered.
Future Income Tax	The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in operations in the year in which the change occurs.
Foreign Currency Translation	<p>Foreign currency accounts are translated into Canadian dollars as follows:</p> <p>At the transaction date, each asset, liability, revenue and expense is translated into Canadian dollars by the use of the exchange rate in effect at that date. At the reporting date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate in effect at that date. The resulting foreign exchange gains and losses are included in income in the current period.</p>

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**Covalon Technologies Ltd.**  
**Summary of Significant Accounting Policies**

**September 30, 2007 and 2006**

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Financial instruments	<p>Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest and currency risks arising from its financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.</p> <p>All of the Company's cash is maintained by one of the major financial institutions.</p> <p>Short term investments consist of Ontario Savings Bonds (interest rate of 5.7% and maturing on December 1, 2008) and the carrying value approximates fair market value.</p> <p>For the year ended September 30, 2007, three customers accounted for 95% (2006 – 88%) of the year end accounts receivable balance. These customers, who act as distributors of the Company's product, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers.</p>
Stock Based Compensation	<p>Direct awards of stock are based on the price of common stock measured at fair value at each reporting date, with the change in fair value reported in the statement of operations.</p> <p>The Company uses the fair value based method of accounting for all its stock-based compensation. Accordingly, the fair value method of accounting is applied for stock options granted to directors, officers, employees and consultants whereby the weighted average fair value of options granted is recognized in the financial statements over the vesting period. When the awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to options.</p>
Use of Estimates	<p>The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from management's best estimate as additional information becomes available in the future.</p>
Loss per Common Share	<p>Loss per common share has been computed by dividing the loss applicable to common shareholders by the weighted average number of shares of common stock outstanding during the respective years.</p>
Impairment of Long-Lived Assets	<p>An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes the assets' carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the asset and its carrying value. Management has determined that no long-lived assets of the Company in the years ended September 30, 2007 and 2006 have met the criteria for impairment.</p>

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# Covalon Technologies Ltd.

## Notes to Consolidated Financial Statements

September 30, 2007 and 2006

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### 1. Financial Instruments

On October 1, 2006, the Company retroactively adopted, without restatement of prior periods, CICA Handbook Section 1530, "Comprehensive Income", Section 3251, "Equity", Section 3861, "Financial Instruments - Disclosure and Presentation", Section 3855, "Financial Instruments - Recognition and Measurement" and Section 3865, "Hedges". These new Handbook Sections provide comprehensive requirements for the recognition and measurement of financial instruments, as well as standards on when and how hedge accounting may be applied. Handbook Section 1530 also introduces a new component of equity referred to as accumulated other comprehensive income. Section 3251, "Equity", replaces Section 3250, "Surplus" and incorporates amendments resulting from the issuance of Section 1530.

Under these new standards, all financial instruments, including derivatives, are included on the consolidated balance sheet and are measured either at fair market value or, in limited circumstances, at cost or amortized cost. Derivatives that qualify as hedging instruments must be designated as either a "cash flow hedge," when the hedged item is a future cash flow, a "fair value hedge," when the hedged item is the fair value of a recognized asset or liability or a "hedge of foreign currency exposures of net investments in self-sustaining foreign operations". The effective portion of unrealized gains and losses related to a cash flow hedge or a hedge of foreign currency exposures of net investments in self-sustaining foreign operations are included in other comprehensive income. For a fair value hedge, the derivative is recorded at fair value and the hedged item is adjusted for changes in fair value related to the hedged risk and the unrealized gains and losses from both items are included in net income. For derivatives that do not qualify as hedging instruments, unrealized gains and losses are reported in net income.

Section 3855 requires all financial assets and liabilities to be classified into one of the following five categories: held-for-trading; held-to-maturity; loans and receivables; available-for-sale financial assets and other financial liabilities.

Upon the adoption of these new standards, the Company designated its cash and cash equivalents as held-for-trading, its short term investments as available for sale, its accounts receivable as loans and receivables and its accounts payable and accrued liabilities as other financial liabilities.

Held-for-trading financial assets are initially measured at fair value with subsequent changes in fair value recognized in current period net income.

Available for sale financial assets are initially measured at fair value with subsequent changes in fair value recognized in other comprehensive income.

For loans and receivables and other financial liabilities: initially measured at fair value and subsequently measured at amortized cost with changes recognized in current period net income

The adoption of these new standards had no material impact on the Company's opening retained earnings or components of shareholders' equity.

