

MANAGEMENT'S DISCUSSION & ANALYSIS

For the three and nine-month periods ended June 30, 2008

August 22, 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 three and nine month periods ending June 30, 2008. 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, refers 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

The Company develops and provides break-through medical products in three areas:

- 1) Wound care and tissue repair solutions,
- 2) Antimicrobial and high-performance coatings for improving medical devices, and

3) A genetic-based tissue regeneration platform using stem cells (EPAS1), where unmet medical needs have been identified.

The products provide the healthcare industry, hospitals, clinics and patients with improved function, performance and cost benefits. Our products and research and development in wound dressings and medical coatings are innovative, and offer an emerging treatment for a variety of conditions centered on ischemia and tissue/organ degeneration. Covalon's products are leading in the treatment of serious medical problems in wound care, hospital acquired catheter associated infections and offer enhanced performance, improved patient outcome and are competitive with existing products in the market.

Our long term vision is to be the leading enterprise in the world in providing innovative medical device coatings, collagen-based dressings for various wound care applications and for genetic-based cellular therapies to treat poor blood flow to tissues and organs (ischemia related conditions). Our research and development, as well as products, are designed to yield long term growth and increased value for stakeholders while improving the quality of life for patients locally, nationally, and internationally. The need for improved methods to repair and regenerate tissue has fueled the development of many innovative technologies in the wound care market. The convergence of pharmaceutical, medical device, and biotechnology companies have both altered and shaped the market in the hard-to-heal wound industry. Advanced-technology bio-engineered products that actively stimulate and/or integrate with wound milieu and tissues to promote faster wound healing are increasingly being sought after. Active wound care products show an added advantage over the traditional dressings in terms of healing rate by providing and promoting an environment conducive to rapid wound healing. Covalon's technologies will address unmet clinical needs of an aging population, as well as improve patient outcome in a wide range of medical fields. Covalon develops interactive wound care products that are intended to actively support the healing of wounds and regeneration of tissues through processes that interact either directly or indirectly with the damaged area. The current products in distribution and the processes under development are far more advanced than traditional wound care treatments, and consist of collagen-based materials and platforms, as well as bioactive, molecular coatings for implantable medical devices. Interactive wound care products can serve as temporary coverage for a wound designed to stimulate improved tissue repair. The components of these products may include growth factors and enzyme inhibitors to stem cells, engineered to carry the EPAS1 gene and induce angiogenesis at the site of cellular deposition, or such cells can be adhered to and delivered via a collagen-based dressing. The target markets for such products include chronic and acute wounds, burn wounds and regenerative medicine.

The strategy is to leverage Covalon's technology platforms in coatings, collagen-based dressings for tissue repair and genetic-based stem cell therapy. Currently the business enters into OEM development relationships for new

products that are identified and designed by the Company or by current and potential customers. Covalon leverages its R&D capabilities, technology transfer as well as regulatory know-how to provide our customers with the expertise to take a product from early stage concept to prototype through to regulatory approval and production. Production of the collagen-based dressings is currently out-sourced and the Company has attained substantial capacity for our current and foreseeable future needs. Licenses for Covalon technology and products may be exclusive or will be non-exclusive, which enables Covalon the benefit to spread its risks by establishing agreements with multiple companies, often in the same marketplace.

2. Company Overview

(i) Our Business

Covalon has focused its expertise in generating sales and cash-flow from three important medical arenas that include antimicrobial coatings on catheter-type medical devices to help reduce hospital acquired infections; advanced collagen-based wound dressings; and genetic-based stem cell therapy. Covalon has developed and patented several collagen dressings for use in advanced wound care industry and surgery. The products in this category include: ColActive™, ColActive Ag™, Biostep™ and Biostep Ag™ currently exclusively distributed by Smith& Nephew, an industry leader in Advanced Wound Management. As well, anti-infective coatings for various medical devices have been developed to meet the growing needs for combating hospital acquired infections, including those caused by antibiotic resistant microbes. The first application for the coating technology has involved its use to inhibit microbial invasion and help reduce infections for urinary tract infections. The Silvertouch™ Foley catheter is distributed in the USA by Medline Industries Inc.

