

Covalon Technologies Ltd.

Consolidated Financial Statements

For the period ending December 31, 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 December 31, 2007, which follow this notice, have not been reviewed by our auditors.

Covalon Technologies Ltd.

Interim Consolidated Balance Sheets

As at December 31, 2007 and September 30, 2007

(Unaudited - prepared by management)

	December 31, 2007	Audited September 30, 2007
Assets		
Current assets		
Cash and cash equivalents	\$ 6,296,374	\$ 6,917,897
Short term investments	9,249,059	9,252,103
Accounts receivable	297,259	320,239
Inventories	186,418	279,331
Prepaid expenses	166,568	204,512
	<u>16,195,678</u>	16,974,082
Capital assets (Note 3)	562,081	580,661
Other assets (Note 4)	573,279	484,368
Deferred developments costs (Note 5)	2,176,167	2,205,350
	<u>\$ 19,507,205</u>	<u>\$ 20,244,461</u>

Liabilities and Shareholders' Equity

Current		
Accounts payable and accrued liabilities	\$ 495,931	\$ 673,357
Deferred revenue (Note 6)	1,866,789	1,977,904
	<u>2,362,720</u>	2,651,261
Shareholders' Equity		
Share Capital (Note 7 (b))	28,792,772	28,664,432
Contributed Surplus	329,004	329,004
Options (Note 7 (c))	1,024,577	925,625
Deficit	(13,001,868)	(12,325,861)
	<u>17,144,485</u>	17,593,200
	<u>\$ 19,507,205</u>	<u>\$ 20,244,461</u>

On behalf on the Board

Director

Director

Covalon Technologies Ltd.

Interim Consolidated Statements of Deficit

For the three months ended December 31, 2007 and December 31, 2006
(Unaudited - prepared by management)

	2007	2006
Deficit , beginning of period	\$ (12,325,861)	\$ (9,249,484)
Loss for the period	<u>(676,007)</u>	<u>(401,371)</u>
Deficit , end of period	<u>\$ (13,001,868)</u>	<u>\$ (9,650,855)</u>

Covalon Technologies Ltd.

Interim Consolidated Statements of Operations and Comprehensive Income

For the three months ended December 31, 2007 and December 31, 2006

(Unaudited - prepared by management)

	2007	2006
Sales	\$ 607,335	\$ 337,767
Cost of goods sold	338,408	198,767
	268,927	139,000
Other revenue		
Interest income	212,443	51,167
Licensing fee	111,115	1,361
	592,485	191,528
Expenses		
Amortization of capital assets	30,744	23,928
Amortization of patents and technology rights	7,080	10,060
Amortization of deferred development costs	29,183	28,850
Bank charges and interest	843	1,553
Directors' fees	79,148	21,366
Foreign currency loss	7,715	192
Management fees	135,786	77,500
Marketing	41,972	93,188
Office and administrative	196,184	99,333
Patent maintenance	-	200
Professional fees	42,179	14,146
Property maintenance	2,307	1,440
Regulatory	233,274	83,053
Research and development	441,131	115,456
Training - professional development	3,377	9,606
Travel	17,569	13,028
	1,268,492	592,899
Loss and comprehensive income for the period	\$ (676,007)	\$ (401,371)
Basic and fully diluted loss per share (Note 7 (d))	\$ (0.01)	\$ (0.01)

Covalon Technologies Ltd.

Interim Consolidated Statements of Cash Flows

For the three months ended December 31, 2007 and December 31, 2006

(Unaudited - prepared by management)

