

MANAGEMENT'S DISCUSSION & ANALYSIS

For the twelve month period ended September 30, 2007

January 28, 2008

The following discussion of Covalon Technology Ltd's (Covalon or the "Company") financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes for the year ended September 30, 2007. We have prepared these financial statements according to Canadian generally accepted accounting principles ("GAAP").

Management's Responsibility for Financial Reporting

The Consolidated Financial Statements and Management's Discussion and Analysis (MD&A) have been prepared by Management, who, when necessary, have made informed judgments and estimates of the outcome of events and transactions, with due consideration given to materiality. Management acknowledges its responsibility for the fairness, integrity and objectivity of all information provided in the consolidated financial statements and in MD&A thereof. As a means of fulfilling its responsibility, Management relies on the Company's system of internal controls. This system has been established to ensure, within reasonable limits, that assets are safeguarded, transactions are properly recorded and are executed with Management's authorization and that the accounting records provide a solid foundation from which to prepare the Consolidated Financial Statements and the MD&A. The Board of Directors carries out its responsibility for the consolidated financial statements principally through its Audit Committee, consisting solely of Non Management directors. This committee meets periodically, reviews the scope of the external audit, the adequacy of the systems of internal control and the appropriateness of financial reporting and then makes its recommendations to the Board of Directors. Based on those recommendations, the Board approves the Consolidated Financial Statements and the MD&A.

All dollar amounts included in the MD&A are Canadian dollars unless otherwise specified.

Non-GAAP Measures

This MD&A, we refer to terms that are not specifically defined in the CICA Handbook and do not have any standardized meaning prescribed by GAAP. These non-GAAP measures may not be comparable to similar measures presented by other companies.

Additional Information

Additional information on Covalon, including our information circular and quarterly reports is available on SEDAR at www.sedar.com and in the investor relations section of our web site at www.covalon.com/Investors.

Forward-looking Statements

The MD&A contains forward-looking statements which reflect the Company's current expectations regarding future events. The forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect", "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These forward-looking statements involve risk and uncertainties, including the difficulty in predicting product

approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in the industry; others are more specific to the Company. Investors should consult the “Risks & Uncertainties” section of this MD&A as well as the Company’s ongoing quarterly filings for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. Management assumes no obligation to update or alter any forward-looking statements whether as a result of new information, further events or otherwise.

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1. Vision and Strategy

Our long term vision is to be the leading enterprise in the world in biomaterials for medical device coatings, wound healing and tissue regeneration. Furthermore, our innovative research and development designed to produce profitable growth and increased value for stakeholders while improving the quality of life for patients locally, nationally, and internationally.

Over the past several months, we have evaluated our progress on achieving our goals. Through this assessment, we determined that we have the technology and technical expertise, personnel and strong Management to support the vision.

Our strategy is to leverage Covalon’s technology platforms (coatings, topical tissue repair and regenerative medicine/cell therapy divisions) and focus our business on higher-value, higher-risk products addressing more complicated and unmet medical needs.

2. Company Overview

Our Business

Covalon is a biotechnology company that has developed and patented advanced therapeutic biomaterials and medical coatings for advanced wound care, surgical applications and medical devices that inhibit microbial invasion to help reduce infections. As well, the Company has an ongoing research program on the use of cell therapy for regenerating damaged heart tissue for treating congestive heart failure. The Company's core competencies in polymer chemistry and surface coatings have been combined to generate several proprietary technologies that create a range of time-release drug delivery platforms that can be applied to many medical devices for treating unmet medical needs. The Company has thus identified unmet medical needs and developed products, received regulatory approvals and is manufacturing products that contain antimicrobial silver ion that have been shown to reduce microbial attachment and invasions, thereby helping to reduce hospital acquired infections. The anti-microbial silver ion-releasing technology has been shown to be effective against many microbes including antibiotic resistant bacteria such as methicillin-resistant *Staphylococcus aureus* (MRSA), vancomycin-resistant *Enterococcus* (VRE), *Pseudomonas aeruginosa*, *E. coli*, yeasts and other microbes. The Company intends to develop its collagen-based scaffolds to deliver other therapeutics and "biologicals" for inducing hemostasis, as well as treating problems related to ischemic diseases. The Company acquired EPAS1 technology that is intended to be used in developing a genetic-based approach to wound healing and congestive heart failure. EPAS1 technology relies on hypoxia inducible-factor-activity to stimulate angiogenesis (new blood vessel formation) for regenerative medicine. The innovative and powerful aspect of the technology lies in the ability of EPAS1 to initiate new blood vessel formation at the site of tissue damage since ischemic organs lack adequate blood supply. New blood vessels are essential in tissue regeneration or wound healing because any regenerating or healing tissue requires blood flow via newly formed blood vessels to deliver nutrients and oxygen to the tissue. The technology is complimentary to Covalon's wound healing program and research is ongoing at a world-renowned contact research facility specializing in coronary and angiogenesis research. Covalon's cell therapy program is designed to generate cells that express useful genes at a site of cell therapy for treating ischemic conditions, such as congestive heart failure, chronic wounds, peripheral vascular disease and other conditions. Numerous studies have shown that bone marrow-derived stem cells may assist in tissue repair and regeneration of many tissues including myocardium, heart valves, damaged bone, skin, blood vessels and other tissues. Optimum healing and tissue regeneration requires new blood vessel formation. The cell therapy technology aims to stimulate the growth of new blood vessels through a process of therapeutic angiogenesis. The work, wholly owned by Covalon, is part of a research contract issued to Dr. Jacques Galipeau, MD, FRCP(C), Associate Professor of Medicine and Oncology at the Sir Mortimer B. Davis Jewish General Hospital (McGill University), for isolation of cells required for Covalon's program in angiogenesis.

The Company has global distribution in place for its collagen wound products and US distribution for its antimicrobial foley catheter. There is a strong pipeline of increasingly sophisticated products using its coatings and collagen matrices.

Covalon Collagen Materials

Covalon collagen materials are bioresorbable collagen-based devices developed by the Company for delivery of therapeutics ranging from antimicrobial silver technology to cell therapy. The technology allows the Company to produce a variety of advanced convergent drug-devices including anti-infective wound dressings as well as cellular scaffolds for tissue regeneration. The Company's initial focus with scaffolds is to develop, license and/or sell a series of CMO (contract manufacturing organization) manufactured silver ion releasing collagen-based wound dressings that reduce bacterial contamination of chronic wounds, such as diabetic ulcers, bed sores, trauma wounds, burns and other conditions in which a wound presents with recalcitrant healing. Improvements to the Company's wound dressings offerings have generated FDA-approved products that improve wound care by inactivating wound bed enzymes that are known to result in slow to heal wounds. Additionally, the products, Biostep™ and Biostep™ Ag are beneficial in the treatment of chronic and diabetic ischemic wounds. The Company expects adoption of the products in treating chronic and hard-to-heal wounds, as well as in other areas, such as burn and trauma treatments. The collagen technology platform is being used in R&D for a number of products for surgical interventions. It is expected that such products will enhance the Company's value proposition for the platform.

Current Collagen Products

Covalon has received regulatory approval for its collagen wound dressing, antimicrobial collagen wound dressing, antimicrobial collagen gel sheet and advanced wound dressings (Biostep™ and Biostep™ Ag) with matrix metalloprotease (MMP) inhibiting activity. Biostep™ and Biostep™ Ag, the latest products using Covalon's proprietary collagen technology for the treatment of chronic wounds were launched to the public at-large at the Clinical Symposium in Advanced Wound Care in Nashville, Tennessee, on October 11, 2007. The products were introduced by Covalon's commercial partner Smith & Nephew's (NYSE:SNN, LSE:SN) Advanced Wound Management division. Smith & Nephew Advanced Wound Management has an exclusive worldwide sales, marketing and distribution agreement with Covalon for its advanced range of collagen dressings, including CovaClear™. The agreement also grants access and distribution rights to an exciting and differentiated new product development portfolio in the field of advanced wound care.