In development under contract with various companies are coatings that reduce blood clot formation whilst reducing microbial adhesion. 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 improve the function of many medical devices. The Company continues to work with its existing customers and new customers to identify applications for its technology platforms to expand its licensing revenue base.

In its genetic-based stem cell therapy research, a recent published account by an independent research group has confirmed that Covalon's approach using "EPAS1" technology is superior to an alternative stem cell therapy technique. The EPAS-1 research project is expected to allow Covalon to produce "universal donor" mesenchymal stem cells that can be used by all individuals for use in improving heart function by therapeutic cell transplantation following loss of blood flow due to coronary vessel occlusion. The use of a "universal donor" will allow for simplification and standardization of procedures related to stem cell therapy including cardiovascular disease and generally in regenerative medicine. Covalon's cell therapy program is designed to generate mesenchymal stem cells

that express genes that control the production of growth factors at the site of cell transplantation that may be useful for new blood vessel formation, maturation and tissue regeneration.

Collagen-based dressings

Covalon has developed collagen-based dressings that can retain therapeutics and have many applications in surface trauma and wound applications, as well as implantable medical devices. The collagen-based dressing is inexpensively produced. The dressing delivers antimicrobial silver ions to the sites of various trauma including burns, topical wounds and surgical interventions. The dressings can also be loaded with various therapeutics, cosmetics, liposomes and nanospheres to impart specific functions to the material as may required by different needs.

The products, ColActive™, ColActive Ag™, Biostep™ and Biostep Ag™ are finding broad and increasing application in the treatment of chronic and diabetic ulcers. 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. For example, research at Women's College Hospital and Baycrest Geriatric Health Care System in Toronto and reported in the Journal of the American Medical Association (August 2006) found that even though pressure ulcers are common among people with reduced mobility, the scientific evidence for prevention is lacking. It's been reported that the actor Christopher Reeves died at the age of 52 from complications that were associated with an infected pressure ulcer. Mr. Reeves had suffered a spinal cord injury that had left him paralyzed and vulnerable to pressure ulcers.

It's not just victims of spinal cord injuries that can suffer from pressure ulcers. In fact, 60% of pressure ulcers develop on patients within hospitals. The patients generally are elderly and have diabetes and/or vascular disease, with reduced blood flow to sensitive areas. Furthermore, immobile patients can develop pressure ulcers within less than 12 hours of lying on an emergency room stretcher. Many other patients that are immobile are also at risk of developing pressure ulcers. In the USA, over 2 million pressure ulcers are treated in acute-care facilities with an associated cost of treatment of \$500-\$40,000. In Canada, the prevalence of pressure ulcers is at least as high as that in the USA, an average of 25% of patients within healthcare facilities developing a pressure ulcer (cited in Healthy Skin, vol.5, issue 2). The Centers for Medicare and Medicaid Services has indicated that beginning on October 1, 2008, the costs of treatment of hospital acquired pressure ulcers will cease and hospitals will not be reimbursed for the costs of treatment.

ColActive™, ColActive Ag™, Biostep™ and Biostep Ag™ were developed by Covalon to address the growing need for treatment of pressure ulcers as well as other wounds. Management expects that sales of Covalon's collagen based dressings, distributed by Smith & Nephew will increase.

Antimicrobial catheter coating

Covalon's coating ("CovaCoat™") technology allows for application of therapeutics of varied molecular structure, including antimicrobial silver, directly to the surface of devices for site-specific delivery. The surface coatings are customized to our customers' specifications and needs. The Company is involved in a number of development relationships that are using the coating platform for various customer targeted applications such as urethral catheters, central venous lines, wound drains, endotracheal tubes, and other devices that are a source of hospital acquired infections.

Covalon's coating technology applies antimicrobial ionic silver to protect against the most common and serious urinary tract pathogens and ultimately may assist in reducing the incidence of urinary tract infections. The most prevalent hospital acquired infections are urinary tract infections that are usually associated with catheter use. Each year more than 5 million patients in acute care and extended-care facilities receive urinary catheterization and have a risk of infection that increases 5% per day.

