

Covalon Technologies Ltd.

Consolidated Financial Statements

For the period ending March 31, 2007

(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	9-13

Covalon Technologies Ltd.

Consolidated Balance Sheets

(Unaudited - prepared by management)

	March 31, 2007	September 30, 2006
Assets		
Current assets		
Cash and cash equivalents	\$ 6,458,215	\$ 5,011,642
Accounts receivable	236,291	232,153
Refundable investment tax credits	-	65,400
Inventories	363,399	269,399
Prepaid expenses	100,963	61,971
	<u>7,158,868</u>	<u>5,640,565</u>
Capital assets (Note 1)	449,638	440,611
Other assets (Note 2)	422,573	302,023
Deferred developments costs (Note 3)	2,352,489	2,410,189
	<u>\$ 10,383,568</u>	<u>\$ 8,793,388</u>

Liabilities and Shareholders' Equity

Current

Accounts payable and accrued liabilities	\$ 528,357	\$ 506,720
Deferred revenue (Note 4)	2,284,182	20,715
	<u>2,812,539</u>	<u>527,435</u>

Shareholders' Equity

Share Capital (Note 5 (b))	15,984,398	15,828,922
Contributed Surplus	316,604	340,297
Warrants (Note 5 (b))	952,428	927,479
Options (Note 5 (c))	475,810	418,739
Deficit	(10,158,211)	(9,249,484)

<u>7,571,029</u>	<u>8,265,953</u>
<u>\$ 10,383,568</u>	<u>\$ 8,793,388</u>

On behalf on the Board

"Frank DiCosmo"

Director

"William Jackson"

Director

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

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

	For the six months ended March 31,	
	<u>2007</u>	<u>2006</u>
Deficit, beginning of year	\$ (9,249,484)	\$ (7,044,494)
Loss for the period	<u>(908,727)</u>	<u>(1,002,225)</u>
Deficit, end of period	<u>\$ (10,158,211)</u>	<u>\$ (8,046,719)</u>

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

Covalon Technologies Ltd.
Consolidated Statements Of Operations
For the three months and six months ended March 31
(Unaudited - prepared by management)

	Three months ended March 31,		Six months ended March 31,	
	2007	2006	2007	2006
Sales	\$ 357,401	\$ 124,133	\$ 695,168	\$ 261,226
Cost of goods sold	<u>189,077</u>	<u>68,712</u>	<u>387,844</u>	<u>130,419</u>
	168,324	55,421	307,324	130,807
Other revenue				
Interest income	47,737	7,546	98,904	9,146
Licensing fee	<u>56,373</u>	<u>1,361</u>	<u>57,734</u>	<u>2,722</u>
	<u>272,434</u>	<u>64,328</u>	<u>463,962</u>	<u>142,675</u>
Expenses				
Amortization of capital assets	25,497	25,930	49,425	51,723
Amortization of patents	599	5,439	10,659	10,252
Amortization of deferred development costs	28,850	35,930	57,700	35,930
Bank charges and interest	704	1,264	2,257	1,995
Consulting fees	-	58,203	-	71,406
Directors' fees	97,910	6,500	119,276	29,000
Foreign currency (gain) loss	1,626	(1,083)	1,817	(1,813)
Management fees	88,730	77,500	166,230	155,000
Marketing	35,463	33,475	128,652	69,360
Office and administrative	126,123	91,644	225,456	173,576
Patent maintenance	400	6,150	600	6,200
Professional fees	9,133	10,997	23,279	31,980
Property maintenance	2,144	4,463	3,584	5,904
Regulatory	132,488	61,537	215,541	110,152
Research and development	211,801	185,635	327,257	348,424
Training - professional development	-	639	9,606	977
Travel	<u>18,322</u>	<u>19,847</u>	<u>31,350</u>	<u>44,834</u>
	<u>779,790</u>	<u>624,070</u>	<u>1,372,689</u>	<u>1,144,900</u>
Loss for the period	<u>\$ (507,356)</u>	<u>\$ (559,742)</u>	<u>\$ (908,727)</u>	<u>\$ (1,002,225)</u>
Loss per share (Note 5 (d))	<u>\$ (0.009)</u>	<u>\$ (0.01)</u>	<u>\$ (0.016)</u>	<u>\$ (0.02)</u>

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

Covalon Technologies Ltd.

