

MANAGEMENT'S DISCUSSION & ANALYSIS

For the three month period ended December 31, 2007

January 28, 2008

The following discussion of Covalon Technology Ltd.'s ("Covalon" or the "Company") financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes for the three month period ending December 31, 2007. We have prepared these financial statements according to Canadian generally accepted accounting principles ("GAAP").

Management's Responsibility for Financial Reporting

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

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

Non-GAAP Measures

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

Additional Information

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

Forward-looking Statements

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

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

This MD&A is divided into the following sections:

1. Vision and Strategy	2
2. Company Overview.....	2
3. Investment and Capitalization	2
4. Results of Operations.....	3
5. Liquidity and Capital Resources	9
6. Risks and Uncertainties	13
7. Related Party Transactions.....	13
8. Critical Accounting Estimates	14
9. Accounting Policies.....	14
10. Opportunities	15
11. Disclosure Controls.....	15
12. Internal Controls over Financial Reporting.....	16

1. Vision and Strategy

Our vision and strategy statements have not changed since the release of our MD&A for the year ended September 30, 2007. Therefore, to review our vision and strategy please refer to the corresponding sections in the MD&A for the year ended September 30, 2007.

2. Company Overview

Our company overview statements have not changed since the release of our MD&A for the year ended September 30, 2007. Therefore, to review our company overview, please refer to the corresponding sections in the MD&A for the year ended September 30, 2007.

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 warrants and options to purchase common shares, in each case as at December 31, 2007.

Common shares	72,802,034
Options to purchase common shares	3,624,388
Total diluted shares outstanding	76,426,422

On October 24, 2006, Covalon completed the acquisition of a 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. The technology uses the endothelial PAS domain protein 1 (EPAS1). EPAS1 is the subject of several US and European patent applications that Covalon has assumed through the acquisition.

4. Results of Operations

Highlights

Overall performance for the three month period ended December 31, 2007

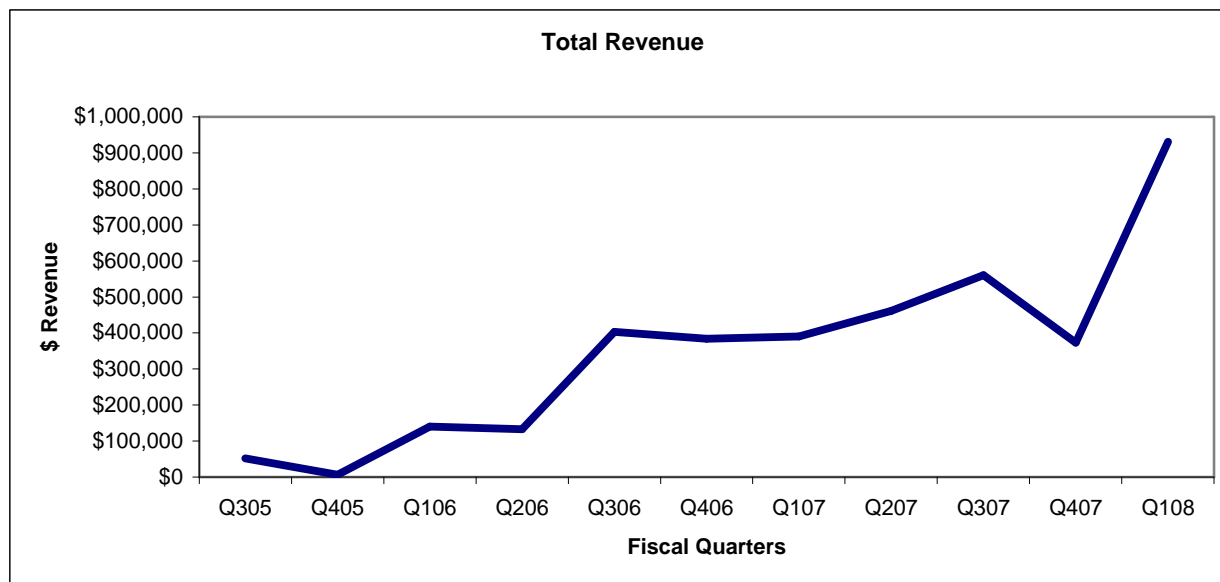
- Total Revenues increased by 139% or \$540,598 over the first quarter of 2007 to \$930,893;
- Total Product Sales Revenues increased by \$269,568 or 80% over the first quarter of 2007 to \$607,335;
- Gross profit as a percentage of sales was 44% in the first quarter of 2008, a 3% improvement compared to the same period last year;
- Regulatory expenses increased by \$150,221 or 181% over the first quarter of 2007 to \$233,274;
- Research and Development increased by \$325,675 or 282% over the first quarter of 2007 to \$441,131;
- Net loss before research and development expenses decreased by 18% over the first quarter of 2007 of \$234,876;
- Net loss increased by 68% over the first quarter of 2007 to \$676,007;
- Loss per share of \$0.01 was the same as the first quarter of 2007.

