

# Covalon Technologies Ltd.

Consolidated Financial Statements

For the period ending June 30, 2007

(Unaudited – prepared by management)

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## **NOTICE OF NO REVIEW BY AUDITOR**

In accordance with National Instrument 51-102 **Continuous Disclosure Obligations** of the Canadian Securities Administrators, WE HEREBY GIVE NOTICE THAT our financial statements for the three-month period ended June 30, 2007, which follow this notice, have not been reviewed by our auditors.

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

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# Covalon Technologies Ltd.

## Consolidated Balance Sheets

(Unaudited - prepared by management)

	June 30, 2007	September 30, 2006
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 6,985,051	\$ 5,011,642
Accounts receivable	413,877	232,153
Refundable investment tax credits	-	65,400
Inventories	359,209	269,399
Prepaid expenses	262,499	61,971
	<b>8,020,636</b>	5,640,565
Capital assets (Note 1)	572,358	440,611
Other assets (Note 2)	494,611	302,023
Deferred developments costs (Note 3)	2,323,638	2,410,189
	<b>\$ 11,411,243</b>	<b>\$ 8,793,388</b>

## Liabilities and Shareholders' Equity

<b>Current</b>		
Accounts payable and accrued liabilities	\$ 686,007	\$ 506,720
Deferred revenue (Note 4)	1,993,276	20,715
	<b>2,679,283</b>	527,435
<b>Shareholders' Equity</b>		
Share Capital (Note 5 (b))	16,655,970	15,828,922
Contributed Surplus	316,604	340,297
Warrants (Note 5 (b))	2,034,182	927,479
Options (Note 5 (c))	626,019	418,739
Deficit	(10,900,815)	(9,249,484)
	<b>8,731,960</b>	8,265,953
	<b>\$ 11,411,243</b>	<b>\$ 8,793,388</b>

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.

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

	For the nine months ended June 30,	
	<u>2007</u>	<u>2006</u>
<b>Deficit</b> , beginning of year	<b>\$ (9,249,484)</b>	\$ (7,044,417)
<b>Loss</b> for the period	<u><b>(1,651,331)</b></u>	<u>(1,520,321)</u>
<b>Deficit</b> , end of period	<u><b>\$ (10,900,815)</b></u>	<u>\$ (8,564,738)</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 nine months ended June 30**  
(Unaudited - prepared by management)

	Three months ended June 30,		Nine months ended June 30,	
	2007	2006	2007	2006
<b>Sales</b>	\$ 203,421	\$ 351,226	\$ 898,589	\$ 612,453
<b>Cost of goods sold</b>	138,433	230,233	526,276	360,652
	64,988	120,993	372,313	251,801
<b>Other revenue</b>				
Interest income	65,914	50,476	164,818	59,622
Licensing fee	290,906	1,361	348,640	4,082
	421,808	172,830	885,771	315,505
<b>Expenses</b>				
Amortization of capital assets	36,707	26,439	86,132	78,162
Amortization of patents	5,323	6,092	15,982	16,344
Amortization of deferred development costs	28,850	17,965	86,550	53,895
Bank charges and interest	641	768	2,898	2,763
Consulting fees	-	27,703	-	99,109
Directors' fees	137,299	10,100	256,575	39,100
Foreign currency (gain) loss	37,382	(37)	39,199	(1,850)
Management fees	153,017	77,500	319,247	232,500
Marketing	49,068	69,706	177,721	139,066
Office and administrative	132,339	93,701	357,795	267,277
Patent maintenance	802	1,091	1,402	7,291
Professional fees	32,600	28,892	55,879	60,873
Property maintenance	2,164	1,440	5,748	7,343
Regulatory	140,493	113,928	356,034	224,080
Research and development	376,126	187,464	703,383	535,888
Training - professional development	3,458	-	13,064	977
Travel	28,143	28,175	59,493	73,009
	1,164,412	690,927	2,537,102	1,835,827
<b>Loss for the period</b>	\$ (742,604)	\$ (518,097)	\$ (1,651,331)	\$ (1,520,322)
<b>Loss per share (Note 5 (d))</b>	\$ (0.01)	\$ (0.009)	\$ (0.03)	\$ (0.027)

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 nine months ended June 30  
(Unaudited - prepared by management)