Consolidated Statements of Cash flows

For the three months and six months ended March 31

(Unaudited - prepared by management)

	Three months ended March 31,		Six months ended March 31,	
	2007	2006	2007	2006
Cash flows from operating activities				
Loss for the period	\$ (507,356)	\$ (559,742)	\$ (908,727)	\$ (1,002,225)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities				
Amortization of capital assets	25,497	25,930	49,425	51,723
Amortization of patent and technology rights	599	5,439	10,659	10,252
Amortization of deferred development costs	28,850	35,930	57,700	35,930
Stock compensation expense	63,803	-	63,803	-
Foreign exchange (gain) loss	1,626	-	1,817	-
Changes in non-cash working capital balances				
Accounts receivable	88,770	4,167	(4,138)	(93,128)
Inventories	(43,082)	69,636	(94,000)	(34,509)
Prepaid expenses	28,590	23,098	(38,992)	(4,900)
Accounts payable and accrued liabilities	(41,676)	(216,665)	21,636	(38,901)
Deferred revenue	2,264,828	(1,351)	2,263,467	(2,722)
	<u>1,910,449</u>	<u>(613,558)</u>	<u>1,422,650</u>	<u>(1,078,480)</u>
Cash flows from investing activities				
Purchase of capital assets (net of disposals and investment tax credits)	33,533	203,283	6,948	179,620
Purchase of patents and technology rights	(98,893)	(22,433)	(131,208)	(38,616)
	<u>(65,360)</u>	<u>180,850</u>	<u>(124,260)</u>	<u>141,004</u>
Cash flows from financing activities				
Net proceeds on issuance of share capital	50,000	6,267,878	150,000	6,267,878
Foreign exchange gain (loss) on cash held	(1,626)	-	(1,817)	-
Increase in cash and cash equivalents during the period	<u>1,893,463</u>	<u>5,835,170</u>	<u>1,446,573</u>	<u>5,330,402</u>
Cash and cash equivalents, beginning of period	<u>4,564,752</u>	<u>139,236</u>	<u>5,011,642</u>	<u>644,004</u>
Cash and cash equivalents, end of period	<u>\$ 6,458,215</u>	<u>\$ 5,974,406</u>	<u>\$ 6,458,215</u>	<u>\$ 5,974,406</u>

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

Covalon Technologies Ltd.
Summary of Significant Accounting Policies
March 31, 2007
(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> <ol 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 are initially recorded as deferred revenue and recognized over the period of the relevant agreements.c) 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
March 31, 2007
(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
March 31, 2007
(Unaudited – prepared by management)

Foreign Currency Translation	<p>Foreign currency accounts are translated into Canadian dollars as follows:</p> <p>At the transaction date, each asset, liability, revenue and expense is translated into Canadian dollars by the use of the exchange rate in effect at that date. At the reporting date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate in effect at that date. The resulting foreign exchange gains and losses are included in income in the current period.</p>
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
March 31, 2007
(Unaudited – prepared by management)

1. Capital Assets

	<u>March 31, 2007</u>		<u>September 30, 2006</u>	
	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Cost</u>	<u>Accumulated Amortization</u>
Furniture and fixtures	\$ 109,898	\$ 38,082	\$ 98,332	\$ 30,744
Lab Equipment	581,154	238,306	534,267	202,844
Leasehold improvements	66,266	31,292	66,265	24,665
	<u>757,318</u>	<u>307,680</u>	<u>698,864</u>	<u>258,253</u>
Cost less accumulated amortization		<u>\$ 449,638</u>		<u>\$ 440,611</u>

