

# Covalon Technologies Ltd.

Interim Consolidated Financial Statements

For the period ending March 31, 2008

(Unaudited – prepared by management)

---

## Contents

### **Consolidated Financial Statements**

Balance Sheets	3
Statements of Operations and Comprehensive Income	4
Statements of Cash Flows	5
Statements of Shareholders' Equity	6

<b>Summary of Significant Accounting Policies</b>	7-9
---	-----

<b>Notes to Financial Statements</b>	10-16
--------------------------------------	-------

---

**NOTICE OF NO REVIEW BY AUDITOR**

In accordance with National Instrument 51-102 **Continuous Disclosure Obligations** of the Canadian Securities Administrators, WE HEREBY GIVE NOTICE THAT our financial statements for the three and six-month periods ended March 31, 2008, which follow this notice, have not been reviewed by our auditors.

---

# Covalon Technologies Ltd.

## Interim Consolidated Balance Sheets

As at March 31, 2008 and September 30, 2007

(Unaudited - prepared by management)

	March 31, 2008	Audited September 30, 2007
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 5,412,708	\$ 6,917,897
Short term investments	9,082,699	9,252,103
Accounts receivable	586,886	320,239
Inventories	249,784	279,331
Prepaid expenses	145,168	204,512
	<u>15,477,245</u>	16,974,082
<b>Capital assets (Note 3)</b>	<b>527,866</b>	580,661
<b>Other assets (Note 4)</b>	<b>576,726</b>	484,368
<b>Deferred developments costs (Note 5)</b>	<b>2,146,983</b>	2,205,350
	<u>\$ 18,728,820</u>	\$ 20,244,461

## Liabilities and Shareholders' Equity

### Current

Accounts payable and accrued liabilities	\$ 447,023	\$ 673,357
Deferred revenue (Note 6)	1,755,673	1,977,904
	<u>2,202,696</u>	2,651,261

### Shareholders' Equity

Share Capital (Note 7 (b))	28,857,658	28,664,432
Contributed Surplus	329,004	329,004
Options (Note 7 (c))	1,298,904	925,625
Deficit	(13,959,442)	(12,325,861)
	<u>16,526,124</u>	17,593,200
	<u>\$ 18,728,820</u>	\$ 20,244,461

On behalf on the Board

\_\_\_\_\_  
Director

\_\_\_\_\_  
Director

# Covalon Technologies Ltd.

## Interim Consolidated Statements of Operations and Comprehensive Income

For the three and six months ended March 31, 2008 and March 31, 2007

(Unaudited - prepared by management)

	Three months ended March 31, 2008		Six months ended March 31, 2008	
	2008	2007	2008	2007
<b>Sales</b>	<b>\$ 308,413</b>	\$ 357,401	<b>\$ 915,748</b>	\$ 695,168
<b>Cost of goods sold</b>	<b>147,998</b>	189,077	<b>486,406</b>	387,844
	<b>160,415</b>	168,324	<b>429,342</b>	307,324
<b>Other revenue</b>				
Interest income	<b>235,097</b>	47,737	<b>447,540</b>	98,904
Licensing fee	<b>111,115</b>	56,373	<b>222,231</b>	57,734
	<b>506,627</b>	272,434	<b>1,099,113</b>	463,962
<b>Expenses</b>				
Amortization of capital assets	<b>30,440</b>	25,497	<b>61,184</b>	49,425
Amortization of patents and technology rights	<b>7,285</b>	599	<b>14,365</b>	10,659
Amortization of deferred development costs	<b>29,183</b>	28,850	<b>58,366</b>	57,700
Bank charges and interest	<b>1,134</b>	704	<b>1,976</b>	2,257
Directors' fees	<b>122,262</b>	97,910	<b>201,409</b>	119,276
Foreign currency loss (gain)	<b>(7,582)</b>	1,626	<b>133</b>	1,817
Management fees	<b>164,225</b>	88,730	<b>300,011</b>	166,230
Marketing	<b>46,848</b>	35,463	<b>88,820</b>	128,652
Office and administrative	<b>302,266</b>	126,123	<b>498,450</b>	225,456
Patent maintenance	<b>275</b>	400	<b>275</b>	600
Professional fees	<b>122,592</b>	9,133	<b>164,772</b>	23,279
Property maintenance	<b>2,025</b>	2,144	<b>4,332</b>	3,584
Regulatory	<b>260,368</b>	132,488	<b>493,641</b>	215,541
Research and development	<b>356,396</b>	211,801	<b>797,527</b>	327,257
Training - professional development	<b>7,039</b>	-	<b>10,416</b>	9,606
Travel	<b>19,447</b>	18,322	<b>37,017</b>	31,350
	<b>1,464,203</b>	779,790	<b>2,732,694</b>	1,372,689
<b>Loss and comprehensive income for the period</b>	<b>\$ (957,576)</b>	\$ (507,356)	<b>\$ (1,633,581)</b>	\$ (908,727)
<b>Basic and fully diluted loss per share (Note 7 (d))</b>	<b>\$ (0.01)</b>	\$ (0.01)	<b>\$ (0.02)</b>	\$ (0.02)