	2007	2006
Cash flows from operating activities		
Loss for the period	\$ (676,007)	\$ (401,371)
Add (deduct) items not involving cash:		
Amortization of capital assets	30,744	23,928
Amortization of patent and technology rights	7,080	10,060
Amortization of deferred development costs	29,183	28,850
Stock compensation expense	109,292	-
Foreign exchange loss	7,715	192
Cash provided by operating activities before change in non-cash working capital balances	<u>(491,993)</u>	<u>(338,341)</u>
Change in non-cash working capital (Note 11)	<u>(134,704)</u>	<u>(149,458)</u>
	<u>(626,697)</u>	<u>(487,799)</u>
Cash flows from investing activities		
Purchase of capital assets (net of disposals and investment tax credits)	(12,164)	(26,584)
Purchase of patents and technology rights	(13,491)	(32,315)
Redemption of short term investments	3,044	-
	<u>(22,611)</u>	<u>(58,899)</u>
Cash flows from financing activities		
Net proceeds on issuance of share capital	<u>35,500</u>	<u>100,000</u>
Foreign exchange loss on cash held	<u>(7,715)</u>	<u>(192)</u>
Net Change in cash and cash equivalents during the period	(621,523)	(446,890)
Cash and cash equivalents, beginning of period	<u>6,917,897</u>	<u>5,011,642</u>
Cash and cash equivalents, end of period	<u>\$ 6,296,374</u>	<u>\$ 4,564,752</u>

Covalon Technologies Ltd.
Interim Consolidated Statements of Shareholders' Equity
For the period ending December 31, 2007
(Unaudited - prepared by management)

	Share Capital		Contributed Surplus	Warrants	Options	Deficit	Total
	Number of Shares	Amount					
Balance, September 30, 2006	56,322,784	\$ 15,828,922	\$ 340,297	\$ 927,479	\$ 418,739	\$ (9,249,484)	\$ 8,265,953
Issue of warrants pursuant to the exercise of broker compensation warrants		(2,338,229)		2,338,229			-
Issue of common shares for cash pursuant to the exercise of warrants	15,888,056	14,907,819		(3,265,708)			11,642,111
Issue of common shares for cash pursuant to the exercise of stock options	501,194	265,920			(71,287)		194,633
Options reinstated to consultant Stock based compensation			(23,693)		23,693		-
Expired stock options			12,400		(12,400)		-
Net loss						(3,076,377)	(3,076,377)
Balance, September 30, 2007	72,712,034	\$ 28,664,432	\$ 329,004	\$ -	\$ 925,625	\$ (12,325,861)	\$ 17,593,200
Issue of common shares for cash pursuant to the exercise of stock options	65,000	45,840			(10,340)		35,500
Issue of common shares to Perfusion Therapeutics Inc.	25,000	82,500					82,500
Stock based compensation					109,292		109,292
Net loss						(676,007)	(676,007)
Balance, December 31, 2007	72,802,034	\$ 28,792,772	\$ 329,004	\$ -	\$ 1,024,577	\$ (13,001,868)	\$ 17,144,485

Covalon Technologies Inc.
Summary of Significant Accounting Policies
Unaudited – prepared by management

December 31, 2007 and 2006

Nature of Business	<p>The Company is incorporated under the laws of Ontario and is engaged in the business of developing medical products. In prior years, up to and including the year ending September 30, 2005, the Company focused its efforts on research and development and the raising of capital to fund the development of medical products. Accordingly, the Company was considered to be in the development stage. The Company has now received regulatory approval on numerous products and is currently generating revenue. The Company's main business function has changed to manufacturing and sales; accordingly the Company is no longer considered a Development Stage Company. All research and development costs subsequent to September 30, 2005 are now expensed as incurred.</p>
Basis of Presentation	<p>The accompanying unaudited interim consolidated financial statements have been prepared by management in accordance with the Canadian generally accepted accounting principles and on a basis consistent with the Company's annual audited financial statements for the year ended September 30, 2007. These statements should be read in conjunction with the September 30, 2007 audited financial statements.</p> <p>The current period's consolidated financial statements include the operations of the Company for the three month period ended December 31, 2007. These consolidated financial statements have not been reviewed by the Company's auditor.</p>
Basis of Consolidation	<p>These financial statements have been prepared using the purchase method of consolidation. The assets and liabilities of the acquired companies are initially recorded at cost. The results of operations of the acquired companies are included from the dates of acquisition. All significant intercompany transactions and balances have been eliminated on consolidation.</p>
Revenue Recognition	<p>Revenue is recognized on an accrual basis as follows:</p> <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 is 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 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 Inc.
Summary of Significant Accounting Policies
Unaudited – prepared by management