The unique and innovative Biostep™ products create a moist wound healing environment, deactivate harmful wound proteases (MMPs) and promote tissue growth in chronic wounds, which affect an increasingly large number of patients and have a serious impact on their quality of life.

The following is a list of products developed by Covalon and approved for sale in the US and Canada. The table also includes products submitted for regulatory approval.

Product	Distribution	Launch
ColActive™ Collagen Wound Dressing	Hartmann-Conco (previous) Smith & Nephew Inc.	June 2005 US April 2007 US
ColActive Ag™ Collagen with Silver	Hartmann-Conco (previous) Smith & Nephew Inc.	June 2005 US April 2007 US
CovaClearAg Collagen with Silver Antimicrobial	Smith & Nephew Inc.	Projected Q4 2008
Collagran Wound Dressing and Collagran Ag Wound Dressing	Smith & Nephew Inc.	
Biostep™	Smith & Nephew Inc.	Q4 2007 US
Biostep™ Ag	Smith & Nephew Inc.	Q4 2007 US

Collagen Technology Pipeline

Covalon has identified a number of product applications for its collagen-based technology platform. The applications are increasingly more sophisticated over its current products in therapeutic delivery and functions. The Company's goal is to take advantage of the collagen platform as an advanced combination device for delivery of certain therapeutics and biologicals (e.g. biological growth factors and cells). The current pipeline of collagen devices includes topical hemostatic dressings, a rapid hemostatic trauma dressing, a biologics delivery device for hormones and growth factors, and EPAS1- engineered altered cells for modulating angiogenesis. Angiogenesis is integral to regenerative medicine, including wound healing, treating ischemic heart disease, peripheral vascular disease as well as having other applications related to new blood vessel growth.

The following chart outlines the various collagen applications under development.

Application	Design Phase	Prototype	Process / Production Scale up	Animal Testing	Regulatory Approval
Hemostatic dressing	Completed	Completed	Completed	In progress	-
Hemostatic dressing delivering PLT	In progress	-	-	-	-
Hemostatic delivering FNS	In progress	-	-	-	-
EPAS1 cells for tissue regeneration	In progress	-	-	-	-

Covalon has successfully achieved an important milestone with its EPAS1 technology that is expected to allow Covalon to engineer human mesenchymal stem cells (hMSCs) for increased expression of EPAS1, a hypoxia inducible factor. EPAS1 is a "master" gene that is a regulator of the expression of vascular endothelial growth factor and several other important angiogenic proteins crucial to new blood vessel growth required to deliver blood, oxygen and nutrients to regenerative tissues by cell transplantation.

This project has successfully produced porcine and human mesenchymal stem cells with EPAS1 and demonstrated that the transcription factor (EPAS1 protein) can effectively be expressed in both human and porcine MSCs. The pre-clinical results show the ability of porcine and human MSCs to over-produce the transcription factor and that it binds DNA (regulatory genetic material) in the nucleus of modified cells. The transcription factor is known to act as a molecular switch that regulates production of vascular endothelial

growth factor and several other angiogenic factors required for new blood vessel growth to deliver blood, oxygen and nutrients to regenerating tissues.

The expected goal is to load precursor cells with Covalon's proprietary gene construct that stimulates blood vessel growth (EPAS1). The altered cells are intended to stimulate blood vessel growth and improve cardiac function in a model of myocardial infarction. The demonstration of the transcription factor to bind nuclear DNA in MSCs is an important milestone toward the objective since it demonstrates that cells can be effectively and efficiently manipulated at the genetic level to produce essential growth factors that may contribute to improved angiogenesis and tissue regeneration required for increased and improved function. Covalon's program offers the potential for a minimally invasive alternative to open heart surgery for those suffering from congestive heart failure. Furthermore, the technology has broad application in areas where improved blood flow is required.

Coatings

Covalon has developed an advanced proprietary coating platform for the emerging combination device market. The technology uses a proprietary ultraviolet light-mediated process to create biocompatible surface coatings capable of carrying a number of therapeutics. The initial focus is to use the platform for delivery of antimicrobial ionic silver from medical devices, such as urinary (Foley) catheters where the risk of catheter associated infection in hospitals is high. It has been widely estimated that 40% of all hospital-acquired infections are due to the use of Foley catheters. Covalon recently announced that it has successfully completed the development of its new anti-microbial / anti-thrombogenic coating to prevent blood clotting on blood access catheters and devices. The development allows the Company to market the technology for application on vascular access catheters, IV lines, hemodialysis lines and pain management ports where an antimicrobial and anti-thrombogenic coating would offer a clinical advantage in minimizing microbial ingress.

Covalon's antimicrobial and low-thrombogenic coating can be applied to a wide variety of in-dwelling, blood contacting devices for reducing the incidence of hospital acquired infection as well as reducing thrombogenicity. Effective antimicrobial and low-thrombogenic coated catheters may reduce infection and thrombus formation thus improving patient outcome.

Antimicrobial CVC are expected to experience a growth rate approximately 5-fold greater than that of un-coated CVC. It is estimated that by 2009, sixty-nine percent (69%) of all CVC used will be antimicrobial (data from Frost and Sullivan, U.S. Antimicrobial Devices Markets, 2003). Hospital-acquired infections affect approximately 2 million people in the United States each year, and cost over \$11 billion to the U.S. healthcare system (data from Frost and Sullivan, U.S. Antimicrobial Coating Markets, 2006). The total antimicrobial catheters market is projected to attain revenues of US \$ 375 million by 2009 (Frost and Sullivan 2006).

Current Coating Products

FDA 510(K) approval for the silver ion releasing coating for Foley catheters was received on February 16, 2006. The Company provides coating services for Medline Industries, Inc., one of the largest distributors in the US. Medline launched the "Silvertouch" Foley

catheter in June 2006. In 2007, Medline has initiated a number of in-market case studies to show the efficacy of the coating. It is anticipated that these studies will show the coatings advantage over other anti-microbial coatings and accelerate adoption in the market.

Coating pipeline

Covalon has provided prototype, antimicrobial coated samples for a number of new customers for a variety of other applications including: peripherally inserted central catheters, central venous lines, sutures, intravenous lines, feeding tubes, stomach anchors, stents and metal for orthopedic applications. The Company is in “fee for service” co-development with a number of customers for these coating applications and is considering other exclusive licensing opportunities.

The chart below outlines the status of coating applications under development.

Application	Design Phase	Prototype	Process / Production Scale up
Central venous lines	Completed	Completed	-
PICC lines	Completed	Completed	-
Sutures	Completed	Completed	-
IV lines	In progress	Completed	-
Catheter ports	In progress	Completed	In progress
Metals for orthopedics	In progress	-	-

Significant Milestones

Covalon’s Board of Directors and Management announced on April 17, 2007 that Mr. Bradford Williams was elected independent Chairman of the Board, a position previously held by the Company’s President and Chief Executive Officer, Dr. Frank DiCosmo. Mr. Williams’ career spanned 30 years in medical devices with 21 years in various leadership positions at Stryker Corporation (“Stryker”). He started at Stryker in 1984 as an International Product Manager, and in 1987 he led the marketing efforts for Latin America. In 1988 Mr. Williams was promoted to Director of Stryker Canada, and later General Manager / Divisional Vice President, Stryker Canada, on the strength of his success building Stryker Canada’s direct sales organization. He joined Stryker’s Osteonics Division in 1996 as their International VP where he led the efforts toward improving the division’s market share outside the USA. In 1998, Mr. Williams was promoted to lead the Knee Business Unit for Stryker Orthopaedics as their Vice President and General Manager, where he focused on driving innovation and marketing on a global basis. In 2002, he was promoted to Senior Vice President for Reconstructive Marketing and R&D; in 2005 he assumed overall responsibility for the Marketing, Business Development and Intellectual Property functions. Mr. Williams has earned a reputation as a leader dedicated to the hiring and support of talented people focused on achieving results, and building great teams. He currently is a medical device consultant.

