

Covalon Technologies Ltd.

Consolidated Financial Statements

For the three month period ended December 31, 2006

(Unaudited – prepared by management)

Contents

Balance Sheets	2
Statements of Deficit	3
Statements of Operations	4
Statements of Cash Flows	5
Summary of Significant Accounting Policies	6-8
Notes to Financial Statements	9-12

Covalon Technologies Ltd. Consolidated Balance Sheets

	December 2006 (Unaudited)	September 2006 (Audited)
Assets		
Current		
Cash and cash equivalents	\$ 4,564,752	\$ 5,011,642
Accounts receivable	325,061	232,153
Refundable investment tax credits	65,400	65,400
Inventories	320,317	269,399
Prepaid expenses	129,553	61,971
	5,405,083	5,640,565
Capital assets (Note 1)	443,267	440,611
Other assets (Note 2)	324,278	302,023
Deferred developments costs (Note 3)	2,381,339	2,410,189
	\$ 8,553,967	\$ 8,793,388

Liabilities and Shareholders' Equity

Current		
Accounts payable and accrued liabilities	\$ 570,031	\$ 506,720
Deferred revenue	19,354	20,715
	589,385	527,435
Shareholders' Equity		
Share Capital (Note 4 (b))	15,953,422	15,828,922
Contributed Surplus	340,297	340,297
Warrants	927,479	927,479
Options (Note 4 (c))	394,239	418,739
Deficit	(9,650,855)	(9,249,484)
	7,964,582	8,265,953
	\$ 8,553,967	\$ 8,793,388

On behalf on the Board

_____ Director
 _____ Director

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

Covalon Technologies Ltd.				
Consolidated Statements of Deficit				
(Unaudited - prepared by management)				
			For the Three months ended, December 31, 2006	For the Three months ended, December 31, 2005
Deficit , beginning of year			\$ (9,249,484)	\$ (7,044,494)
Loss for the period			(401,371)	(442,483)
Deficit , end of period			\$ (9,650,855)	\$ (7,486,977)

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Consolidated Statements of Operations			
(Unaudited - prepared by management)			
		For the Three	For the Three
		Months ended	Months ended
		December 31,	December 31,
		2006	2005
Sales		\$ 337,767	\$ 137,093
Cost of goods sold		198,767	61,707
		139,000	75,386
Other revenue			
Interest income		51,167	1,600
Licensing fee		1,361	1,361
		191,528	78,347
Expenses			
Amortization of capital assets		23,928	25,793
Amortization of patents		10,060	4,813
Amortization of deferred development costs		28,850	-
Bank charges and interest		1,553	731
Consulting fees		-	13,203
Directors' fees		21,366	22,500
Foreign currency (gain) loss		192	(725)
Management fees		77,500	77,500
Marketing		93,188	30,216
Office and administrative		99,333	81,923
Patent maintenance		200	49
Professional fees		14,146	20,983
Property maintenance		1,440	1,440
Regulatory		83,053	48,614
Research and development		115,456	162,789
Training - professional development		9,606	847
Travel		13,028	30,154
		592,899	520,830
Loss for the period		\$ (401,371)	\$ (442,483)
Loss per share (Note 4 (d))		\$ (0.007)	\$ (0.01)

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Covalon Technologies Ltd.
Consolidated Statements of Cash flows
(Unaudited - prepared by management)

	For the three month period ended December 31, 2006	For the three month period ended December 31, 2005
Cash flows from operating activities		
Loss for the period	\$ (401,371)	\$ (442,483)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities		
Amortization of capital assets	23,928	25,793
Amortization of patent and technology rights	10,060	4,813
Amortization of deferred development costs	28,850	-
Foreign exchange (gain) loss	192	(725)
Changes in non-cash working capital balances		
Accounts receivable	(92,908)	(97,293)
Inventories	(50,918)	(104,145)
Prepaid expenses	(67,582)	(27,998)
Accounts payable and accrued liabilities	63,311	177,764
Deferred revenue	(1,361)	(1,361)
	(487,799)	(465,635)
Cash flows from investing activities		
Purchase of capital assets (net of disposals and investment tax credits)	(26,584)	(23,665)
Purchase of patents and technology rights	(32,315)	(16,193)
	(58,899)	(39,858)
Cash flows from financing activities		
Net proceeds on issuance of share capital	100,000	-
	(192)	725
Increase (decrease) in cash and cash equivalents during the period	(446,890)	(504,768)
Cash and cash equivalents, beginning of period	5,011,642	644,004
Cash and cash equivalents, end of period	\$ 4,564,752	\$ 139,236

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

Covalon Technologies Ltd.
Summary of Significant Accounting Policies
For the three month period ended December 31, 2006
(Unaudited – prepared by management)

Basis of Presentation	<p>The financial statements of the Company have been prepared by management in accordance with Canadian general accepted accounting principles for interim financial statements. The interim financial statements have, in management's opinion, been properly prepared using judgment within reasonable limits of materiality.</p> <p>These interim financial statements do not include note disclosure for annual financial statements and should be read in conjunction with the Company's audited consolidated financial statements for the year ended September 30, 2006.</p>
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> <p>The Company has incurred operating losses since inception and its ability to realize the carrying value of its assets is dependent on successfully bringing its technologies to market and achieving future profitable operations, the outcome of which cannot be determined at this time.</p>
Revenue Recognition	<p>Revenue is recognized on an accrual basis as follows:</p> <ul style="list-style-type: none">a) Revenue arising from product sales is recognized once the product has been shipped to the customer.b) Revenue arising from licensing fees and royalties is recognized over the period of the relevant agreementsc) Revenue arising from interest is recognized as earned.
Cash and Cash Equivalents	<p>Cash and cash equivalents are defined as highly liquid investments with original maturities of three months or less 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>