December 31, 2007 and 2006

Capital Assets	<p>Capital assets are recorded at cost less related investment tax credits. Amortization is based on the estimated useful life of the asset and is calculated as follows:</p> <table><tr><td>Furniture and fixtures</td><td>- 20% diminishing balance basis</td></tr><tr><td>Lab equipment</td><td>- 20% diminishing balance basis</td></tr><tr><td>Leasehold improvements</td><td>- straight-line basis over 5 years</td></tr></table>	Furniture and fixtures	- 20% diminishing balance basis	Lab equipment	- 20% diminishing balance basis	Leasehold improvements	- straight-line basis over 5 years
Furniture and fixtures	- 20% diminishing balance basis						
Lab equipment	- 20% diminishing balance basis						
Leasehold improvements	- straight-line basis over 5 years						
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 meet generally accepted criteria, including reasonable assurance regarding recoverability, are deferred and amortized from the beginning of commercial production and sales. Annually the Company reviews the recoverability of deferred development costs through evaluation of the expected future cash inflows from commercialization of the associated products to determine if there is an impairment in the recoverable amount.</p> <p>Development costs for each product (project) are amortized when the product regulatory approval to sell the product is received, on a straight-line basis over the years remaining on the patent.</p>						
Investment Tax Credits	<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 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.</p>						
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>						

Covalon Technologies Inc.
Summary of Significant Accounting Policies
Unaudited – prepared by management

December 31, 2007 and 2006

Financial instruments	<p>Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest and currency risks arising from its financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.</p> <p>All of the Company's cash is maintained by one of the major financial institutions.</p> <p>Short term investments consist of Ontario Savings Bonds (interest rate of 5.7% and maturing on December 1, 2008) and the carrying value approximates fair market value.</p> <p>As at December 31, 2007, two customers accounted for 97% (September 2007 – three customers for 95%) of the accounts receivable balance. These customers, who act as distributors of the Company's product, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers.</p>
Stock Based Compensation	<p>Direct awards of stock are based on the price of common stock measured at fair value at each reporting date, with the change in fair value reported in the statement of operations.</p> <p>The Company uses the fair value based method of accounting for all its stock-based compensation. Accordingly, the fair value method of accounting is applied for stock options granted to directors, officers, employees and consultants whereby the weighted average fair value of options granted is recognized in the financial statements over the vesting period. When the awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to options.</p>
Use of Estimates	<p>The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from management's best estimate as additional information becomes available in the future.</p>
Loss per Common Share	<p>Loss per common share has been computed by dividing the loss applicable to common shareholders by the weighted average number of shares of common stock outstanding during the respective years.</p>
Impairment of Long-Lived Assets	<p>An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes the assets' carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the asset and its carrying value. Management has determined that there is no impairment of long-lived assets.</p>

Covalon Technologies Inc.
Notes to Consolidated Financial Statements
Unaudited – prepared by management

December 31, 2007 and 2006

1. Going Concern

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 to liquidate, cease trading or cease operations. These consolidated financial statements are prepared on a going concern basis. Accordingly, they do not give effect to adjustments that would be necessary should the Company be unable to realize its assets at the amounts recorded and discharge its liabilities in other than the normal course of business. The Company's continued existence as a going concern is dependent upon the continued support of shareholders and achieving profitable operations.

The financial statements do not reflect adjustments that would be necessary if the going concern assumption was not appropriate. If the going concern basis was not appropriate for these financial statements, then adjustments, which may be material, would be necessary to the carrying value of assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used.

2. New Accounting Standards

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. Management has determined that the application of Section 1506 did not have any impact on the unaudited interim consolidated financial statements for the three month period ending December 31, 2007.

In December 2006, the CICA issued Handbook Section 1535, Capital Disclosures, (Section 1535), effective for interim and annual periods relating to fiscal years beginning on or after October 1, 2007. Section 1535 specifies disclosures of (1) information about the entity's objectives, policies, and processes for managing capital structure; (2) quantitative data about what the entity regards as capital; and (3) whether the entity has complied with externally imposed capital requirements (for example bank covenants) and if it has not complied, the consequences of such non-compliance. The Company does not expect the adoption of this standard to have a material impact on its financial position and results of operations. Management has determined that the application of Section 1535 did not have any impact on the unaudited interim consolidated financial statements for the three month period ending December 31, 2007.