Operating and Financial Results

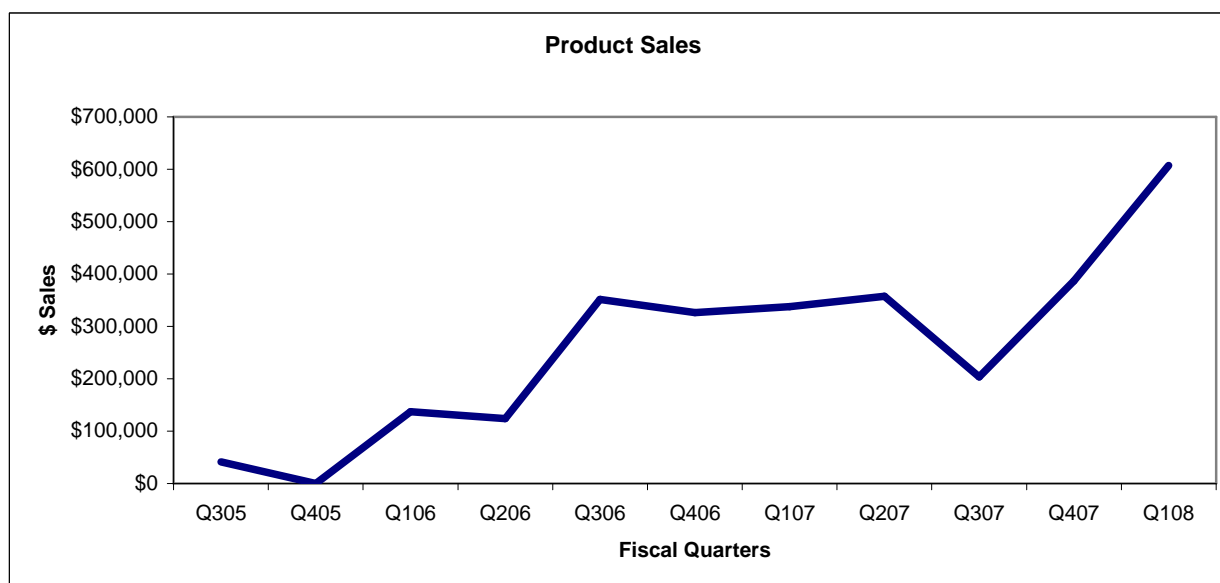
<i>(in Canadian \$)</i>	Three months ended December 31,	
	2007	2006
Product Sales		
Wound care	\$ 536,663	\$ 308,549
Coated catheters	56,954	29,218
Coating services	13,718	-
	\$ 607,335	\$ 337,767
Cost of goods sold	338,408	198,767
Gross Profit	\$ 268,927	\$ 139,000
Gross Profit %	44.3%	41.2%
Other Revenue		
Interest income	\$ 212,443	\$ 51,167
Licensing fee	111,115	1,361
Total Expenses	\$ 1,268,492	\$ 592,899
Net Loss	\$ (676,007)	\$ (401,371)
Net Loss before research and development expenses	\$ (234,876)	\$ (285,915)
Loss per share	\$ (0.01)	\$ (0.01)