Recently, in the Journal of Urology, Ms. Jackie Kassler, the nurse manager at St. Vincent Rehabilitation Hospital, in Sherwood, Arkansas, USA, described her facility's experience with the *Silvertouch™* urinary catheter that carries Covalon's patented CovaCoat™ silver ion releasing coating. After the first month, the hospital had no hospital acquired catheter associated urinary infections. The next month the unit was again infection-free. During the six-months study period the number of urinary tract infections dropped to zero.

Beginning October 1, 2008, the Centers for Medicare & Medicaid Services (CMS) will stop reimbursement for the treatment of catheter associated urinary infections acquired during hospital stays. The costs of treating an infection can become very high, especially when treating antimicrobial resistant strains of bacteria. The extra care required coupled with increasing costs makes it very attractive for hospitals to adopt the silver coated urinary catheter as one way to help prevent infections and improve patient outcomes. Management expects that the CMS ruling will result in increased sales of Covalon's urinary catheters by Medline Industries, Inc., USA.

The coatings offer robust and long-lived covalent attachment to inner and outer surfaces of polymeric medical devices, with versatile surface characteristics formulated to the customer's specifications, such as:

- Provides antimicrobial surface to inhibit bacterial adhesion, slippery when wet
- allows therapeutic loading and controllable therapeutic delivery
- coating does not significantly alter the diameter of the device
- anti-thrombogenic

- applicable to a variety of metals
- applicable to many medical devices; does not alter current medical use and improves functionality

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

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 approximately 200,000 catheter-related bloodstream infection are caused by CVCs in U.S. hospitals. Together, these two categories of devices account for about 50% of total hospital infections. Antimicrobial coatings could be an effective solution to this growing concern. Furthermore, blood-contacting medical devices such as peripherally inserted central catheters and CVC, and related devices 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.

Covalon's antimicrobial and low-thrombogenic proprietary 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 of 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 (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 healthcare system (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).

Cellular Therapy

Covalon's developmental-stage tissue regenerative technology (EPAS1) uses the transplantation of human cells, genetically engineered to produce new blood vessels necessary to improve blood flow to areas where blood delivery is limited by vascular disease and/or occlusion and allow the body to repair the damaged tissue.

EPAS1 cellular therapy proposes to use genetically altered stem cells to improve tissues and organs damaged by poor blood flow to the tissues. In recently completed preclinical studies, swine stem cells derived from the marrow of a single donor animal could be readily isolated, genetically manipulated with EPAS1, frozen and thawed for use. Various dosages of mesenchymal stem cells, greater than 90% viability, prior to injection, could be introduced into the myocardium of eight recipient swines 7 days post-myocardial infarction; surviving cells could be readily identified two weeks post-implantation. Mesenchymal stem cells altered with the EPAS1 gene showed significantly enhanced production and secretion in vitro of several important protein factors that are essential to new blood vessel growth (angiogenic) and further maturation. Direct introduction of genetically engineered EPAS1 cells by intra-cardiac injection into the hearts of swines showed no significant, adverse side-effects. In vivo, mesenchymal stem cells altered with the EPAS1 gene initiated an enhanced host-derived angiogenic response over that of non-EPAS1 modified mesenchymal stem cells. EPAS1 over-expression and the various proteins under control of the EPAS1 gene, enhances the cellular regenerative properties of mesenchymal stem cells by inducing secretion of certain protein factors that are essential to robust angiogenesis and functional maturation. EPAS1 is mainly expressed in vascular endothelial cells, that are essential to new blood vessel growth and appears to drive a superior angiogenic response with enhanced stability of the resultant vessels. The overall significance is that mesenchymal stem cells can be readily isolated, grown to useful dosages and manipulated genetically to express EPAS1 for therapeutic application in damaged heart tissue. Covalon's approach is intended to improve the function of damaged tissue, rather than merely address the symptoms of the disease. EPAS1 cell therapy is intended to enhance the beating of the damaged heart tissue with a cell therapy that delivers mesenchymal stem cells loaded with the EPAS1 gene that controls the production of many essential blood vessel growth factors. The system is expected to improve blood flow and oxygen delivery to the damaged heart by stimulating the growth of new blood vessels, by a process of therapeutic angiogenesis.