# Covalon Technologies Ltd.

## Interim Consolidated Statements of Cash Flows

For the three and six months ended March 31, 2008 and March 31, 2007

(Unaudited - prepared by management)

	Three months ended March 31,		Six months ended March 31,	
	2008	2007	2008	2007
<b>Cash flows from operating activities</b>				
Loss and comprehensive income for the period	\$ (957,576)	\$ (507,356)	\$ (1,633,581)	\$ (908,727)
Add (deduct) items not involving cash:				
Amortization of capital assets	30,440	25,497	61,184	49,425
Amortization of patent and technology rights	7,285	599	14,365	10,659
Amortization of deferred development costs	29,183	28,850	58,366	57,700
Stock compensation expense	296,071	63,803	405,362	63,803
Foreign exchange loss	(7,582)	1,626	133	1,817
Cash provided by operating activities before change in non-cash working capital balances	(602,179)	(386,981)	(1,094,171)	(725,323)
Change in non-cash working capital (Note 11)	(491,616)	2,297,430	(626,321)	2,147,973
	<u>(1,093,795)</u>	<u>1,910,449</u>	<u>(1,720,492)</u>	<u>1,422,650</u>
<b>Cash flows from investing activities</b>				
Purchase of capital assets (net of disposals and investment tax credits)	3,775	33,533	(8,389)	6,948
Purchase of patents and technology rights	166,360	(98,893)	169,404	(131,208)
Redemption of short term investments	(10,732)	-	(24,223)	-
	<u>159,403</u>	<u>(65,360)</u>	<u>136,792</u>	<u>(124,260)</u>
<b>Cash flows from financing activities</b>				
Net proceeds on issuance of share capital	43,144	50,000	78,644	150,000
Foreign exchange loss on cash held	7,582	(1,626)	(133)	(1,817)
Net Change in cash and cash equivalents during the period	(883,666)	1,893,463	(1,505,189)	1,446,573
Cash and cash equivalents, beginning of period	6,296,374	4,564,752	6,917,897	5,011,642
Cash and cash equivalents, end of period	<u>\$ 5,412,708</u>	<u>\$ 6,458,215</u>	<u>\$ 5,412,708</u>	<u>\$ 6,458,215</u>

**Covalon Technologies Ltd.**

Interim Consolidated Statements of Shareholders' Equity

For the period ending March 31, 2008

(Unaudited - prepared by management)

	Share Capital		Contributed Surplus	Warrants	Options	Deficit	Total
	Number of Shares	Amount					
<b>Balance, September 30, 2006</b>	56,322,784	\$ 15,828,922	\$ 340,297	\$ 927,479	\$ 418,739	\$ (9,249,484)	\$ 8,265,953
Issue of warrants pursuant to the exercise of broker compensation warrants		(2,338,229)		2,338,229			-
Issue of common shares for cash pursuant to the exercise of warrants	15,888,056	14,907,819		(3,265,708)			11,642,111
Issue of common shares for cash pursuant to the exercise of stock options	501,194	265,920			(71,287)		194,633
Options reinstated to consultant			(23,693)		23,693		-
Stock based compensation					566,880		566,880
Expired stock options			12,400		(12,400)		-
Net loss and comprehensive income						(3,076,377)	(3,076,377)
<b>Balance, September 30, 2007</b>	72,712,034	\$ 28,664,432	\$ 329,004	\$ -	\$ 925,625	\$ (12,325,861)	\$ 17,593,200
Issue of common shares for cash pursuant to the exercise of stock options	163,181	110,726			(32,085)		78,641
Issue of common shares to Perfusion Therapeutics Inc.	25,000	82,500					82,500
Stock based compensation					405,364		405,364
Net loss and comprehensive income						(1,633,581)	(1,633,581)
<b>Balance, March 31, 2008</b>	72,900,215	\$ 28,857,658	\$ 329,004	\$ -	\$ 1,298,904	\$ (13,959,442)	\$ 16,526,124