Analysis of Operating and Financial Results
Three month period ending December 31, 2007

Revenue



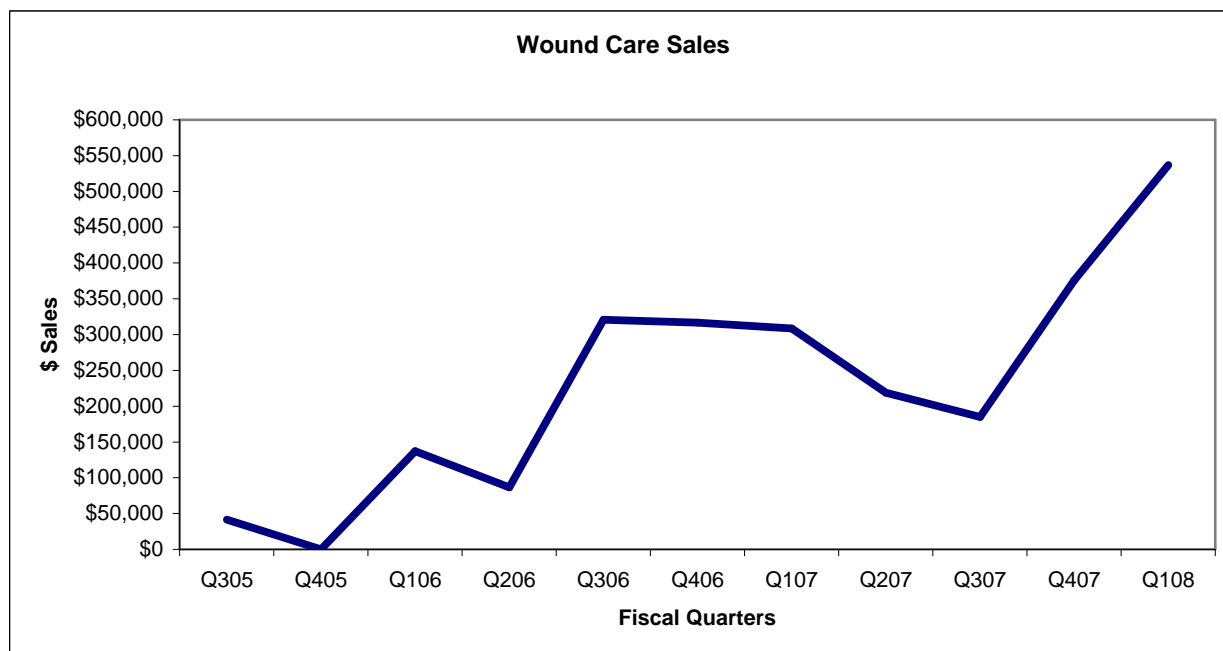
Covalon's total revenue increased by \$540,598 to \$930,893 during the first quarter of 2008 compared to the same period last year. Higher products sales, particularly in the wound care products and interest and licensing fees accounted for the increase in revenue. Total revenue was in line with Management's expectations.



Consolidated product sales increased by \$269,568 to \$607,335 during the first quarter of 2008 compared to the same period last year. Covalon continues to see a ramp up in production from Biostep™ and Biostep™ Ag bioactive collagen dressings resulting from the exclusive