According to the American Heart Association, one in three deaths in the western world is caused by heart disease and with only 20,000 transplant hearts available each year, new treatment options are urgently needed. This market has huge revenue possibilities and has the potential to grow in excess of \$10 billion by 2013. Stem cell and tissue engineering technology has applications over a wide range of diseases; the potential for this market will be immense.

Improving the Products that Improve Lives

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 on 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 currently focused on.

Collagen -based dressings

The Covalon strategy is working with existing and new customers to define applications for the platform and enter into OEM development contracts that require relatively rapid, low risk 510 (k) regulatory approvals that are expected to yield products that 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.

Ocular dressings

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 development phase but are anticipated to have a low regulatory risk.

Hemostatic dressings

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 a topical haemostatic 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 dressing, according to the Centers for Disease Control. Approximately 6.2 million puncture site wounds according to Millennium Research Group's report on US Markets for Vascular Access will require a hemostatic dressing as well. 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; as expected, limited clinical trials will likely be required. The Covalon platform for this application has advantages over the current market leaders.

Dental dressings

Dental extractions in the US exceed 50 million per year and incidence of dry socket 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.

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.

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, 2007, the Company had 72,712,034 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 options to purchase common shares, in each case as at June 30, 2008.

Common shares	73,263,915
Options to purchase common shares	3,847,507
Total diluted shares outstanding	77,111,422

On October 24, 2006, Covalon completed the acquisition of a therapeutic cell engineering platform for improving blood vessel development ("angiogenesis") for improving outcomes for patients with congestive heart failure 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. To date, 75,000 shares have been released from escrow. The technology uses the endothelial PAS domain protein 1 (EPAS1). Covalon's EPAS1 technology is the subject of several US and European patent applications that Covalon has assumed through the acquisition.

4. Results of Operations

Highlights

Overall performance for the three month period ended June 30, 2008

- Total Revenues were \$337,262 for the third quarter;

- Gross profit as a percentage of sales was 50% in the third quarter of 2008, an 18% improvement compared to the same period last year;
- Expenses of \$436,328 for Covalon's innovative EPAS1 Research and development project have been capitalized;
- Regulatory investments increased by \$99,749 or 71% over the third quarter of 2007 to \$240,242;
- Net loss decreased by 33% over the third quarter of 2007 to \$498,949;
- Loss per share of \$0.01 was the same as the third quarter of 2007.

Operating and Financial Results

	Three month period ended June 30,		Nine month period ended June 30,	
	2008	2007	2008	2007
Revenues				
Product sales and coating services	\$ 226,300	\$ 203,421	\$ 1,142,048	\$ 898,589
License fees	110,962	290,906	333,193	348,640
Total Revenues	\$ 337,262	\$ 494,327	\$ 1,475,241	\$ 1,247,229
Operating Costs and Expenses				
Product	\$ 113,070	\$ 138,433	\$ 599,476	\$ 526,276
Regulatory	240,242	140,493	733,884	356,034
Marketing	23,720	49,068	112,540	177,721
General and administrative	\$ 740,158	\$ 598,725	\$ 2,092,865	\$ 1,299,964
Total operating costs and expenses	1,117,190	926,719	3,538,765	2,359,995
Loss before undernoted items	\$ (779,928)	\$ (432,392)	\$ (2,063,524)	\$ (1,112,766)
Interest income	130,477	65,914	578,017	164,818
Research and development activities	\$ 150,502	\$ (376,126)	\$ (647,025)	\$ (703,383)
Loss and comprehensive income for the period	\$ (498,949)	\$ (742,604)	\$ (2,132,532)	\$ (1,651,331)
Loss per share	\$ (0.01)	\$ (0.01)	\$ (0.03)	\$ (0.03)

Analysis of Operating and Financial Results

Three and nine-month period ending June 30, 2008

Revenue

Covalon's total revenue was \$337,262 during the third quarter of 2008 and increased by \$228,012 to \$1,475,241 for the nine-month period ended June 30, 2008 compared to the same period last year. Revenues in the coating division in the third quarter of 2008 were lower than the comparable period last year as a number of substantial orders occurred subsequent to the end of the quarter.