Covalon’s increasingly sophisticated pipeline of advanced products has required investment in resources to implement development of a strong regulatory and clinical affairs component within the Company. Regulatory and clinical affairs are becoming

increasingly important to Covalon as the Company begins to develop more bioactive coatings and increasingly sophisticated wound management products, as well as beginning to develop cellular therapy products. Management attracted and retained an experienced Vice President of Regulatory / Clinical Affairs and Operational Processes. Dr. Sonia Sanhueza was recently promoted to Chief Operating Officer; she has more than twenty years experience in R&D, technology transfer, clinical/regulatory affairs and quality systems. Dr. Sanhueza will help to guide the Covalon's products through the technology transfer and manufacturing steps and through the complex regulatory/clinical pathways associated with bioactive devices, combination devices and cellular therapies.

Consistent with improving the Management team and more specifically the finance infrastructure, Covalon has recruited a Chief Financial Officer in Mr. Francis Lindayen who has over 20 years of experience in both public and private companies. His background encompasses corporate finance, mergers and acquisitions, planning, treasury, operations and public accounting. Mr. Lindayen will have primary responsibilities for directing and coordinating all Company financial objectives.

Mr. William Jackson was the Chief Operating Officer and Chief Financial Officers prior to the arrival of Dr. Sanhueza and Mr. Lindayen. Mr. Jackson will continue as Chief Business Officer (CBO) in the Company. Mr. Jackson has been with Covalon since its inception in late 1999. Mr. Jackson's role as CBO will take the Company through the next stage of success. He has over 15 years experience in the medical device industry. Mr. Jackson's experience in deal development ranges from being a leading sales executive for Stryker Corporation and Karl Storz Endoscopy to building start up company, Preferred Medical Products, an anesthesia catheter company into a North American market leader. Mr. Jackson will now lead the deal side of the business to expand the Company's customer base and revenue potential. A number of product opportunities and potential relationships have been identified and Mr. Jackson will direct his efforts on the execution of contracts.

Covalon is pleased to report that on June 20, 2007, the Company was selected as one of the top 50 companies on the TSX Venture exchange and was ranked in 7 of the top 10 companies in the Life Sciences market sector. Covalon is among a select group of companies recognized as the "2007 TSX Venture 50" of over 2,100 companies (The Globe and Mail, Wednesday, June 20, 2007, Report on the TSX Venture 50, page B9). The Company attributes the accomplishment to our dedicated team of employees who have made Covalon the success it is today. The Company remains focused on delivering the innovations and performance that will allow it to remain at the top its field in the quarters and years ahead.

Covalon achieved significant milestones for the year 2007. The Company completed the acquisition of technology from Perfusion Therapeutics Inc. and acquired a cell engineering platform for improving blood vessel development (angiogenesis). The technology uses endothelial PAS domain protein (EPAS1). EPAS1 is the subject of several US and European patent applications that Covalon has assumed through the acquisition. EPAS1 is a naturally occurring hypoxia-inducible transcription factor that is predominantly expressed in endothelial cells such as those lining the walls of blood vessels. Covalon has initiated a gene therapy program with the development and potential commercialization of EPAS1 for inducing angiogenesis.

Covalon acquired the technology from Perfusion Therapeutics Inc. for 1,100,000 common shares of Covalon Technologies Ltd. which are held in escrow to be released as fully paid non-assessable common shares on various success milestones. The Company is pleased to report that the first milestone was achieved subsequent to year end and 25,000 shares were released from escrow. The Company estimates 150,000 shares will be released from escrow in 2008. Covalon has agreed to fund the development of EPAS1 through various milestones and a budget of \$628,000 has been committed for the 12 month period ending September 30, 2008. A budget will be established on a year by year basis for the development of EPAS1 technology that will depend on the successful completion of each successive development milestone. Covalon entered into a one-year research contract with Dr. Jacques Galipeau, MD, FRCP(C), Associate Professor of Medicine and Oncology at the Sir Mortimer B. Davis Jewish General Hospital (McGill University) for isolation of cells required for Covalon's program in angiogenesis.

Covalon has successfully achieved an important milestone with its EPAS1 technology that is expected to allow the Company to engineer mesenchymal stem cells (MSCs) as noted above. This program offers an alternative to open heart surgery for those suffering from congestive heart failure. The American Heart Association estimates that about 5 million U.S. residents are living with heart failure, and more than 550,000 people are diagnosed with the condition each year. In 2005, the disease was estimated to cost an estimated \$27.9 billion in direct and indirect health care expenses.

Covalon successfully applied its hydrophilic antimicrobial silver ion releasing coating to stainless steel. This development allows the Company to further develop its antimicrobial technology for orthopedic trauma and orthopedic surgical applications. Opportunities for the Company include hip, knee, shoulder, external and internal fracture fixation and stabilization devices. The development fits precisely with Covalon's strategy to deter infection and improve patient outcomes. According to Medtech Insight's Market & Technology Report: Trends and Opportunities in U.S. Orthopedic Markets for Implant, Reconstruction and Trauma Products, in 2004 the total market for orthopedic products for implant, reconstruction, and trauma applications was estimated to be \$11.5 billion; the market is expected to double to approximately \$23 billion by the year 2012.

Covalon and Smith & Nephew Inc. (NYSE:SNN; LSE: SN) entered into a five year exclusive distribution arrangement for collagen-based dressings in March 2007. The major financial component will be sales of product to Smith & Nephew Inc. for worldwide distribution. The value will vary depending on the commercial conditions in the markets in which Smith & Nephew Inc. will promote the products. The Company expects to receive total minimum milestone payments of US\$5 million (including an up-front exclusivity payment of \$2 million already received) over the five year term in addition to sales. Smith & Nephew Inc. is dedicated to helping improve people's lives. Smith & Nephew prides itself on the strength of its relationships with its surgeons and professional healthcare customers, with whom its name is synonymous with high standards of performance, innovation and trust. Smith & Nephew has over 8,500 employees and operates in 33 countries around the world, generating annual sales in excess of \$2.6 billion.

Covalon successfully developed a covalently-bonded, silver-ion releasing antimicrobial and low-blood-clotting coating that can be applied to a wide variety of blood-contacting catheters and devices in order to minimize potential for blood-clot formation.

The Orthopaedic Trauma Association (OTA), the premier international organization for orthopaedic trauma surgeons, has announced grant funding to Indiana Hand Center and Dr. Gregory A. Merrell. The work is being done at Indiana University Department of Orthopaedics. The grant funding is for a study titled “Efficacy and Safety of Covalent Bonding of Silver to Orthopedic Trauma Hardware: Investigation of a Novel Coating Technology”. This is one of just a few grants given worldwide by the OTA for the study of prominent new technologies in the field of orthopaedic trauma. The study will fund preclinical evaluations over the next year of the efficacy and safety of Covalon’s technology for orthopaedic applications.

3. Investments and Capitalization

Covalon became a publicly listed company on the Toronto Venture Exchange (TSXV) on December 21, 2004, trading under the symbol (COV). At the beginning of the current fiscal year, October 1, 2006, the Company had 56,322,784 common shares issued and outstanding.

The table below sets out the number of issued and outstanding common shares as well as the number of issued and outstanding warrants and options to purchase common shares, in each case as at September 30, 2007.