In December 2006, the CICA released Handbook Section 3862, Financial Instruments – Disclosure, (Section 3862), and Handbook Section 3863, Financial Instruments – Presentation, (Section 3863), which replace Handbook Section 3861, Financial Instruments – Disclosure and Presentation. These new standards revise and enhance the disclosure requirements, and carry forward, substantially unchanged, the presentation requirements. Sections 3862 and 3863 emphasize the significance of financial instruments for the entity's financial position and performance, the nature and extent of risks arising from financial instruments, and how these risks are managed. These new standards are applicable to interim and annual periods relating to fiscal years beginning on or after October 1, 2007. Management has determined that the application of

Covalon Technologies Inc.
Notes to Consolidated Financial Statements
Unaudited – prepared by management

December 31, 2007 and 2006

2. New Accounting Standards (continued)

Sections 3862 and 3863 did not have any impact on the unaudited interim consolidated financial statements for the three month period ending December 31, 2007.

In June 2007, the CICA issued Section 3031 – Inventories, which supersedes existing guidance on inventories in Section 3030, Inventories. This standard introduces significant changes to the measurement and disclosure of inventory. The measurement changes include; the elimination of LIFO, the requirement to measure inventories at the lower of cost and net realizable value, the allocation of overhead based on normal capacity, the use of the specific cost method for inventories that are not ordinarily interchangeable or goods and services produced for specific purposes, the requirement for an entity to use a consistent cost formula for inventory of a similar nature and use, and the reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of inventories. Disclosures of inventories have also been enhanced. Inventory policies, carrying amounts, amounts recognized as an expense, write-downs and the reversals of write-downs are required to be disclosed. This standard is effective for interim and annual periods relating to fiscal years beginning on or after January 1, 2008. Management has determined that the application of Sections 3862 and 3863 did not have any impact on the unaudited interim consolidated financial statements for the three month period ending December 31, 2007.

On October 1, 2006, the Company retroactively adopted, without restatement of prior periods, CICA Handbook Section 1530, "Comprehensive Income", Section 3251, "Equity", 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.

Covalon Technologies Inc.
Notes to Consolidated Financial Statements
Unaudited – prepared by management

December 31, 2007 and 2006

2. New Accounting Standards (continued)

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

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

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

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

3. Capital Assets

	Dec-07		Audited Sep-07	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 170,775	\$ 56,212	\$ 160,295	\$ 50,458
Lab Equipment	736,532	308,049	734,849	285,543
Leasehold improvements	49,656	30,621	49,656	28,138
	956,963	394,882	944,800	364,139
Cost less accumulated amortization		\$ 562,081		\$ 580,661

4. Other Assets

	Dec-07	Audited Sep-07
Patents and technology rights (net of \$127,012 accumulated amortization; Sep 2007 - \$119,932)	\$ 573,279	\$ 484,368
	\$ 573,279	\$ 484,368

Covalon Technologies Inc.
Notes to Consolidated Financial Statements
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December 31, 2007 and 2006

5. Deferred Development Costs

	Dec-07	Audited Sep-07
Cost	\$ 2,434,066	\$ 2,434,066
Less: accumulated amortization	257,899	228,716
	\$ 2,176,167	\$ 2,205,350

6. Deferred Revenue

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

7. 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 September 30, 2006	56,322,784	14,792,328	\$ 15,828,922	\$ 927,479
Options exercised	501,194		265,920	
Warrants granted		1,095,728	(2,338,229)	2,338,229
Warrants exercised	15,888,056	(15,888,056)	14,907,819	(3,265,708)
Balance, September 30, 2007	72,712,034	-	\$ 28,664,432	\$ -
Issued to Perfusion Therapeutics Inc.	25,000		82,500	
Options exercised	65,000		45,840	
Balance, December 31, 2007	72,802,034	-	\$ 28,792,772	\$ -

At December 31, 2007, 6,884,830 (2006 – 9,786,368) shares are held in escrow.