2. Other Assets

	<u>March 31, 2007</u>	<u>September 30, 2007</u>
Patents and technology rights (net of \$107,705 accumulated amortization Sep 2006 - \$73,005)	\$ 422,573	\$ 253,005
Deferred acquisition costs	-	49,018
	<u>\$ 422,573</u>	<u>\$ 302,023</u>

3. Deferred Development Costs

	<u>March 31, 2007</u>	<u>September 30, 2007</u>
Cost	\$ 2,525,590	\$ 2,525,590
Less: accumulated depreciation	173,101	115,401
	<u>\$ 2,352,489</u>	<u>\$ 2,410,189</u>

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements
March 31, 2007
(Unaudited – prepared by management)

4. Deferred Revenue

The Company received an exclusivity milestone payment of US\$2,000,000 from Smith and Nephew. This payment represents milestone commitments from Smith and Nephew for the next two years. The Company has recorded the exclusivity payment as a deferred revenue and is recording licensing fee revenue monthly for the 24 month initial exclusivity period of the agreement.

5. 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
Warrants exercised	65,000	(65,000)	17,551	(4,076)
Warrants granted		25,000		29,025
Options exercised	275,000		137,925	
Balance, March 31, 2007	56,662,784	14,752,328	\$ 15,984,398	\$ 952,428

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 three month period ending December 31, 2006, 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.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements
March 31, 2007
(Unaudited – prepared by management)

In the three month period ending March 31, 2007, 25,000 options to purchase common shares with a value of \$5,925 were exercised for cash consideration of \$7,500.

A total of 40,000 warrants to purchase common shares with an exercise price of \$0.75 per warrant with a value of \$2,508 were exercised for consideration of \$30,000 during the three month period ending March 31, 2007.

In the three month period ending March 31, 2007, 25,000 broker warrants with an exercise price of \$0.50 and value of \$1,568 were exercised for cash consideration of \$12,500. Upon the exercise of the broker warrants the holder was issued 25,000 common share purchase warrants with an exercise price of \$0.75 per warrant and a value of \$29,025.

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:

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements
March 31, 2007
(Unaudited – prepared by management)

	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	(450,000)	(94,580)	
Balance, September 30, 2006	3,215,582	442,432	
Exercised	(275,000)	(30,425)	\$ 0.40
Granted to related parties	975,000	35,950	\$ 1.53
Granted to related parties	100,000	7,163	\$ 1.22
Vested to related parties		20,690	\$ 0.50
Balance, March 31, 2007	4,015,582	\$ 475,810	

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.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements
March 31, 2007
(Unaudited – prepared by management)

361,000 options with a value of \$91,848 were exercised for common shares for cash consideration of \$115,545.

In the three month period ended March 31, 2007, 25,000 options to purchase common shares with a value of \$5,925 were exercised for cash consideration of \$7,500.

Total Stock options of 1,075,000 were granted to related parties during the three month period ending March 31, 2007. Of the total options granted, 100,000 options have an exercise price of \$1.22 per share and expiry date of March 20, 2010 and 12,500 vested in the period for a value of \$7,163 which was expensed; 825,000 options have an exercise price of \$1.53 per share and expiry date of March 27, 2010 and 50,000 vested in the period for a value of \$35,950 which was expensed; and 150,000 options have an exercise price of \$1.53 per share and expiry date of March 27, 2012 and 25,000 vested in the period for a value of \$22,559 which was expensed.

The fair market value of options granted in the three month period ending March 31, 2007 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.

(d) Loss per Share

Loss per share is calculated using the weighted average number of common shares outstanding during the period ended March 31, 2007, which is 56,529,452 (2006 - 48,183,853) shares. Fully diluted loss per share for the periods ended March 31, 2007 and March 31, 2006 have not been presented since the potential conversions of options and warrants outstanding are anti-dilutive.