Product Sales

	Three month period ended June 30,		Nine month period ended June 30,	
	2008	2007	2008	2007
Wound Care	\$ 181,304	\$ 185,026	\$ 1,009,484	\$ 712,478
Coated catheters	4,515	10,019	61,169	175,215
Coating services	40,481	8,376	71,395	10,896
	\$ 226,300	\$ 203,421	\$ 1,142,048	\$ 898,589

Wound care sales were generally flat at \$181,304 during the third quarter of 2008 and by increased by \$297,006 to \$1,009,484 for the nine-month period ended June 30, 2008 compared to the same periods last year. The wound care sales stayed flat over the third quarter of 2008 due to the traditional pre-summer order slow down. There has been a demand in the ColActive product line due to the focus on the third party biller market for outpatient and home care. Smith and Nephew continue to invest resources and sales call time to position the new Biostep™ product line in the acute market. The sale cycle in advance wound care is multi-tiered and conversions take time to work through the system but both companies are confident that the trend will be positive with continued investment.

Coating sales was \$4,515 during the third quarter of 2008 and \$61,169 for the nine-month period ended June 30, 2008. The Company received a number of orders subsequent to the end of the quarter and is now beginning to see increased activity. The increase is a result of the Centers for Medicare & Medicaid Services ceasing reimbursement, effective October 1, 2008, for the care and treatment of catheter associated urinary tract infections acquired during a hospital stay.

Coating services increased by \$32,105 to \$40,481 during the third quarter of 2008 and by \$60,499 to \$71,395 for the nine-month period ended June 30, 2008 compared to the same periods last year. The Company continues to do contract research and development applying its anti-microbial coating on a number of medical devices in contact with blood, such as central venous lines and the like.

License Revenues

License revenues decreased by \$179,944 to \$110,962 during the third quarter of 2008 and by \$15,447 to \$333,193 for the nine-month period ended June 30, 2008 compared to the same periods last year. This decrease is due to the amortization of the US\$2 million milestone payment the Company received from Smith & Nephew Inc. The milestone payment was recognized over 2 years in the third quarter of 2007 and later recognized over a 5 year period at the end of 2007.

Product Costs

The Company's product costs were \$113,070 in the third quarter of 2008 and \$599,476 for the nine-month period ended June 30, 2008 compared to \$138,433 and \$526,276 for the same periods last year. Overall product margins increased from 32% in the third quarter of 2007 to 50% in the third quarter of 2008 and from 41% to 48% for the nine-month periods ended June 30, 2007 and June 30, 2008, respectively. The increase in gross profit was primarily attributable to an increase in revenue realized from the coating services for the three and nine-month periods ended June 30, 2008 compared to the same periods last year.

Regulatory Expense

Regulatory expenses increased by \$99,749 to \$240,242 during the third quarter of 2008 and by \$377,850 to \$733,884 for the nine-month period ended June 30, 2008 compared to the same periods last year. Most of this increase was due to compensation and benefit expenses associated with the additional technical personnel hired by the Company.

Marketing

Marketing expenses decreased by \$25,348 to \$23,720 during the third quarter of 2008 and decreased by \$65,181 to \$112,540 for the nine-month period ended June 30, 2008 compared to the same periods last year. Investor relations fees are no longer paid to a third party since this is being handled in-house.

General and Administration

General and administration expense increased by \$141,433 to \$740,158 during the third quarter of 2008 and by \$792,901 to \$2,092,865 for the nine-month period ended June 30, 2008 compared to the same periods last year. The increase was primarily due to increased amortization of capital assets, capital tax payment, legal bills related to corporate governance and the addition of the Chief Financial Officer and related stock compensation expenses.