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.

Covalon Technologies Inc.
Notes to Consolidated Financial Statements
Unaudited – prepared by management

December 31, 2007 and 2006

7. Share Capital (continued)

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.

During the period, the Company issued a total of 90,000 common shares.

The Company issued 1,100,000 shares in escrow in December 2007 relating to the acquisition of technology from Perfusion Therapeutics Inc. to be released on various successful milestones. To date, 25,000 shares valued at \$82,500 have been released from escrow.

In the period, 65,000 options to purchase common shares with a value of \$10,340 were exercised for cash consideration of \$35,500.

c) Stock Option Plan

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

	Number of Shares	Value	Exercise Price
Balance, September 30, 2006	3,103,082	\$ 418,739.00	
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	\$ 0.75
Vested to related parties		53,050	\$ 0.50
Exercised	(501,194)	(71,287)	
Expired	(200,000)	(12,400)	
Balance, September 30, 2007	3,589,388	\$ 925,625	
Granted to employees	100,000	19,300	\$ 3.29
Vested to related parties		83,656	\$ 0.98
Vested to employees		6,336	\$ 1.22
Exercised	(65,000)	(10,340)	
Balance December 31, 2007	3,624,388	\$ 1,024,577	

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

Covalon Technologies Inc.
Notes to Consolidated Financial Statements
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December 31, 2007 and 2006

7. Share Capital (continued)

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.

In fiscal 2008, 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 5 years.

Total value of options granted to employees during fiscal 2008 was \$193,900, of which \$19,300 vested. These options expire on September 30, 2012.

65,000 stock options with a value of \$10,320 were exercised for common shares for cash consideration of \$35,500.

As at December 31, 2007, 2,603,181(2006 – 2,087,457) options were available for exercise.

(d) Loss per Share

Loss per share is calculated using the weighted average number of common shares outstanding during the period ended December 31, 2007, which is 72,750,784 (2006 – 56,456,117) shares. As the Company experienced losses for the period ended December 31, 2007 and 2006, all potential common shares outstanding from dilutive securities are considered anti-dilutive and are excluded from the calculation of loss per share for those years.

Details of anti-dilutive potential securities outstanding not included in diluted EPS calculations at December 31, 2007 and 2006 are as follows:

Anti-dilutive potential securities	2007	2006
Common shares potentially assumable:		
- pursuant to warrants	-	14,792,328
- under stock options	3,624,388	2,853,082
	3,624,388	17,645,410

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8. Related Party Transactions

- a) During the period the Company paid fees to related parties as follows:
- (i) Management fees totaling \$135,786 (2006 – \$77,500) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$38,012 (2006 - \$Nil).
 - (ii) Directors fees include cash compensation of \$33,504 (2006 - \$21,366) paid to the four independent directors and stock option benefits that have been valued at \$45,644 (2006 – \$Nil).
- b) The management fees are paid pursuant to two separate management agreements, expiring September 30, 2008. The commitments for the 2008 fiscal year are \$330,000.

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

9. 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 two years are as follows:

2009	\$ 115,723
2010	<u>29,429</u>
	<u>\$ 145,152</u>

10. Supplemental Cash Flow Information

	<u>2007</u>	<u>2006</u>
<i>Non-Cash Financing and Investing</i>		
Shares issued on payment of agent fee	\$ -	\$ 68,702
Issuance of shares for technology rights	\$ 82,500	\$ -

Covalon Technologies Inc.
Notes to Consolidated Financial Statements
Unaudited – prepared by management

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11. Change in Non-Cash Operating Working Capital Items

Net changes in non-cash working capital balances are as follows:

	Three months ended December 31	
	2007	2006
Accounts receivable	\$ 22,980	\$ (92,908)
Inventories	92,913	(50,918)
Prepaid expenses	37,944	(67,582)
Accounts payable and accrued liabilities	(177,426)	63,311
Deferred revenue	(111,115)	(1,361)
	<u>\$ (134,704)</u>	<u>\$ (149,458)</u>