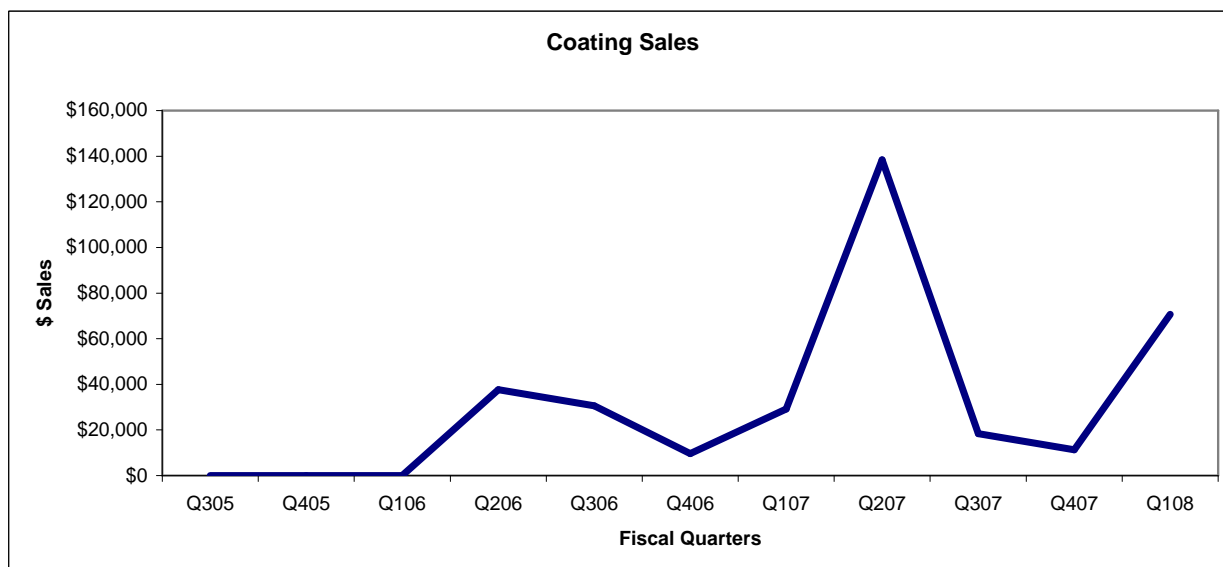
distribution agreement with Smith & Nephew, the world leader in advance wound care. Total products sales in the first quarter of 2008 were better than Management's expectations.

Wound Care Sales



Wound care sales increased by \$228,114 to \$536,663 during the first quarter of 2008 compared to the same period last year. The wound care sales increased due to the enhanced marketing and sales support from Smith & Nephew. In addition, the consumers have begun to accept the value of our products. Wound care sales in the first quarter of 2008 were better than Management's expectations.

Coatings



Coating sales increased by \$41,454 to \$70,672 during the first quarter of 2008 compared to the same period last year. The distributor, Medline Industries, Inc., continues to focus its marketing efforts on two major in-market clinical trials to prove the efficacy and economics of the “Silvertouch” anti-microbial catheters.

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

Cost of Goods Sold

Cost of goods sold amounted to \$338,408 during the first quarter of 2008 compared to \$198,767 for the same period last year. Cost of goods sold represented 55.7% of sales in the first quarter of 2008 compared to 58.9% in 2007. The increase in sales in the first quarter of 2008 compared to the same period last year resulted in the decrease in the cost of goods sold, as a percentage of sales.

Gross Profit

Gross profit for the first quarter of 2008 was \$268,927 compared to \$139,000 in the first quarter of 2007, an increase of 93.5%. The increase in gross profit was primarily attributable to the increase in sales. Gross profit, as a percentage of sales, in the first quarter of 2008 was 44.3% compared to 41.1% for the same period in 2007.

Interest Income

Interest income increased by \$161,276 to \$212,443 during the first quarter of 2008 compared to the same period last year. The increase is primarily due to cash generated from the exercise of 15,888,056 of Series III warrants in the fourth quarter of 2007. All investments are made in accordance with the Company’s audit committee investment guidelines.

License Revenues

License revenues increased by \$109,754 to \$111,115 during the first quarter of 2008 compared to the same period last year. This increase is due to the recognition of the US\$2 million milestone payment the Company received from Smith & Nephew Inc. The milestone payment is being recognized over a 5 year period. As this licensing model with Smith & Nephew Inc. has to date proven to be successful, it is Management’s intention to pursue similar deals based on this model.

Expenses

Covalon’s administrative and overhead expenses increased by \$675,593 to \$1,268,492 during the first quarter of 2008 compared to the same period last year. Although administrative and overhead expenses are slightly lower than the fourth quarter of 2007, they are consistent with Management’s expectation given the build up of the regulatory and research and development infrastructure.

The expenses for the three month period and year ended December 31 for 2007 and 2006 are summarized below.