Covalon Technologies Ltd.
Summary of Significant Accounting Policies
For the three month period ended December 31, 2006
(Unaudited – prepared by management)

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 improvement</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 improvement	- straight-line basis over 5 years
Furniture and fixtures	- 20% diminishing balance basis						
Lab equipment	- 20% diminishing balance basis						
Leasehold improvement	- straight-line basis over 5 years						
Other Assets	<p>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.</p>						
Deferred Development Costs / Research Development	<p>During the development stage research costs were expensed as incurred. Development costs which met generally accepted criteria, including reasonable assurance regarding recoverability, were deferred and amortized from the beginning of commercial production and sales. Annually the company reviewed the recoverability of deferred development costs through evaluation of the expected future cash inflows from commercialization of the associated products to determine if there was 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	<p>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.</p>						
Future Income Tax	<p>The company follows the 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.</p>						

Covalon Technologies Ltd.
Summary of Significant Accounting Policies
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Foreign Currency Translation	<p>Foreign currency accounts are translated into Canadian dollars as follows:</p> <p>At the transaction date, each assets, 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>
Financial instruments	<p>Unless otherwise noted, it is management's opinion that the company is not exposed to significant interest, currency or credit 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>
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 decided to adopt 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>

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements
For the three month period ended December 31, 2006
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1. Capital Assets

	Dec-06 (Unaudited)		Sep-06 (Audited)	
	Accumulated		Accumulated	
	Cost	Amortization	Cost	Amortization
Furniture and fixtures	\$ 107,679	\$ 34,358	\$ 98,332	\$ 30,744
Lab Equipment	551,504	219,846	534,267	202,844
Leasehold improvements	66,266	27,978	66,265	24,665
	725,449	282,182	698,864	258,253
Cost less accumulated amortization		\$ 443,267		\$ 440,611

2. Other Assets

	Dec-06 (Unaudited)	Sep-06 (Audited)
Patents and technology rights (net of \$104,106 accumulated amortization Sep 2006 - \$73,005)	\$ 324,278	\$ 253,005
Deferred acquisition costs	-	49,018
	\$ 324,278	\$ 302,023

3. Deferred Development Costs

	Dec-06 (Unaudited)	Sep-06 Audited
Cost	\$ 2,525,590	\$ 2,525,590
Less: accumulated depreciation	144,251	115,401
	\$ 2,381,339	\$ 2,410,189

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4. Share Capital

a) Authorized

Unlimited number of Common Shares

b) Issued – Common shares and warrants

	Number of Common Shares	Number of Warrants	Stated Capital	Warrants
Balance at September 30, 2006	56,322,784	14,792,328	\$ 15,828,922	\$ 927,479
Options exercised	250,000		124,500	
Balance, December 31, 2006	56,572,784	14,792,328	\$ 15,953,422	\$ 927,479

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 the period 250,000 options to purchase common shares with a value of \$24,500 were exercised for cash consideration of \$100,000.

During the three month period ended December 31, 2006, Covalon acquired technology from Perfusion Therapeutics for 1,100,000 fully paid non-assessable common shares of Covalon Technologies Ltd., in escrow to be released on various success milestones.

c) Stock Option Plan

The Company has Stock Option Agreements with its shareholders, 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:

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Notes to Consolidated Financial Statements
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	Number of Shares	Value	Exercise Price
Balance, September 30, 2004	1,655,000	\$ -	
Granted to employees	1,059,123	245,162	\$ 0.30
Granted to related parties	573,934	136,022	\$ 0.30
Granted to employees	485,165	58,545	\$ 0.40
Granted to related parties	608,566	50,152	\$ 0.40
Granted to employees	445,000	104,130	\$ 0.70
Exercised	(997,606)	(395)	
Expired	(677,600)		
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	
Exercised	(250,000)	(24,500)	\$ 0.40
Balance, December 31, 2006	2,853,082	\$ 394,239	

Options outstanding at September 30, 2004 expired on January 8, 2005 (875,000) with an exercise price of \$1 and January 7, 2005 (780,000) with an exercise price of \$2.

Total Options granted during fiscal 2005 were \$594,011, of which approximately \$415,000 was expensed and the balance of \$178,601 was charged to deferred development costs. Stock Options granted during fiscal 2005 expire on September 1, 2009 (211,000), December 22, 2009 (1,344,844), January 14, 2010 (643,731), February 7, 2007 (450,000) and June 9, 2010 (445,000).

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 September 22, 2007.

The fair market value of options granted in 2006 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 years. 361,000 options with a value of \$91,848 were exercised for common shares for cash consideration of \$115,545.

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In the three month period ended December 31, 2006, 250,000 options to purchase common shares with a value of \$24,500 were exercised for cash consideration of \$100,000.

(d) Loss per Share

Loss per share is calculated using the weighted average number of common shares outstanding during the period ended December 31, 2006, which is 56,456,117 (2005 – 41,221,323) shares. Fully diluted loss per share for the periods ended December 31, 2006 and December 31, 2005 have not been presented since the potential conversions of options and warrants outstanding are anti-dilutive.