Common shares	72,712,034
Options to purchase common shares	3,589,388
Total diluted shares outstanding	76,301,422

On October 24, 2006, Covalon completed the acquisition of a cell engineering platform for improving blood vessel development (“angiogenesis”) from Perfusion Therapeutics Inc. of Montreal. Covalon acquired the technology in exchange for 1,100,000 of its common shares to be released upon the completion of various milestones. The technology uses the endothelial PAS domain protein 1 (EPAS1). EPAS1 is the subject of several US and European patent applications that Covalon has assumed through the acquisition.

4. Results of Operations

Highlights

- Cash used in operating activities for the year 2007 was (\$146,210) compared to (\$2,116,806) for the same period in 2006;
- Total Product Sales Revenues increased by \$346,873 or 36.9% over the previous year to \$1,285,673;
- Total Other Revenues increased by \$377,956 or 312% over the previous year;
- Net loss for the year 2007 was \$3,076,377 compared to net loss of \$2,204,990 for the same period in 2006;
- Covalon lost \$0.05 per share for the year 2007 which is the same loss compared to the same period in 2006;



Operating and Financial Results

<i>(in Canadian \$)</i>	Three months ended September 30,		Year ended September 30,	
	2007	2006	2007	2006
Product Sales				
Wound care	\$ 375,731	\$ 316,711	\$ 1,077,483	\$ 860,046
Coated catheters	(3,221)	-	182,720	52,158
Coating services	14,574	9,636	25,470	26,596
	\$ 387,084	\$ 326,347	\$ 1,285,673	\$ 938,800
Cost of goods sold	330,130	179,626	856,406	540,278
Gross Profit	\$ 56,954	\$ 146,721	\$ 429,267	\$ 398,522
Other Revenue				
Interest income	\$ 84,325	\$ 56,121	\$ 249,143	\$ 115,743
Licensing fee	(98,641)	1,361	249,999	5,443
Total Expenses	\$ 1,467,684	\$ 888,871	\$ 4,004,786	\$ 2,724,698
Net Loss	\$ (1,425,046)	\$ (684,668)	\$ (3,076,377)	\$ (2,204,990)
Loss per share	\$ (0.02)	\$ (0.01)	\$ (0.05)	\$ (0.05)

Analysis of Operating and Financial Results Fiscal 2007 compared to Fiscal 2006

Revenue

Covalon's consolidated product sales increased by \$60,737 to \$387,084 during the fourth quarter of 2007 compared to the same period last year. Consolidated product sales increased by \$346,873 to \$1,285,673 in 2007 compared to \$938,800 in 2006. This increase was expected due to the ramp up in production from Biostep™ and Biostep™ Ag bioactive collagen dressings.

The Company launched the ColActive line, its first generation wound dressings, through Hartmann-Conco, Inc. of the US, late in the third quarter of 2005. In March of 2007, Covalon completed an exclusive distribution agreement with Smith & Nephew, the world leader in advanced wound care.

Biostep™/Biostep™ Ag, the new generations of higher gross margin bioactive collagen dressings developed by Covalon are now being delivered to Smith & Nephew. Major wound care centres have been sampled and key influential clinicians are using the products. The feed-back is excellent. Smith & Nephew has invested substantially in the development of marketing support and sales training of over 100 direct sales representatives to launch the Biostep™ brands throughout United States. Covalon achieved validation and scale-up during the third quarter of 2007. The production and delivery of product to Smith & Nephew was launched during the fourth quarter of 2007. Biostep™ and Biostep™ Ag are promising new products that are expected to lead to a higher gross margin product mix in 2008. Covalon's Management is optimistic about launching its new generation of collagen dressings, Biostep™ and Biostep™ Ag into the US potential market of approximately US \$100 million with the distribution partner who has the largest global market share.

Wound Care Sales

Wound care sales increased by \$59,020 to \$375,731 during the fourth quarter of 2007 compared to the same period last year. Sales increased by \$217,437 to \$1,077,483 in 2007 compared to the same period last year. The wound care sales increased due to the enhanced marketing and sales support from Smith & Nephew. It is expected that based on the early clinician response to Biostep™ and Biostep™ Ag, the conversion rate to the Biostep™ will be strong.

Coatings

Coating sales decreased by \$3,221 to (\$3,221) during the fourth quarter of 2007 compared to the same period last year. Sales increased by \$130,562 to \$182,720 in 2007 compared to the same period last year. The distributor, Medline Industries, Inc., focused its marketing efforts on two major in-market clinical trials to prove the efficacy and economics of the “Silvertouch” anti-microbial catheters. The Company anticipates that on completion these studies will provide strong evidence of the catheter’s performance and lead to a faster conversion rate of accounts as large accounts receive clinical evidence of the catheter’s efficacy.

The Company continues to do contract research and development applying its anti-microbial coating on a number of medical devices. Covalon recently announced that it developed an anti-microbial coating with anti-thrombogenic properties (prevents blood from clotting on the surface of the device). Covalon expects to seek a distribution partner in the vascular access market with substantial market-share.

Cost of Goods Sold

Cost of goods sold for 2007 was \$856,406 compared to \$540,278 in 2006. Cost of goods sold represented 66.6% of sales in 2007 compared to 57.6% in 2006. The product mix in the Company, particularly the reduction in contribution of the higher margin products, has resulted in the increase in the cost of goods sold, as a percentage of sales.

Gross Profit

Gross profit was 33.4% for 2007 compared to 42.4% for 2006. The decrease in the year is attributable to changes in product mix and the lower yield from the scale-up of Biostep™ and Biostep™ Ag.

Interest Income

Interest income increased by \$28,204 to \$84,325 during the fourth quarter of 2007 compared to the same period last year. Interest income increased by \$133,400 to \$249,143 in 2007 compared to the same period last year. The increase is primarily due to cash generated from the exercise of 15,888,056 of Series III warrants in the fourth quarter of 2007. All investments are made in accordance with the Company’s audit committee investment guidelines.

License Revenues

License revenues increased as a result of the recognition of the US\$2 million milestone payment the Company received from Smith & Nephew Inc. The milestone payment is being recognized over a 5 year period.

Expenses

Covalon administrative and overhead expenses increased by \$578,813 to \$1,467,684 during the fourth quarter of 2007 compared to the same period last year. Total administrative and overhead expenses were \$4,004,786 in 2007 compared to \$2,724,698 for 2006, an increase of \$1,280,088. The increase was primarily due to staff additions in operations and regulatory affairs and the value of stock option compensation awarded to directors and key employees. Key staff members were added as part of the Company's distribution expansion into non-domestic markets. The investment in personnel was required to achieve the expansion.

The expenses for the three month period and year ended September 30 for 2007 and 2006 are summarized below.

<i>(in Canadian \$)</i>	Three months ended September 30,		Year ended September 30,	
Administrative and overhead	2007	2006	2007	2006
Amortization	\$ 64,324	\$ 95,195	\$ 252,988	\$ 243,596
Bank Charges and interest	876	1,335	3,774	4,098
Consulting fees	2,400	13,203	2,400	112,312
Director fees	191,873	19,503	448,448	58,603
Foreign currency (gain) loss	14,070	783	53,269	(1,067)
Loss on disposal of equipment	9,218	-	9,218	-
Management fees	208,747	82,491	527,994	314,991
Marketing	42,325	96,075	220,046	235,141
Office and administrative	134,454	132,348	429,249	399,625
Patent maintenance	3,369	-	4,771	7,291
Professional fees	90,163	83,350	146,042	144,223
Property maintenance	1,872	1,440	7,620	8,783
Regulatory	232,799	128,963	588,833	353,043
Research & Development	348,175	112,687	1,051,558	648,575
Training	1,400	4,499	14,464	5,476
Travel	22,475	23,684	81,968	96,693
Write-downs of intangible assets	99,144	93,315	99,144	93,315
Total	\$ 1,467,684	\$ 888,871	\$ 4,004,786	\$ 2,724,698

Consulting Fees

Consulting fees for 2007 decreased by \$10,803 to \$2,400 during the fourth quarter of 2007 compared to the same period last year. The same fees decreased by \$109,912 to \$2,400 in 2007 compared to 2006. All regulatory work was done internally in 2007.