Interest Income

Interest income increased by \$64,563 to \$130,477 during the third quarter of 2008 and by \$413,199 to \$578,017 for the nine-month period ended June 30, 2008 compared to the same periods last year. The increase is due to higher cash balance during the comparable periods. (\$13,886,375 – June 30, 2008, \$6,985,051 – June 30, 2007). All investments are made in accordance with the Company's audit committee investment guidelines.

Research and Development Activities

Research and Development activities decreased by \$526,628 to (\$150,502) during the third quarter of 2008 and decreased by \$56,358 to \$647,025 for the nine-month period ended June 30, 2008 compared to the same periods last year. The decrease in activities in the third quarter of 2008 reflects the adjustment made to capitalized

expenditures related to EPAS1 during the nine month period ended June 30, 2008. The Company has spent \$43,667 for the three month period ended June 30, 2008 and \$401,028 for the nine-month period ended June 30, 2008 on EPAS1 activities. This investment in EPAS1 is in line with Management's expectations. Overall, the level of spending for the three-month period in Research and Development is consistent with Management's expectations.

Summary of Quarterly Results

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

<i>(In Canadian \$)</i>	2008 Third Quarter	2008 Second Quarter	2008 First Quarter	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter	2007 First Quarter	2006 Fourth Quarter
Revenue (1)	467,739	654,625	\$930,893	\$372,768	\$560,241	\$461,511	\$390,295	\$383,89
Net loss	(498,949)	(957,576)	\$(676,007)	\$(1,425,046)	\$(742,604)	\$(507,356)	\$(401,371)	\$(684,668)
Net loss per share	(0.01)	(0.01)	\$(0.01)	\$(0.02)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.02)

(1) Includes interest income

The Company's ongoing quarterly losses relate primarily to the continuing buildup of the regulatory and research and development departments.

Other Performance Indicators

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

	2008 Third Quarter	2008 Second Quarter	2008 First Quarter	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter	2007 First Quarter	2006 Fourth Quarter
Current Ratio	17.7	7.0	6.9	6.4	3.0	2.5	9.2	10.7
Net Working Capital	13,652,270	\$13,274,549	\$13,832,958	\$14,322,821	\$5,341,353	\$4,346,329	\$4,815,698	\$5,113,130

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.

The Company's cash balance of \$13,886,375 at June 30, 2008 has enabled the Company to maintain its strong liquidity ratios while allowing us to continue investing in research, product and business development.

5. Liquidity & Capital Resources

Financial Position

<i>(Canadian \$)</i>	June 30, 2008	As at	September 30, 2007
Total assets	\$ 18,453,525		\$ 20,244,461
Deferred revenue	\$ 1,637,909		\$ 1,977,904

Total Assets

Total assets at June 30, 2008 were \$18,453,525 compared to \$20,244,461 at September 30, 2007. The decrease of \$1,790,936 is comprised of decreases in cash and cash equivalents and short term investments of \$2,283,625, accounts receivable of \$97,195, inventory of \$25,619, and prepaid expenses of \$97,878. Increases relate to capital assets of \$146,687, other assets of \$217,916 and deferred development costs of \$348,778. Covalon's coating equipment was substantially refurbished and a new phone system was installed to meet the increased headcount. The Company drew down on its cash balance to fund its operations.

Deferred Revenue

Total deferred revenue decreased by \$339,995 to \$1,637,909 at June 30, 2008 compared to the period ended September 30, 2007. The reduction in deferred revenue relates to the amortizing element of this account.

Liquidity

On June 30, 2008, cash and cash equivalents amounted to \$13,886,375. The Company follows a policy of investing its surplus cash resources in high quality, liquid, short-term notes. As at June 30, 2008 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 Road East, Mississauga commencing December 1, 2004 and expiring November 30, 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 \$477 per month under a lease expiring in 2013.