<i>(in Canadian \$)</i>	Three months ended December 31,	
Administrative and overhead	2007	2006
Amortization	\$ 67,007	\$ 62,838
Bank Charges and interest	843	1,553
Director fees	79,148	21,366
Foreign currency (gain) 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 & Development	441,131	115,456
Training	3,377	9,606
Travel	17,569	13,028
Total	\$ 1,268,492	\$ 592,899

Director Fees

The Director fees increased by \$57,782 to \$79,148 during the first quarter of 2008 compared to the same period last year. This increase is due primarily to increases in stock compensation to the Directors resulting from the valuation of vested options.

Marketing

Marketing decreased by \$51,216 to \$41,972 during the first quarter of 2008 compared to the same period last year. Significantly less travel and no deal related expenses were incurred in the first quarter of 2008 compared to the same period last year.

Management Fees

The Management fees increased by \$58,286 to \$135,786 during the first quarter of 2008 compared to the same period last year. The increase is due primarily to an increase in cash compensation and the value of stock options vesting during the period.

Office and Administration

Office and administration costs increased by \$96,851 to \$196,184 during the first quarter of 2008 compared to the same period last year. A majority of this increase reflects build up of the Company's infrastructures.

Regulatory Expense

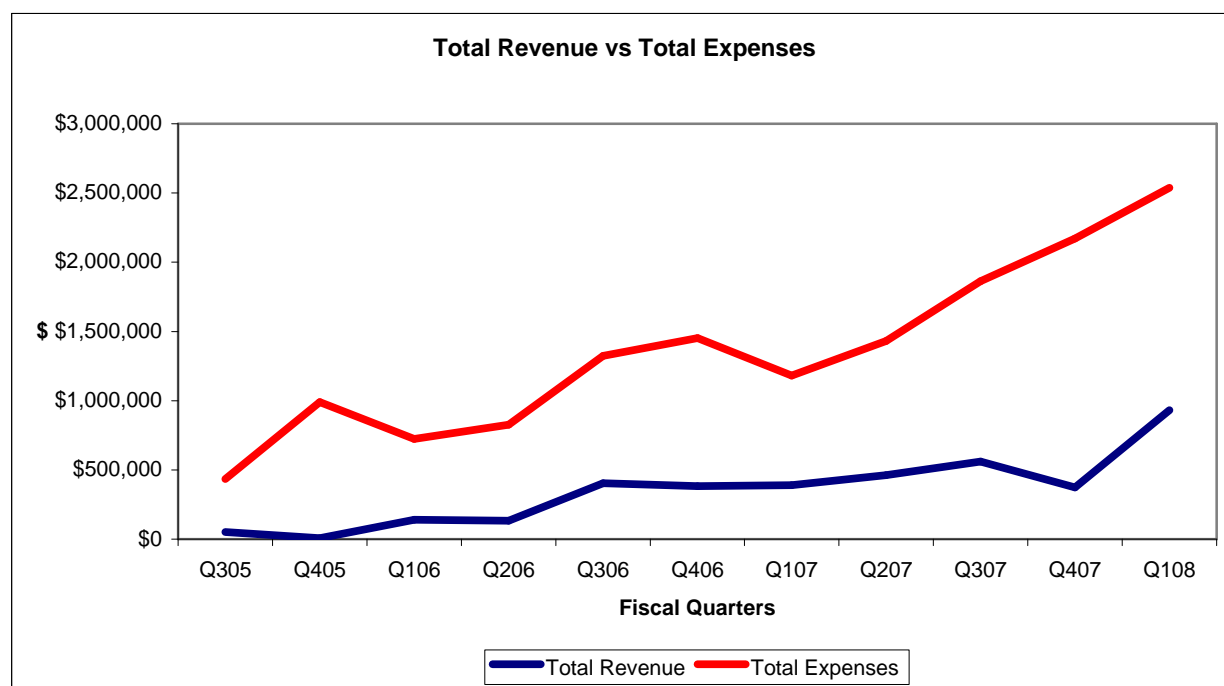
Regulatory expenses increased by \$150,221 to \$233,274 during the first quarter of 2008 compared to the same period last year. The majority of the increase is due to the build up of this function's infrastructure. The regulatory expenses in the first quarter of 2008 are consistent with the expenses incurred in the fourth quarter of 2007. The regulatory expenses in the first quarter of 2008 were better than Management's expectations.