Director Fees

The Director fees increased by \$172,370 to \$191,873 during the fourth quarter of 2007 compared to the same period last year. The same fees increased by \$389,845 to \$448,448 in 2007 compared to 2006. This increase is due primarily to increases in stock compensation to the Directors.

Foreign currency (gain) loss

The foreign currency loss of \$53,269 was due to the stronger Canadian dollar. Most of the revenues are received in US dollars while most of the administration and overhead are in Canadian dollars.

Management Fees

The Management fees increased by \$126,256 to \$208,747 during the fourth quarter of 2007 compared to the same period last year. The same fees increased by \$213,003 to \$527,994 for 2007 compared to 2006. The cash compensation was unchanged and the increase was a result of the value of stock options vesting during the period.

Office and Administration

Office and administration costs increased slightly during the fourth quarter of 2007. For the year, these costs increased by \$29,624 to \$429,249 in 2007 compared to 2006. A majority of this increase reflects the addition of one new accounting staff member and increases in general office expenses.

Regulatory Expense

Regulatory expenses increased by \$103,836 to \$232,799 during the fourth quarter of 2007 compared to the same period last year and by \$235,790 to \$588,833 in 2007 compared to 2006. The majority of the increase was related to the addition of an experienced Vice President of Regulatory Affairs, Quality Affairs and Clinical Affairs who was subsequently elevated to the role of Chief Operating Officer and an increase of 6 headcount in support staff. The Company increased the compensation for this position to attract a senior level candidate. In addition, the TSXV increased its filing fees.

Research and Development

Research and Development expenses increased by \$235,488 to \$348,175 during the fourth quarter of 2007 compared to the same period last year. It increased by \$402,983 to \$1,051,558 in 2007 compared to 2006, because of activities related the Smith & Nephew Inc. distribution agreement and increased coatings research related to the development of the anti-thrombogenic coating.

Net Income (Loss)

The Company had a net loss of \$3,076,377 or \$0.05 per share in 2007 compared to net loss of \$2,204,990 or \$0.05 per share in 2006. The following items contributed to the net loss:

- An increase of \$531,632 (pre-tax) in stock-based compensation over 2006;
- Hired a Chief Operating Officer;
- Regulatory activities have increased which resulted in an increase of \$235,790. Global filings and increased product development has necessitated the expansion of the Regulatory department leading to increase headcount to 5 people;
- Research and Development increased \$402,983 due to activities related to Smith & Nephew Inc. and EPAS1.

The increase in expenses was mitigated by increases in wound care revenue and investment income resulting from the warrants exercised during the year netted \$11,836,743.

Selected Annual Financial Data

The following table is a summary of selected audited consolidated financial information of the Company for each of the most recently completed financial years for the year ended September 30th:

<i>(in Canadian \$)</i>	2007	2006	2005
Revenue (1)	\$1,784,815	\$1,059,986	\$27,173
Net loss	\$(3,076,377)	\$(2,204,990)	\$(1,861,542)
Net loss per share	\$(0.05)	\$(0.05)	\$(0.05)
Total Assets	\$20,244,461	\$8,793,388	\$4,500,484

(1) Includes Other Revenues

The Company's initial relationship with Smith and Nephew in 2007 has paved the way to an upward trend in revenues. Net losses for each year continue to accumulate due to the Company's investments in regulatory and research and development infrastructure. Total assets increased significantly in 2007 due to the exercise of all outstanding warrants. All of these factors are discussed in greater detail in other sections of this document. The operations of the Company are not subject to any material seasonality or cyclical factors.

Summary of Quarterly Results

The quarterly financial information presented below represents eight quarters of operating results.

<i>(in Canadian \$)</i>	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter	2007 First Quarter	2006 Fourth Quarter	2006 Third Quarter	2006 Second Quarter	2006 First Quarter
Revenue (1)	\$372,768	\$560,241	\$461,511	\$390,295	\$383,829	\$403,063	\$133,040	\$140,054
Net loss	\$(1,425,046)	\$(742,604)	\$(507,356)	\$(401,371)	\$(684,668)	\$(518,097)	\$(559,742)	\$(442,483)
Net loss per share	\$(0.02)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.02)	\$(0.01)	\$(0.01)	\$(0.01)

(1) Includes Other Revenues

The Company's ongoing quarterly losses relate primarily to the continuing buildup of the regulatory and research and development departments. There was a significant non-cash stock option compensation expense incurred in the fourth quarter to recognize employees, directors and management employees for past service to the Company. All of these factors are discussed in greater detail in other sections of this document.

Other Performance Indicators

In addition to the key financial, revenue, and earnings-related metrics described above Management regularly reviews the following working capital metrics:

	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter	2007 First Quarter	2006 Fourth Quarter	2006 Third Quarter	2006 Second Quarter	2006 First Quarter
Current Ratio	6.4	3.0	2.5	9.2	10.7	11.5	9.6	1.0
Net Working Capital	\$14,322,821	\$5,341,353	\$4,346,329	\$4,815,698	\$5,113,130	\$5,508,379	\$5,760,544	\$10,260
Net Working Capital as % of Revenue	802%	162%	139%	308%	482%	611%	575%	2%

The Current Ratio is a model for measuring the liquidity of the Company by calculating the ratio between all current assets and all current liabilities. It is an indicator of the Company's ability to pay short-term obligations. Current assets includes cash and cash equivalents, short term investments, accounts receivable, refundable investment tax credits, inventories and prepaid expenses. Current liabilities include accounts payable and accrued liabilities and deferred revenue. Net Working Capital is calculated as current assets minus current liabilities. Net Working Capital as a percentage of Revenue is calculated as the ratio between Net Working Capital and Revenue.

The exercise of the warrants has significantly strengthened the liquidity of the Company and consequently allows us to invest in research and development and build infrastructure in our operations.

5. Liquidity & Capital Resources

Financial Position

<i>(Canadian \$)</i>	September 30, 2007	As at September 30, 2006
Total assets	\$ 20,244,461	\$ 8,793,388
Deferred revenue	\$ 1,977,904	\$ 20,715

Total Assets

Total assets at September 30, 2007 were \$20,244,461 compared to \$8,793,388 at September 30, 2006. The increase is primarily due to increases in cash and cash equivalents and short term investments of \$11,158,358. This cash was generated from proceeds from the exercise of warrants offset by capital expenditures and patents and technology rights.

Deferred Revenue

The five year agreement with Smith and Nephew included the upfront payment of \$2,321,200. This accounts for the increase in deferred revenue. Not included in the deferred revenue is the additional guarantee of US\$3,000,000, which will be received in accordance with the terms of the Distribution Agreement between Smith and Nephew and Covalon.

Liquidity

The Company follows a policy of investing its surplus cash resources in high quality, liquid, short-term notes. Cash equivalents as of September 30, 2007 and 2006 had less than three months maturity. Short-term investments have a maturity on December 1, 2008 which is greater than one year but the investment is readily cashable in a short period of time for use in our operations. As at September 30, 2007 there were no restrictions on the flow of these funds nor have any of these funds been committed in any way. The Company believes that it has the capital resources and liquidity necessary to meet its commitments, support its operations and finance its current growth strategies.