	Three months ended June 30,		Nine months ended June 30,	
	2007	2006	2007	2006
<b>Cash flows from operating activities</b>				
Loss for the period	\$ (742,604)	\$ (518,097)	\$ (1,651,331)	\$ (1,520,322)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities				
Amortization of capital assets	36,707	26,439	86,132	78,162
Amortization of patent and technology rights	5,323	6,092	15,982	16,344
Amortization of deferred development costs	28,850	17,965	86,551	53,895
Stock compensation expense	186,438	-	250,243	-
Foreign exchange (gain) loss	37,382	-	39,199	-
Changes in non-cash working capital balances				
Accounts receivable	(177,586)	(88,729)	(181,724)	(181,857)
Inventories	4,190	(39,778)	(89,810)	(74,287)
Prepaid expenses	(161,536)	8,322	(200,528)	3,422
Accounts payable and accrued liabilities	157,647	(141,079)	179,281	(179,980)
Deferred revenue	(290,906)	(1,361)	1,972,561	(4,082)
	<u>(916,095)</u>	<u>(730,226)</u>	<u>506,556</u>	<u>(1,808,705)</u>
<b>Cash flows from investing activities</b>				
Purchase of capital assets (net of disposals and investment tax credits)	(159,427)	(7,694)	(152,479)	171,925
Purchase of patents and technology rights	(77,361)	(38,249)	(208,570)	(76,866)
	<u>(236,788)</u>	<u>(45,943)</u>	<u>(361,049)</u>	<u>95,059</u>
<b>Cash flows from financing activities</b>				
Net proceeds on issuance of share capital	1,717,101	261,378	1,867,101	6,529,255
Foreign exchange gain (loss) on cash held	(37,382)	-	(39,199)	-
<b>Increase in cash and cash equivalents during the period</b>	<b>526,836</b>	<b>(514,791)</b>	<b>1,973,409</b>	<b>4,815,610</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>6,458,215</b>	<b>5,974,405</b>	<b>5,011,642</b>	<b>644,004</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 6,985,051</b>	<b>\$ 5,459,614</b>	<b>\$ 6,985,051</b>	<b>\$ 5,459,614</b>

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  
June 30, 2007  
(Unaudited – prepared by management)

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Basis of Presentation	<p>The financial statements of the Company have been prepared by management in accordance with Canadian generally 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"><li>a) Revenue arising from product sales is recognized once the product has been shipped to the customer.</li><li>b) Revenue arising from licensing fees and royalties are initially recorded as deferred revenue and recognized over the period of the relevant agreements.</li><li>c) Revenue arising from interest is recognized as earned.</li></ol>
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.**  
Notes to Consolidated Financial Statements  
June 30, 2007  
(Unaudited – prepared by management)

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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.**  
Notes to Consolidated Financial Statements  
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Foreign Currency Translation	<p>Foreign currency accounts are translated into Canadian dollars as follows:</p> <p>At the transaction date, each 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  
June 30, 2007  
(Unaudited – prepared by management)

**1. Capital Assets**

	June 30, 2007		September 30, 2006	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 141,055	\$ 44,087	\$ 98,332	\$ 30,744
Lab Equipment	709,424	265,695	534,267	202,844
Leasehold improvements	66,266	34,605	66,265	24,665
	<b>916,745</b>	<b>344,387</b>	698,864	258,253
Cost less accumulated amortization		<b>\$ 572,358</b>		\$ 440,611

**2. Other Assets**

	June 30, 2007	September 30, 2006
Patents and technology rights (net of \$110,028 accumulated amortization Sep 2006 - \$73,005)	\$ 494,611	\$ 253,005
Deferred acquisition costs	-	49,018
	<b>\$ 494,611</b>	<b>\$ 302,023</b>

**3. Deferred Development Costs**

	June 30, 2007	September 30, 2006
Cost	\$ 2,525,589	\$ 2,525,590
Less: accumulated depreciation	201,951	115,401
	<b>\$ 2,323,638</b>	<b>\$ 2,410,189</b>

**Covalon Technologies Ltd.**  
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**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 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	2,624,088	(2,624,088)	2,910,760	(1,214,126)
Warrants granted		1,085,728	(2,320,829)	2,320,829
Options exercised	445,000		237,117	
Balance, June 30, 2007	59,391,872	13,253,968	\$ 16,655,970	\$ 2,034,182

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.