**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**

**September 30, 2007 and 2006**

**2. Capital Assets**

	<u>2007</u>		<u>2006</u>	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 160,295	\$ 50,458	\$ 98,332	\$ 30,744
Lab Equipment	734,849	285,543	534,267	202,844
Leasehold improvements	49,656	28,138	66,265	24,665
	<u>944,800</u>	<u>364,139</u>	<u>698,864</u>	<u>258,253</u>
Cost less accumulated amortization		<u>\$ 580,661</u>		<u>\$ 440,611</u>

**3. Other Assets**

	<u>2007</u>	<u>2006</u>
Patents and technology rights (net of \$119,932 accumulated amortization; Sep 2006 - \$73,005)	\$ 484,368	\$ 253,005
Deferred costs (net of \$Nil accumulated amortization; Sep 2006 - \$Nil)	-	49,018
	<u>\$ 484,368</u>	<u>\$ 302,023</u>

**4. Deferred Development Costs**

	<u>2007</u>	<u>2006</u>
Cost	\$ 2,434,066	\$ 2,525,590
Less: accumulated depreciation	<u>228,716</u>	<u>115,401</u>
	<u>\$ 2,205,350</u>	<u>\$ 2,410,189</u>

**5. Deferred Revenue**

The Company received an initial exclusivity payment of Cdn \$2,321,200 from Smith and Nephew. The Company has recorded the exclusivity payment as deferred revenue and is recording this licensing fee revenue monthly over the five year term of the agreement. Related costs have been offset against deferred revenue.

**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**

**September 30, 2007 and 2006**

**6. Share Capital**

a) **Authorized** – Unlimited number of Common Shares

b) **Issued** – Common shares and warrants

	Number of Common Shares	Number of Warrants	Share Capital	Warrants
Balance at September 30, 2005	41,221,323	1,063,084	\$ 9,872,463	\$ 333,930
Common shares and warrants issued for funds received	13,696,600	13,696,600	5,989,523	858,777
Options exercised	361,000	-	207,393	-
Warrants exercised	1,043,861	(474,486)	528,632	(149,043)
Warrants expired	-	(588,598)	-	(184,887)
Share issuance costs	-	1,095,728	(769,089)	68,702
Balance, September 30, 2006	56,322,784	14,792,328	15,828,922	927,479
Options exercised	501,194		265,920	
Warrants granted		1,095,728	(2,338,229)	2,338,229
Warrants exercised	15,888,056	(15,888,056)	14,907,819	(3,265,708)
Balance, September 30, 2007	72,712,034	-	\$ 28,664,432	\$ -

A Private Placement financing was completed March 22, 2006 for 13,696,600 shares at \$0.50 per share for net proceeds of \$6,184,801. The Private Placement units included a total of 13,696,600 warrants with an exercise price of \$0.75 per warrant for 1 common share and an expiry date of September 22, 2007. Covalon also issued 1,095,728 broker compensation warrants. The holder is entitled to acquire at any time until 4:00 p.m. on September 22, 2007 (“expiry time”) units in the capital of the Company. Each unit consisting of one common share and one purchase warrant (“warrant”) at a price of \$0.50 per unit up and until the expiry time. Each warrant entitles the holder to purchase an additional common share at a price of \$0.75 per warrant up and until the expiry time.

In fiscal 2006, 361,000 options to purchase common shares with a value of \$91,849 were exercised for cash consideration of \$115,545. 562,500 options to purchase common shares expired, resulting in a corresponding increase to contributed surplus of \$118,273.

In fiscal 2006, 474,486 Series II warrants to purchase 1,043,861 common shares, with a value of \$149,043 were exercised for cash consideration of \$379,589. 588,598 series II warrants to purchase common shares expired, resulting in a corresponding increase to contributed surplus of \$184,887.

In fiscal 2007, 501,194 options to purchase common shares with a value of \$71,287 were exercised for cash consideration of \$194,633. 200,000 options to purchase common shares expired, resulting in a corresponding increase to contributed surplus of \$12,400.

In fiscal 2007, 1,095,728 broker warrants were exchanged for Series III warrants.

In fiscal 2007, 15,888,056 Series III warrants to purchase 15,888,056 common shares, with a value of \$3,265,708 were exercised for cash consideration of \$11,642,111.