Commitments

The Company has entered into an operating lease for its premises at 405 Britannia, 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>

The Company intends to continue to use its capital resources to fund research and development activities, including EPAS1. The amount of capital resources to be allocated to these activities will depend upon the scale of programs undertaken and a number of factors, such as the terms of our partnering agreement, input from outside experts and regulatory authorities on clinical programs. The Company has agreed to fund the development of EPAS1 through various milestones and has committed \$628,000 for the twelve month period ending September 30, 2008.

Shares Outstanding

Authorized - Unlimited number of Common Shares

Issued – Common shares and warrants

	<u>Number of Common Shares</u>	<u>Number of Warrants</u>	<u>Stated Capital</u>	<u>Warrants</u>
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	-	<u>1,095,728</u>	<u>(769,089)</u>	<u>68,702</u>
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	<u>15,888,056</u>	<u>(15,888,056)</u>	<u>14,907,819</u>	<u>(3,265,708)</u>
Balance, September 30, 2007	<u>72,712,034</u>	-	\$ 28,664,432	-

A private placement financing was completed March 22, 2006 for 13,696,600 units at \$0.50 per unit for net proceeds of \$6,184,801. The 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 was priced at \$0.50 and consists 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.

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.

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:

	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	<u>(562,500)</u>	<u>(118,273)</u>	
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	<u>(200,000)</u>	<u>(12,400)</u>	
Balance, September 30, 2007	<u>3,589,388</u>	<u>\$ 925,625</u>	

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.

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.



Sources and Uses of Cash

	Three month period ended September 30,		Year ended September 30,	
	2007	2006	2007	2006
Cash Provided By (Used in)				
Operating Activities				
Cash flow from operating activities before change in non-cash working capital	\$ (921,654)	\$ (461,381)	\$ (2,094,878)	\$ (1,833,308)
Change in non-cash working capital	268,888	153,280	1,948,668	(283,498)
	\$ (652,766)	\$ (308,101)	\$ (146,210)	\$ (2,116,806)
Investing Activities				
Purchase of capital assets, net	\$ (107,748)	\$ (226,733)	\$ (260,227)	\$ (54,808)
Purchase of patents and technology rights	(10,109)	(27,996)	(218,679)	(104,862)
Short term investments	(9,252,103)	-	(9,252,103)	-
	\$ (9,369,960)	\$ (254,729)	\$ (9,731,009)	\$ (159,670)
Financing Activities				
Issuance of share capital, net	\$ 9,969,642	\$ 113,792	\$ 11,836,743	\$ 6,643,047
Foreign exchange gain (loss) on cash held	\$ (14,070)	\$ 1,067	\$ (53,269)	\$ 1,067
Increase (decrease) in cash and cash equivalents	\$ (67,154)	\$ (447,971)	\$ 1,906,255	\$ 4,367,638

Operating Activities

Cash flow used in operations for the fourth quarter of 2007 was (\$652,766) compared to (\$308,101) for the same period last year. For 2007, cash flow used in operations was (\$146,210) compared to (\$2,116,806) in 2006. The net decrease in the fourth quarter of 2007 compared to the fourth quarter of 2006 is mainly due to higher loss during the three months ended September 30, 2007, net the effect of the changes in non-cash working capital items. The increase in cash flow used in operations in 2007 is primarily due to the increase in deferred revenue of \$1,957,189.

Investing Activities

Cash used in investing activities was (\$9,369,960) in the fourth quarter of 2007, compared to (\$254,729) in the fourth quarter of 2006. Cash used in investing activities in 2007 was (\$9,731,009) compared to (\$159,670) in 2006. Cash flow uses from investing activities during the fourth quarter of 2007 mostly consisted of the purchase of capital assets totaling \$107,748 and short term investments of \$9,252,103. Cash flow uses from investing activities in 2007 consisted of \$260,227 of capital asset purchases, \$218,679 for the acquisition of patents and patent application filings and short term investments of \$9,252,103.

Financing Activities

Cash flow from financing activities for the fourth quarter of 2007 and the year was \$9,969,642 and \$11,836,743 respectively. The increase quarter over quarter and year over year in cash provided by financing activities is due to the exercise of options and warrants to purchase a total of 16,389,250 common shares.

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements.

Financial Instruments

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.

All of the Company's cash is maintained by one of the major financial institutions.

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.

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.

The Company has not entered into any futures or forward contracts or other derivative instruments as at September 30, 2007.

6. Risk and Uncertainties

An investment in the securities of the Company is speculative due to the proposed nature of the Company's business and the present stage of Covalon's development.

Consequently, an investment in the Company is subject to certain risks and investors should not invest in securities of the Company unless they can afford to lose their entire investment. In addition to the factors disclosed elsewhere in this MD&A, investors should consider the following risk factors in assessing the investment merits of such securities.

Biotechnology companies in the early revenue stage are subject to a number of risks and uncertainties that are inherent to the development of any new technology. General business risks include, among other things, uncertainty in product development and related clinical trials, the regulatory environment including delays or denial of approval to market products, the impact of technological change and competing technologies, the ability to protect and enforce its patent portfolio and intellectual property assets, the availability of capital to finance continued and new product development, the ability to secure strategic collaborators and its reliance on these collaborators for the development, regulatory approval, testing, manufacturing and commercialization of its products and the risk of product liability claims. In addition, market prices for securities of biotechnology companies are generally volatile, and may or may not move in a manner consistent with the progress being made by such company. To the extent possible, the Company's Management pursues and implements strategies to reduce or mitigate the risks and uncertainties associated with its business. See "Information concerning the Resulting Issuer – Risk Factors" outlined in Seder Capital Corp.'s Filing Statement dated December 9, 2004 and available for review on SEDAR at www.sedar.com.

7. Related Party Transactions

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).

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).

8. Critical Accounting Estimates

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. Management believes that the estimates and assumptions upon which the Company relies are reasonable based upon information available at the time these estimates and assumptions are made. Estimates and assumptions may be revised as new information is acquired, and are subject to change. Areas of significant estimates include, research and development costs, and stock based compensation.

Deferred Development Costs/Research Development

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 impairment in the recoverable amount.

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.

Stock Based Compensation

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.

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.

9. Accounting Policies

Policies Adopted in Fiscal 2007

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 consolidated statement of operations.

Accounting Policies Not Yet Implemented

In July 2006, the CICA replaced Handbook Section 1506, Accounting Changes (Section 1506), with a new Section based on International Financial Reporting IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, effective for interim and annual periods beginning on or after January 1, 2007. The new Section 1506 establishes criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies and estimates, and correction of errors, replacing former CICA Section 1506. The replacement states changes in accounting policy are to be applied retrospectively, if practicable. Additionally, prior period errors should be corrected retrospectively. The final standard also ascertains the new disclosures required in respect of changes in accounting policies, changes in accounting estimates and correction of errors.

In December 2006, the CICA issued Section 3862, "Financial Instruments, Disclosures," and Section 3863, "Financial Instruments, Presentation." These standards provide additional guidance on disclosing risks related to recognized and unrecognized financial instruments and how those risks are managed. The CICA also issued Section 1535, "Capital Disclosures," which provides guidance for disclosing information about an entity's capital and how it manages its capital. These standards are effective for 2008. We are currently evaluating the impact of adopting these standards on our consolidated financial statements.

In June 2007, the CICA issued Section 3031, "Inventories," which requires inventory to be measured at the lower of cost and net realizable value. The standard provides guidance on the types of costs that can be capitalized and requires the reversal of previous inventory write-downs if economic circumstances have changed to support higher inventory values. The standard is effective for 2008. Commencing in the first quarter of 2008, we are required to disclose the amount of inventory recognized in cost of sales each quarter, as well as any inventory write-down or reversals each quarter. We are currently evaluating the impact of adopting this standard on our consolidated financial statements.