Research and Development

Research and Development expenses increased by \$325,675 to \$441,131 during the first quarter of 2008 compared to the same period last year. This increase is attributable not only from activities related to the Smith & Nephew Inc. distribution agreement and EPAS1 activities

but also the Company's efforts in developing new product offerings which leverages off our existing technology platforms. New product offerings would come out of the collagen matrices, coatings and EPAS1 technologies. The Company anticipates an increase in the level of spending in research and development in order to bring new products to market.

Net Income (Loss)



The Company had a net loss of \$676,007 or \$0.01 per share during the first quarter of 2008 compared to net loss of \$401,371 or \$0.01 per share during the same period in 2007. Higher expenses during the first quarter of 2008 in director fees, management fees, office and administration, regulatory and research and development compared to the same period last year were mitigated by higher total revenues in the first quarter of 2008 compared to the same period last year. Net loss for the first quarter of 2008 was better than Management's expectations.

Summary of Quarterly Results

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

(in Canadian \$)	2008 First Quarter	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter	2007 First Quarter	2006 Fourth Quarter	2006 Third Quarter	2006 Second Quarter
Revenue (1)	\$930,893	\$372,768	\$560,241	\$461,511	\$390,295	\$383,829	\$403,063	\$133,040
Net loss	\$(676,007)	\$(1,425,046)	\$(742,604)	\$(507,356)	\$(401,371)	\$(684,668)	\$(518,097)	\$(559,742)
Net loss per share	\$(0.01)	\$(0.02)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.02)	\$(0.01)	\$(0.01)

(1) Includes Other Revenues

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

of the ramp up in the wound care sales resulting from the partnership agreement with Smith & Nephew.

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 First Quarter	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter	2007 First Quarter	2006 Fourth Quarter	2006 Third Quarter	2006 Second Quarter
Current Ratio	6.9	6.4	3.0	2.5	9.2	10.7	11.5	9.6
Net Working Capital	\$13,832,958	\$14,322,821	\$5,341,353	\$4,346,329	\$4,815,698	\$5,113,130	\$5,508,379	\$5,760,544

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 exercise of the warrants in the fourth quarter of 2007 has significantly strengthened the liquidity of the Company and consequently allows us to invest in research and development and build infrastructure in our operations.

5. Liquidity & Capital Resources

Financial Position

(Canadian \$)	December 31, 2007	As at September 30, 2007
Total assets	\$ 19,507,205	\$ 20,244,461
Deferred revenue	\$ 1,866,789	\$ 1,977,904

Total Assets

Total assets at December 31, 2007 were \$19,507,205 compared to \$20,244,461 at September 30, 2007. The decrease is primarily due to decreases in cash and cash equivalents and short term investments of \$624,567 which was drawn down to fund the Company's operations. Other assets increased \$88,911 due to the realization in value of the 25,000 shares that were released from escrow as part of the Perfusion Technologies Inc. acquisition. These shares were valued at \$3.30 per share.

Deferred Revenue

The reduction in deferred revenue relates to the amortizing element of this account.

Liquidity

The Company follows a policy of investing its surplus cash resources in high quality, liquid, short-term notes. Cash equivalents as of September 30, 2007 and 2006 had less than three months maturity. Short-term investments have a maturity on December 1, 2008 which is greater than one year but the investment is readily cashable in a short period of time for use in our operations. As at December 31, 2007 there were no restrictions on the flow of these funds nor have any of these funds been committed in any way. The Company believes that it has the

capital resources and liquidity necessary to meet its commitments, support its operations and finance its current growth strategies.

Commitments

The Company has entered into an operating lease for its premises at 405 Britannia, Mississauga commencing December 1, 2004 and expiring December 31, 2009. The annual rental payments for the first two years are \$68,627 payable monthly and \$91,855 payable monthly for the remaining portion of the lease.