During fiscal 2007, the Company issued a total of 16,389,250 common shares.

**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**

**September 30, 2007 and 2006**

**6. Share Capital** (continued)

At September 30, 2007, 8,335,599 (2006 – 10,663,402) shares are held in escrow.

In fiscal 2006, Covalon acquired technology from Perfusion Therapeutics Inc. for 1,100,000 fully paid non-assessable common shares of Covalon Technologies Ltd., issued in escrow to be released on various success milestones. At September 30, 2007, no shares have been released from escrow as no milestones were met during the year. Subsequent to year end, the first milestone was met and 25,000 of the escrowed shares were released to Perfusion Therapeutics Inc.

**c) Stock Option Plan**

The Company has Stock Option Agreements with its employees, directors and consultants, granting options to them exercisable in whole or part. Common shares have been reserved for fully exercisable stock options on the following basis:

	Number of Options	Value	Exercise Price
Balance, September 30, 2005	3,151,582	\$ 593,616	
Granted to related parties	875,000	9,194	\$ 0.50
Vested to related parties		26,050	\$ 0.40
Exercised	(361,000)	(91,848)	
Expired	(562,500)	(118,273)	
Balance, September 30, 2006	3,103,082	418,739	
Options reinstated to consultant	112,500	23,693	\$ 0.33
Granted to related parties	975,000	473,336	\$ 1.53
Granted to employees	100,000	40,494	\$ 1.22
Vested to related parties		53,050	\$ 0.50
Exercised	(501,194)	(71,287)	
Expired	(200,000)	(12,400)	
Balance, September 30, 2007	3,589,388	\$ 925,625	

In fiscal 2006, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: risk-free rate of interest – 4.5%, dividend rate NIL, volatility – 53% and a term of 3 and 5 years respectively. 361,000 options with a value of \$91,848 were exercised for common shares for cash consideration of \$115,545.

Stock Options granted to related parties expired in August 2006. During fiscal 2006, 387,793 options with an exercise price of \$0.30 per share expired and 174,707 options with an exercise price of \$0.40 per share expired. Stock options granted during fiscal 2006 expire October 2, 2009.

In fiscal 2007, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: risk-free rate of interest – 4.5%, dividend rate NIL, volatility – 66% and a term of 3 and 5 years respectively.

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**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**

**September 30, 2007 and 2006**

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**6. Share Capital** (continued)

Total value of options granted to related parties during fiscal 2007 was \$728,475, of which \$473,336 vested, total value of options granted to employees during fiscal 2007 was \$57,300 of which \$40,494 vested. Stock Options granted to related parties during fiscal 2007 expire on March 27, 2010 (675,000), July 10, 2010 (150,000), July 10, 2012 (150,000), Stock options granted to employees during fiscal 2007 expire on March 20, 2010.

501,194 stock options with a value of \$71,287 were exercised for common shares for cash consideration of \$194,633.

200,000 stock options granted to related parties with an exercise price of \$0.30 expired in February 2007.

As at September 30, 2007, 2,474,431 (2006 – 2,337,457) options were available for exercise.

**(d) Loss per Share**

Loss per share is calculated using the weighted average number of common shares outstanding during the period ended September 30, 2007, which is 58,987,216 (2006 - 48,870,962) shares. As the Company experienced losses for the years ended September 30, 2007 and 2006, all potential common shares outstanding from dilutive securities are considered anti-dilutive and are excluded from the calculation of loss per share for those years.

Details of anti-dilutive potential securities outstanding not included in diluted EPS calculations at September 30, 2007 are as follows:

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Anti-dilutive potential securities	2007	2006
Common shares potentially assumable:		
- pursuant to warrants	-	14,792,328
- under stock options	<b>3,589,388</b>	3,103,082
	<b>3,589,388</b>	17,895,410

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**7. Related Party Transactions**

a) During the year the Company paid fees to related parties as follows:

- (i) Management fees totaling \$527,994 (2006 – \$314,991) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$217,994 (2006 - \$4,991).
- (ii) Directors fees include cash compensation of \$140,057 (2006 - \$54,400) paid to the four independent directors and stock option benefits that have been valued at \$308,391 (2006 – \$4,203).

b) The management fees are paid pursuant to two separate management agreements, expiring September 30, 2008. The commitments for the 2008 fiscal year are \$330,000.