In June 2007, The CICA issued Section 1400, "Going Concern Amendments". The standard requires Management to make an assessment of an entity's ability to continue as a going concern. Financial statements must be prepared on a going concern basis unless Management intends either to liquidate, cease trading or cease operations. We have prepared the consolidated financial statements on a going concern basis.

10. 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 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.

(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%)	\$ (1,107,500)	\$ (793,800)
Permanent differences	207,400	(7,000)
Expiring losses	162,800	48,400
Change in future tax rates	87,900	445,300
Other	81,800	112,000
Valuation allowance	<u>567,600</u>	<u>195,000</u>
	<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	\$ 2,457,000	\$ 2,568,300
Capital loss carry forwards	166,200	208,300
Capital and other assets	114,000	61,000
Deferred development costs	(50,100)	(103,600)
Deferred revenue	642,800	-
Other	7,700	36,000
Valuation allowance	<u>(3,337,600)</u>	<u>(2,770,000)</u>
	<u>\$ -</u>	<u>\$ -</u>

(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	<u>346,000</u>
	<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 could earn 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.

11. Opportunities

While our business continues to focus on our current platforms, there are opportunities to leverage the technology to areas in the ophthalmology, orthopedics, pharmaceuticals and biotechnology industries. The broad applicability of our technology and licensing business model allows Covalon to participate in diverse product offerings used for treating patients.

The Company's focus in addressing unmet clinical needs complements our passion for innovation and could potentially position us at the forefront of the convergence of drugs, cells (EPAS1 technology) and devices. Below are a few of these opportunities we are focusing on in the coming fiscal year.

Antimicrobial Coatings

Indwelling catheters are associated with very serious infections such as catheter associated urinary tract infection and catheter-related bloodstream infection. Central venous catheters (CVC) and urinary catheters are the most susceptible to bacterial growth causing infection; each year 200,000 catheter-related blood stream infections are caused by CVCs in U.S. hospitals. Together, these two categories of devices account for over 50% of total hospital-acquired infections. Antimicrobial coatings are expected to be an effective solution to this growing concern. Furthermore, blood-contacting medical devices such as peripherally inserted central catheters (PICC) and CVC, etc. are susceptible to vascular access-related infections and blood-clotting. Blood clots on the surface of devices raise significant concerns for stroke, heart attack, pulmonary embolism and conditions related to impaired blood flow. Prolonged hospital stay, morbidity or mortality and serious economical consequences are a result of infections and blood-clotting-related events caused by a variety of vascular access devices.

Recently, the Centers for Medicare and Medicaid Services (CMS, USA) issued a ruling that updates the USA hospital inpatient prospective payment system for 2008. The new ruling requires that hospitals and other patient care facilities identify conditions present at admission. Furthermore, guidelines were provided that emphasized that re-imburement payment would not be made for certain (eight identified) conditions determined to be hospital-acquired. Two of the eight conditions affect patients with incontinence; they are: catheter-associated urinary tract infections and pressure ulcers. The conditions, if noted in a patient on admission to an acute care facility, must be identified by the clinical staff and attending physician. When patients are admitted without these conditions, evidence-based, preventive protocols must be implemented in order to provide optimal care and prevent costly complications.

In essence, all hospital-acquired conditions identified should be of concern for all facilities; the two conditions that impact patients with incontinence are catheter-associated UTIs and pressure ulcers.

“The CMS included this complication with the objective to reduce the rate of UTIs through decreased use of indwelling catheters in the hospitalized Medicare patient. According to information in the final rule within this guideline, 12 catheter-associated UTIs are the most common nosocomial infection; thus, this condition meets the criteria of high volume with associated costs.

CDC (Center for Disease Control, USA) reports that there are 561,667 catheter-associated urinary tract infections per year. For FY 2006, there were 11,780 reported cases of Medicare patients who had a catheter-associated urinary tract infection as a secondary diagnosis. The cases had average charges of \$40,347 for the entire hospital stay. According to a study in the American Journal of Medicine, catheter-associated urinary tract infection is the most common nosocomial infection, accounting for more than 1 million cases in hospitals and nursing homes nationwide. Approximately 11.3 million women in the United States had at least one presumed acute community-acquired urinary tract infection resulting in antimicrobial therapy in 1995, with direct costs estimated at \$659 million and indirect costs totaling \$936 million. Nosocomial urinary tract infection necessitates one extra hospital day per patient or nearly 1 million extra hospital days per year. It is estimated that each episode of symptomatic urinary tract infection adds \$676 to a hospital bill. In total, according to the study, the estimated annual cost of nosocomial urinary tract infection in the United States ranges between \$424 and \$451 million.

According to the CDC, “Catheter-associated urinary tract infections are caused by a variety of pathogens, including *Escherichia coli*, *Klebsiella*, *Proteus*, *Enterococcus*, *Pseudomonas*, *Enterobacter*, *Serratia*, and *Candida*. Many of these microorganisms are part of the patient’s endogenous bowel flora, but they can also be acquired by cross-contamination from other patients or hospital personnel or by exposure to contaminated solutions or non-sterile equipment.” (cited in Hess & Rook, Understanding Recent Regulatory Guidelines for Hospital-Acquired Catheter-Related Urinary Tract Infections and Pressure Ulcers, OWM Wound Ostomy Management 53:34-42, 2007).

Furthermore, vascular catheter-associated infection, that is those caused by central venous catheters use or other vascular catheter, was also identified by CMS as a non-reimbursable condition if acquired by a patient during treatment within an acute care facility.

Management expects that the ruling by CMS will generate significant and renewed interest with medical professionals, acute care facilities and medical device distributors in the use of effective antimicrobial coatings, such as Covalon's coating on urinary catheters, to reduce hospital acquired infections.

Covalon's antimicrobial and low-thrombogenic coating can be applied to a wide variety of in-dwelling, blood contacting devices for reducing the incidence of hospital acquired infection as well as reducing thrombogenicity. Effective antimicrobial and low-thrombogenic coated catheters may reduce infection and thrombus formation thus improving patient outcome.

Antimicrobial CVC are expected to experience a growth rate approximately 5-fold greater than that of un-coated CVC. It is estimated that by 2009, sixty-nine percent (69%) of all CVC used will be antimicrobial (data from Frost and Sullivan, U.S. Antimicrobial Devices Markets, 2003). Hospital-acquired infections affect approximately 2 million people in the United States each year, and cost over \$11 billion to the U.S. healthcare system (data from Frost and Sullivan, U.S. Antimicrobial Coating Markets, 2006). The total antimicrobial catheters market is projected to attain revenues of US \$ 375 million by 2009 (Frost and Sullivan 2006).

Collagen Matrices

The Covalon collagen matrix is a proprietary technology platform targeted at tissue regeneration. The science team at Covalon started with the hypothesis that "if one can develop a biomaterial that offers an optimal biological environment for specific tissue regeneration, cellular functions can be activated and functional tissues can be regenerated".

The Covalon Research Team investigated a variety of biomaterials and determined that Type I collagen was the best biomaterial for the intended uses, but that the triple helix structure of collagen has inherent limitations with respect to cell activation, migration, tissue integration and regeneration. It was determined that a hybrid structure of Type I triple helix collagen and open helix denatured collagen would be ideal. The Covalon Collagen matrix has portions of open structure of denatured collagen where well-known and specific molecular sequences containing the amino acids; arginine, glycine and aspartic acid, referred to as "RGDs sites" are exposed for interaction with cell receptors called integrins leading to the stimulation of cellular functionality, while maintaining portions of triple helix structures for cellular support. These unique features create the optimal conditions for functional tissue regeneration.