**Covalon Technologies Ltd.**  
Notes to Consolidated Financial Statements  
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**Summary of common share purchases for the nine months ended June 30, 2007**

Description of Transaction	Quarter	Number of shares issued	Value	Cash consideration
Exercise of options with an exercise price of \$0.40	Q1	250,000	\$24,500	\$100,000
Issue of 1,100,000 common shares into escrow for Acquisition of technology from Perfusion Therapeutics	Q1			
Exercise of options with an exercise price of \$0.30	Q2	25,000	\$5,925	\$7,500
Exercise of warrants with an exercise price of \$0.75	Q2	40,000	\$2,508	\$30,000
Exercise of warrants with an exercise price of \$0.75	Q2	1,046,600	\$65,622	\$784,950
Exercise of broker warrants with an exercise price of \$0.50	Q2	25,000	\$1,568	\$12,500
Exercise of options	Q3	170,000	\$36,225	\$62,967
Exercise of broker warrants with an exercise price of \$0.50	Q3	1,060,728	\$66,507	\$530,364
Exercise of warrants with an exercise price of \$0.75 issued to brokers upon the exercise of broker warrants with an exercise price of \$0.50	Q3	451,760	\$1,077,921	\$338,820
<b>Total</b>		<b>3,069,088</b>	<b>\$1,280,778</b>	<b>\$1,867,101</b>

**Covalon Technologies Ltd.**  
Notes to Consolidated Financial Statements  
June 30, 2007  
(Unaudited – prepared by management)

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**Issuance of warrants to purchase common shares for the nine month period ended June 30, 2007**

<b>Description of Transaction</b>	<b>Quarter</b>	<b>Number of shares issued</b>	<b>Value</b>
Warrants with an exercise price of \$0.75 per share issued to brokers upon the exercise of broker warrants with an exercise price of \$0.50	Q1	25,000	\$29,025
Warrants with an exercise price of \$0.75 per share issued to brokers upon the exercise of broker warrants with an exercise price of \$0.50	Q2	1,060,728	\$2,291,804
<b>Total</b>		<b>1,085,728</b>	<b>\$2,320,829</b>

**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  
June 30, 2007  
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	Number of Options	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	
Exercised	(361,000)	(91,848)	
Expired	(450,000)	(94,580)	
Balance, September 30, 2006	3,215,582	442,432	
Granted to related parties	975,000		\$ 1.53
Granted to employees	100,000		\$ 1.22
Vested to related parties		235,913	
Vested to employees		14,326	
Exercised	(445,000)	(66,652)	
Balance, June 30, 2007	3,845,582	\$ 626,019	

As at June 30, 2007, 2,517,457 options were available for exercise.

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 value of 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  
June 30, 2007  
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**Issuance of Options for the nine month period ended June 30, 2007**

Description of Transaction	Date	Options issued	Option price	Valuation Price	Expiry date
Options issued	March 20, 2007	100,000	\$1.22	\$0.58	July 17, 2010
Options issued	March 27, 2007	50,000	\$1.53	\$0.72	July 10, 2010
Options issued	March 27, 2007	675,000	\$1.53	\$0.72	March 27, 2010
Options issued	March 27, 2007	100,000	\$1.53	\$0.72	July 10, 2010
Options issued	March 27, 2007	75,000	\$1.53	\$0.90	July 10, 2012
Options issued	March 27, 2007	75,000	\$1.53	\$0.90	July 10, 2012
Total		1,075,000			

The fair market value of options granted in the nine month period ending June 30, 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.

**Options vesting for the nine month period ended June 30, 2007**

Description of Transaction	Quarter	Valuation
Options vested	Q1	-
Options vested	Q2	63,803
Options vested	Q3	186,438

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.

In the three month period ended June 30, 2007, 170,000 options to purchase common shares with a value of \$36,225 were exercised for cash consideration of \$62,967.

**Covalon Technologies Ltd.**  
Notes to Consolidated Financial Statements  
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(d) Loss per Share

Loss per share is calculated using the weighted average number of common shares outstanding during the period ended June 30, 2007, which is 57,283,379 (2006 - 56,308,185) shares. Fully diluted loss per share for the periods ended June 30, 2007 and June 30, 2006 have not been presented since the potential conversions of options and warrants outstanding are anti-dilutive.