These transactions are in the normal course of operations and are measured at the exchange amount (the amount of consideration established and agreed by the related parties).

**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**

**September 30, 2007 and 2006**

**8. Commitments**

The Company has entered into an operating lease for its premises at 405 Britannia Rd, Mississauga commencing December 1, 2004 and expiring December 31, 2009. The annual rental payments for the first two years are \$68,627 payable monthly and \$91,855 payable monthly for the remaining portion of the lease.

The Company has also entered into an operating lease for its equipment. The equipment is leased at \$235 per month under a lease expiring in 2010.

The minimum annual lease payments for the next three years are as follows:

2008	\$ 115,723
2009	115,723
2010	<u>29,429</u>
	<u>\$ 260,875</u>

**9. Income Taxes**

(a) Reconciliation between statutory rate and actual rate

	<u>2007</u>	<u>2006</u>
Income tax recovery computed at statutory combined basis rate of 36% (2006 - 36%)	<b>\$(1,107,500)</b>	\$ (793,800)
Permanent differences	<b>207,400</b>	(7,000)
Expiring losses	<b>162,800</b>	48,400
Change in future tax rates	<b>87,900</b>	445,300
Other	<b>81,800</b>	112,100
Valuation allowance	<b>567,600</b>	195,000
	<u>\$ -</u>	<u>\$ -</u>

(b) Future tax assets

The tax effect of the temporary differences that gives rise to future tax assets (liabilities) as of September 30, 2007 and 2006 is presented below. No benefit has been recorded in these financial statements as there is no assurance that the Company will generate taxable income to utilize these differences.

	<u>2007</u>	<u>2006</u>
Non-capital loss carry forwards	<b>\$ 2,457,000</b>	\$ 2,568,300
Capital loss carry forwards	<b>166,200</b>	208,300
Capital and other assets	<b>114,000</b>	61,000
Deferred development costs	<b>(50,100)</b>	(103,600)
Deferred revenue	<b>642,800</b>	-
Other	<b>7,700</b>	36,000
Valuation allowance	<b>(3,337,600)</b>	(2,770,000)
	<u>\$ -</u>	<u>\$ -</u>

**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**

**September 30, 2007 and 2006**

**9. Income Taxes** (continued)

- (c) The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2007 of approximately \$7,559,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

<u>Year</u>	<u>Amount</u>
2008	\$ 685,000
2009	880,000
2010	844,000
2014	816,000
2015	1,963,000
2026	2,025,000
2027	346,000
	<u>\$ 7,559,000</u>

- (d) The Company has capital losses carry forward for income tax purposes as at September 30, 2007 of approximately \$1,022,000 which are available to reduce taxable capital gains of future years. These losses do not expire.
- (e) Prior to going public, the Company earned federal tax credits at a rate of 35% on the first \$2 million of SR&ED expenditures each year (subject to limitations based on prior year's taxable income and total capital) and 20% thereafter. The Company should also be eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% subject to similar limitations as the federal credits earned at the 35% rate. A portion of the tax credits is refundable in cash to the Company, with the remainder available as an offset against income taxes payable in future years. When the Company ceased to be a Canadian controlled private corporation, it is no longer eligible for the 35% refundable SR&ED credit. It is now only eligible for a 20% federal credit on its SR&ED expenditures which can only be used to offset against income taxes payable.

At September 30, 2007, the Company has nil (2006 - \$nil) of federal SR&ED refundable tax credits. The amount of refundable tax credits ultimately received by the Company is subject to review by Canada Revenue Agency and the Ontario Ministry of Finance.

Under the Income Tax Act of Canada, certain expenditures are classified as SR&ED expenditures and for tax purposes are grouped into a pool, which is 100% deductible in the year incurred. This SR&ED expenditure pool can also be carried forward indefinitely and deducted in full in any subsequent year. The balance of the federal SR&ED expenditure pool at September 30, 2007 is \$1,556,672 (2006 - \$1,556,672) and \$2,382,512 for Ontario tax purposes (2006 - \$2,382,512).

At September 30, 2007, the Company has \$17,119 (2006 - \$17,119) of unclaimed investment tax credits available to reduce federal income taxes payable in future years. If not utilized, these investment tax credits will expire in 2013.

**10. Supplemental Cash Flow Information**

	2007	2006
<b><i>Non-Cash Financing and Investing</i></b>		
Shares issued on payment of agent fee	\$ -	\$ 68,702