The Covalon strategy is to define applications for the platform by first exploiting opportunities that require relatively rapid, low risk 510 (k) regulatory approvals that are expected to yield products that therefore are quick to market. These applications will create the revenue base to internally develop more research-intensive and sophisticated applications. As the Company shifts its focus to the more sophisticated applications the returns on the investments should increase substantially.

Wound Care

Covalon has developed and received regulatory approval for five collagen-based wound care products. The products have broad application in advanced wound care for difficult

to heal wounds such as pressure ulcers, diabetic ulcers, venous ulcers and dehiscent wounds. According to MedMarket Diligence Worldwide Wound Management 2005-2014 report, the world wide market for advanced wound care is approximately \$2.6 billion reaching \$5 billion by 2014. The Covalon products Biostep and Biostep Ag (step up wound healing) was launched in mid 2007 by Smith and Nephew, the world leader in advanced wound care. Covalon expects that the product advantages of Biostep products combined with Smith and Nephew's distribution power will make this product a sector leader.

The Covalon team is investigating a number of product line extensions in the wound care market niche to expand the product positioning of the technology platform and capture an increasing share of the market. The Company looks forward to more communication of progress in the wound care market.

Pressure Ulcers

As noted in the report by Hess & Rook (ibid 2007) pressure ulcers represent a high-cost and high-volume condition. According to the final rule in FY 2006, 322,946 cases of Medicare patients with a secondary diagnosis of pressure ulcer with an associated average cost of \$40,381 per patient were reported.

Pressure ulcers are ruled as a hospital acquired condition and hence "the CMS hopes to 1) improve screening of patients for pressure ulcers on admission, 2) promote early identification of pressure ulcers to improve treatment, and 3) greatly improve patients' quality of care." (ibid)

As of October 1, 2008, physicians and hospitals will be expected to perform more accurate skin assessments at patients' admissions in order to diagnose pressure ulcers and potential skin complications earlier and implement appropriate treatments and management. "Therefore, the use of accurate assessment skills, coupled with coordinated skin care formularies and management pathways based on clinical practice guidelines, should be initiated on all patients incontinent of urine and feces admitted to the facility. These pathways should be initiated as either a prevention pathway (patients with intact skin) and/or intervention pathway (patients with skin injury)" (ibid).

In the USA, Medicare reimbursement rulings will affect how facilities are reimbursed or paid for services in the next several years. The rulings will necessitate re-educating clinical staff and attending physicians on the absolute need for accurate assessments, prevention and management implementation. Accurate diagnoses and documentation will impact reimbursement. And most importantly from a healthcare perspective, reinforce the need for best practice in the care of individuals whose incontinence threatens skin integrity.

Covalon's ColActive and Biostep line of wound collagen dressings were specifically designed for the treatment of pressure ulcers, as well as other conditions. Management expects that the ruling by CMS relating to pressure ulcers will generate significant and renewed interest with medical professionals, acute care facilities and medical device distributors in the use of Covalon's wound care products. Management views the rulings by CMS as positive indicators for the continuing and increasing need and sales of Covalon's products.

Ocular

The Covalon team has identified the Ocular market as a priority target. The Company has identified a number of high value applications for its Collagen platform. Applications include a variety of high value post-surgical bio-resorbable antimicrobial dressings that are placed on the surface of the eye. The developments of these applications will begin to transition Covalon's product offerings into higher value opportunities. The US market opportunity alone exceeds \$100 million. These new products are in the early design and development phase but are anticipated to have a low regulatory risk. The Covalon team looks forward to providing news on these opportunities.

Hemostatics

The market opportunities for topical and surgical hemostats have been identified by the Covalon team as niches where the Company's collagen platform has significant advantages over the existing competitive product offerings. The Company is in the development stage of at a topical hemostatic dressing. The dressings will be targeted for military, trauma, surgical interventions and puncture site wounds. The Company estimates that there are approximately 6 million trauma and surgical wounds in the US that require a hemostatic, according to the Centers for Disease Control, as well as approximately 6.2 million puncture site wounds according to Millennium Research Group's report on US Markets for Vascular Access. The US market when combined with the military requirements exceeds \$150 million. The topical hemostatic is anticipated to require a 510(k) and poses a low regulatory risk. The Covalon team is investigating the value of entering the surgical hemostatic market. Although the market is large the regulatory risk is greater. The Covalon platform for this application has advantages over the current market leaders. As expected, limited clinical trials are expected. The Company intends to evaluate the risk/return of entering this market and make a decision in 2008.

Dental

Dental extractions in the US exceed 50 million per year and incidence of alveolar osteitis ranges between 5% and 40%. The treatment of the condition is painful, time consuming and expensive and no current product offering is effective. The Covalon team has determined that its collagen platform could be useful for developing a product for this need. The regulatory pathway for the product has low to moderate risk. The Company is in the design and development phase for this product and looks forward to providing news of its development.

Vascular

The Covalon collagen platform appears to have advantages for a variety of applications in the vascular market including coatings on stents and vascular wraps. The properties of the denatured collagen portion of the technology appear to offer some advantages that may be desired by the current device manufacturers in this market. The Company recognizes that development in this market will require consideration of the higher regulatory risks. The Company has received "freedom to operate" opinions for the intended applications. The returns are high for successful technologies in this market niche but development is expensive. The Company is evaluating its development strategy and looks forward to more communications on this development.

Orthopedics

Soft tissue repair, connective tissue damage, bone/tissue integration continues to be a significant problem in orthopedics. The Covalon Collagen platform appears to have some

unique features that may be beneficial. The total orthopedic market in the US alone exceeds \$2 billion. Developments may include collagen pads for shoulder cuff repairs, ACL scaffolds, small joint plugs and coatings on implants. The regulatory risk in this niche is moderate to high but the relative return is high. The Covalon directors and executive have a wide range of experience in this market niche and are currently working on selecting the best targets for the technology platform.

Neurological

The neurology related applications for the collagen platform are high unit price, high value opportunities. The Covalon team has identified applications such as dura patches and nerve wraps as opportunities. According to "Effect of Populations Trends on the Spine Surgery market in the U.S." (22 Mar 2004, Balaji Ramamurti, Industry Analyst, Frost & Sullivan) there are approximately 250,000 spinal surgery interventions a year. Covalon estimates the market for these products exceed \$250 million. The Company looks forward to more communications on developments in this market niche.

12. Disclosure Controls

The Company continues to formalize procedures and control measures that are already in place and to introduce new ones to ensure good evaluation and control practices. As of September 30, 2007, the Company's Management evaluated the effectiveness of the design and operation of its disclosure controls and procedures as defined under the rules. The evaluation was performed under the supervision, and with the participation, of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on the evaluation of the Disclosure Controls, the CEO and the CFO have concluded that, subject to the fact that an evaluation of controls can provide only reasonable, not absolute, assurance that all control issues and instances of fraud or error, if any, within the Company have been detected, the Company's Disclosure Controls are effective in providing reasonable assurance that material information relating to the Company is made known to Management. Changes and new controls are evaluated and implemented as required to provide greater business control.

13. Internal Controls over Financial Reporting

The design of internal controls over financial reporting ("ICFR") within the Company is a Management responsibility to provide reasonable assurance that the reliability of financial reporting and that the preparation of financial statements for external purposes follow Canadian generally accepted accounting principles. While the CEO and CFO believe that the internal controls are adequate to provide the above information, a process is underway to evaluate and document all policies and procedures that could impact financial reporting. Shareholders should be aware that Covalon is a small sized company without the departmental resources associated with larger firms and consequently the on-going changes imposed by the accounting industry and securities regulators are an added burden for your Company. Notwithstanding, examination of the Company's process for segregation of duties, compliance with accounting standards and assurance that the consolidated financial statements meet all material reporting requirements is reviewed quarterly and updated within the limitations of the resources of the Company.