The minimum annual lease payments for the next five years are as follows:

2009	\$	100,624
2010		21,541
2011		5,724
2012		5,724
2013		5,724
	\$	<u>139,337</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

- 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.	75,000	-	192,500	-
Options exercised	476,881	-	286,653	-
Balance, June 30, 2008	73,263,915	-	\$ 29,143,585	\$ -

At June 30, 2008, 5,615,502 (2007 – 9,179,772) 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.

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 561,881 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, 75,000 shares valued at \$192,500 have been released from escrow.

In the period, 476,881 options to purchase common shares with a value of \$98,901 were exercised for cash consideration of \$187,752.

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	
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 related parties	375,000	155,141	\$ 2.79
Granted to employees	360,000	188,073	\$ 2.93
Vested to related parties		242,621	\$ 1.01
Vested to employees		13,993	\$ 1.22
Exercised	(476,881)	(98,901)	
Balance June 30, 2008	3,847,507	\$ 1,426,552	

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.

During the period, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 3.75%, dividend rate NIL, volatility – 66% and a term of 5 years.

Total value of options granted to related parties during the period was \$600,000 of which \$155,141 vested, total value of options granted to employees during the period was \$609,900 of which \$188,073 vested. Stock options granted to related parties during the period expire on March 31, 2013. Stock options granted to employees during the period expire on September 30, 2012 (100,000) and on March 31, 2013 (260,000).

During the period, 476,881 stock options with a value of \$98,901 were exercised for common shares for cash consideration of \$187,752.

As at June 30, 2008, 2,822,280 (2007 – 2,468,707) options were available for exercise.

Sources and Uses of Cash

	Three month period ended June 30,		Nine month period ended June 30,	
	2008	2007	2008	2007
Cash Provided By (Used in)				
Operating Activities				
Cash flow from operating activities before change in non-cash working capital	\$ (328,259)	\$ (738,810)	\$ (1,644,661)	\$ 799,337
Change in non-cash working capital	326,294	(177,285)	(77,794)	(292,781)
	\$ (1,965)	\$ (916,095)	\$ (1,722,455)	\$ 506,556
Investing Activities				
Purchase of capital assets, net	\$ (251,600)	\$ (159,427)	\$ (259,989)	\$ (152,479)
Expenditure on deferred development costs	(436,328)	-	(436,328)	-
Purchase of patents and technology rights	(23,259)	(77,361)	(47,482)	(208,570)
Short term investments	9,082,699	-	9,252,103	-
	\$ 8,371,512	\$ (236,788)	\$ 8,508,304	\$ (361,049)
Financing Activities				
Issuance of share capital, net	\$ 109,110	\$ 1,717,101	\$ 187,752	\$ 1,867,101
Foreign exchange gain (loss) on cash held	\$ (4,990)	\$ (37,382)	\$ (5,123)	\$ (39,199)
Increase (decrease) in cash and cash equivalents	\$ 8,473,667	\$ 526,836	\$ 6,968,478	\$ 1,973,409

Operating Activities

Cash flow used in operations decreased by \$914,130 during the third quarter of 2008 and increased by \$2,229,011 for the nine-month period ended June 30, 2008. The net decrease in three month period ending June 30, 2008 is primarily due to lower losses compared to the same period last year and a decrease in accounts receivable and prepaid expenses and an increase in accounts payable and accrued liabilities. The net increase in cash flow used in operations for the nine-month period ending June 30, 2008 compared to the same period last year is mainly due to the higher losses due to increased infrastructure costs for the comparable periods last year, exclusive of the effect of the changes in non-cash working capital items.

Investing Activities

Cash flow from investing activities increased from (\$236,788) in the third quarter of 2007 to \$8,371,512 in the third quarter of 2008 reflecting the conversion of short term investments to cash equivalents and the refurbishment of the coating equipment and the capitalization of development costs.

Financing Activities

The exercise of vested options in the third quarter of 2008 resulted in additional funding.

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.

As at June 30, 2008, two customers accounted for 61% (three customers, September 30, 2007 – 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.

The Company has not entered into any futures or forward contracts or other derivative instruments as at June 30, 2008.