The Company has also entered into an operating lease for its equipment. The equipment is leased at \$235 per month under a lease expiring in 2010.

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

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

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	<u>(200,000)</u>	<u>(12,400)</u>	
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	<u>(65,000)</u>	<u>(10,340)</u>	
Balance December 31, 2007	<u>3,624,388</u>	<u>\$ 1,024,577</u>	

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.

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.

In the period, 65,000 stock options with a value of \$10,340 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.

Sources and Uses of Cash

	Three month period ended December 31,	
	2007	2006
Cash Provided By (Used in)		
Operating Activities		
Cash flow from operating activities before change in non-cash working capital	\$ (491,993)	\$ (338,341)
Change in non-cash working capital	(134,704)	(149,458)
	\$ (626,697)	\$ (487,799)
Investing Activities		
Purchase of capital assets, net	\$ (12,164)	\$ (26,584)
Purchase of patents and technology rights	(13,491)	(32,315)
Net Redemption of short term investments	3,044	-
	\$ (22,611)	\$ (58,899)
Financing Activities		
Issuance of share capital, net	\$ 35,500	\$ 100,000
Foreign exchange gain (loss) on cash held	\$ (7,715)	\$ (192)
Net change in cash and cash equivalents	\$ (621,523)	\$ (446,890)

Operating Activities

Cash flow used in operations for the first quarter of 2008 was (\$626,697) compared to (\$487,799) for the same period last year. The net increase in the first quarter of 2008 compared to the first quarter of 2007 is mainly due to the higher loss during the three months ended December 31, 2007, net the effect of the changes in non-cash working capital items.

Investing Activities

Cash used in investing activities was (\$22,611) in the first quarter of 2008, compared to (\$58,899) in the first quarter of 2007. Lower capital expenditure activities and purchases of patents and technology rights explain the lower amount in investing activities.

Financing Activities

Cash flow from financing activities for the first quarter of 2008 was \$35,500 compared to \$100,000 for the same period last year. There were some director's vested options that were exercised in the first quarter of 2008.

Off-Balance Sheet Arrangements

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

Financial Instruments

Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest and currency risks arising from its financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.

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

Short term investments consist of Ontario Savings Bonds (interest rate of 5.7% and maturing on December 1, 2008) and the carrying value approximates fair market value.

For the three months ended December 31, 2007, two customers accounted for 97% (three customers, September 30, 2007 – 95%) of the year end accounts receivable balance. These customers, who act as distributors of the Company's product, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers.

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

6. Risk and Uncertainties

Our risk and uncertainties statements have not changed since the release of our MD&A for the year ended September 30, 2007. Therefore, to review our risk and uncertainties please refer to the corresponding sections in the MD&A for the year ended September 30, 2007.

7. 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).

8. Critical Accounting Estimates

Our critical accounting estimates statements have not changed since the release of our MD&A for the year ended September 30, 2007. Therefore, to review our critical accounting estimates, please refer to the corresponding sections in the MD&A for the year ended September 30, 2007.

9. Accounting Policies

Policies Adopted in Fiscal 2008

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

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. 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 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 3031 did not have any impact on the unaudited interim consolidated financial statements for the three month period ending December 31, 2007.

The adoption of these new standards had no material impact on the company's consolidated statement of operations.

10. Opportunities

Our opportunities statements have not changed since the release of our MD&A for the year ended September 30, 2007. Therefore, to review our opportunities, please refer to the corresponding sections in the MD&A for the year ended September 30, 2007.

11. 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 December 31, 2007, the Company's Management evaluated the effectiveness of the design and operation of its disclosure controls and procedures as defined under the rules. The evaluation was performed under the supervision, and with the participation, of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on the evaluation of the Disclosure Controls,

the CEO and the CFO have concluded that, subject to the fact that an evaluation of controls can provide only reasonable, not absolute, assurance that all control issues and instances of fraud or error, if any, within the Company have been detected, the Company's Disclosure Controls are effective in providing reasonable assurance that material information relating to the Company is made known to Management. Changes and new controls are evaluated and implemented as required to provide greater business control.

12. 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.