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

- a) During the period the Company paid fees to related parties as follows:
 - (i) Management fees totaling \$426,804 (2007 – \$319,247) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$162,670 (2007 – \$86,747).
 - (ii) Directors fees include cash compensation of \$110,708 (2007 - \$107,406) paid to certain of the independent directors and stock option benefits that have been valued at \$209,045 (2007 – \$107,406).
- 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).

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

CICA Handbook New Section 1506, based on International Reporting IAS 8—Accounting Policies, Changes in Accounting Policies together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates, and the correction of errors. The notes describe disclosure, on an interim and annual basis, of the description and the impact on financial statements of any new primary source of GAAP that has been issued but not yet instituted. It is effective for interim and annual periods beginning on or after January 1, 2007. At this time, there is no impact of this section on our financial position or on the results of our operations.

For interim and fiscal years beginning on or after October 1, 2007, the CICA Handbook Section 3862, Financial Instruments – Disclosure, and CICA Handbook Section 3863, Financial Instruments - Presentation applies. 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. 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 and nine-month period ending June 30, 2008, however, it did result in expanded note disclosure.

For interim and fiscal years beginning on or after October 1, 2007, the CICA Handbook Section 1535, Capital Disclosures applies. This section specifies disclosures of information about a company's objectives, policies and processes for managing capital structure; quantitative data about what the company regards as capital; and whether the company has complied with externally imposed capital requirements, like bank covenants, and if it has not complied, the consequences of such non-compliance. The adoption of this new accounting standard did not impact the amounts reported in the Company's financial statements, however, it did result in expanded note disclosure.

Section 3031, Inventories, is effective for annual and interim periods beginning on or after January 1, 2008. This new section requires inventory to be measured at the lower of cost or net realizable value and provides guidance on the methodology used to assign costs to inventory, it disallows the use of the last-in first-out inventory costing methodology and requires that, when circumstances which previously caused inventories to be written down below cost no longer exist, the amount of the write-down is to be reversed. Upon adoption, the impact on the financial statements was immaterial.

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets, effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. Section 3064, which replaces Section 3062, Goodwill and Other Intangible Assets, and section 3450, Research and Development Costs, establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets. This new standard is effective for the Company's fiscal year commencing January 1, 2009. Management is assessing the impact of this new standard on its consolidated financial statements.

In March 2006, the Accounting Standards Board of the CICA released its new strategic plan which will abandon Canadian GAAP and affect a complete convergence to the International Financial Reporting Standards. At the end of a transitional period of approximately five years, Canadian GAAP will cease to exist as a separate, distinct basis of financial reporting for public companies. Management will closely monitor changes arising from this convergence.

10. 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 June 30, 2008, 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.

11. 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.

12. Glossary

<i>Biomatrices</i>	<i>A unique and measurable characteristic of a human being used to identify an individual.</i>
<i>Dry Socket</i>	<i>Painful condition following a tooth extraction caused by a blood clot that does not properly fill the empty socket.</i>
<i>Endotracheal</i>	<i>A soft plastic tube inserted through the mouth and into the airway (trachea) to help a baby breathe that needs the assistance of a ventilator.</i>
<i>Hydrophilic</i>	<i>Having a strong affinity for water; attracting, dissolving in or absorbing water.</i>
<i>Liposomes</i>	<i>Multilayered spherical particles of a lipid in an aqueous medium within a cell.</i>
<i>Nanosperes</i>	<i>Active ingredient delivery system; micro-reservoir particles of porous polymers that have a special structure permitting high absorption and timed release of the agents into the skin.</i>
<i>Nosocomial</i>	<i>Originating or taking place in a hospital, acquired in a hospital, especially in reference to an infection.</i>
<i>OEM</i>	<i>Original Equipment Manufacturing is typically a company which uses a component made by a second company in its own product, or sells the product of the second company under its own brand.</i>
<i>Polymer</i>	<i>A substance consisting of large molecules which have been formed from smaller molecules of similar make-up.</i>
<i>Thrombogenic</i>	<i>Causing or resulting in coagulation of the blood.</i>