---

**Covalon Technologies Ltd.**  
**Notes to the Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

---

Nature of Business                      The Company is incorporated under the laws of Ontario and is engaged in the business of developing medical products. In prior years, up to and including the year ending September 30, 2005, the Company focused its efforts on research and development and the raising of capital to fund the development of medical products. Accordingly, the Company was considered to be in the development stage. The Company has now received regulatory approval on numerous products and is currently generating revenue. The Company's main business function has changed to manufacturing and sales; accordingly the Company is no longer considered a Development Stage Company. All research and development costs subsequent to September 30, 2005 are now expensed as incurred.

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Basis of Presentation                      The accompanying unaudited interim consolidated financial statements have been prepared by management in accordance with the Canadian generally accepted accounting principles and on a basis consistent with the Company's annual audited financial statements for the year ended September 30, 2007. These statements should be read in conjunction with the September 30, 2007 audited financial statements.

The current period's consolidated financial statements include the operations of the Company for the three and six month period ended March 31, 2008. These consolidated financial statements have not been reviewed by the Company's auditor.

Basis of Consolidation                      These financial statements have been prepared using the purchase method of consolidation. The assets and liabilities of the acquired companies are initially recorded at cost. The results of operations of the acquired companies are included from the dates of acquisition. All significant intercompany transactions and balances have been eliminated on consolidation.

Revenue Recognition                      Revenue is recognized on an accrual basis as follows:

- a) Revenue arising from product sales is recognized once the product has been shipped to the customer.
- b) Revenue arising from licensing fees and royalties is initially recorded as deferred revenue and recognized over the period of the relevant agreements.
- c) Revenue arising from interest is recognized as earned.

Cash and Cash Equivalents                      Cash and cash equivalents are defined as highly liquid investments and consist of cash and money market instruments.

Inventories                                      Raw materials and supplies are stated at the lower of average cost and replacement cost. Cost is generally determined on the first-in, first-out basis. Work in process and finished goods are stated at the lower average cost and net realizable value.

---

**Covalon Technologies Ltd.**  
**Notes to the Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

---

Capital Assets	<p>Capital assets are recorded at cost less related investment tax credits. Amortization is based on the estimated useful life of the asset and is calculated as follows:</p> <table><tr><td>Furniture and fixtures</td><td>- 20% diminishing balance basis</td></tr><tr><td>Lab equipment</td><td>- 20% diminishing balance basis</td></tr><tr><td>Leasehold improvements</td><td>- straight-line basis over 5 years</td></tr></table>	Furniture and fixtures	- 20% diminishing balance basis	Lab equipment	- 20% diminishing balance basis	Leasehold improvements	- straight-line basis over 5 years
Furniture and fixtures	- 20% diminishing balance basis						
Lab equipment	- 20% diminishing balance basis						
Leasehold improvements	- straight-line basis over 5 years						
Other Assets	<p>Other assets include expenditures related to obtaining patents and technology rights and are stated at cost less accumulated amortization. Amortization is being provided on a straight-line basis over the remaining life of the patent being 20 years less the number of years since application for the patent.</p>						
Deferred Development Costs / Research Development	<p>During the development stage, research costs were expensed as incurred. Development costs which meet generally accepted criteria, including reasonable assurance regarding recoverability, are deferred and amortized from the beginning of commercial production and sales. Annually the Company reviews the recoverability of deferred development costs through evaluation of the expected future cash inflows from commercialization of the associated products to determine if there is an impairment in the recoverable amount.</p> <p>Development costs for each product (project) are amortized when the product regulatory approval to sell the product is received, on a straight-line basis over the years remaining on the patent.</p>						
Investment Tax Credits	<p>Investment tax credits arising from qualifying research and experimental development costs are recorded as a reduction of deferred development costs or capital asset purchases in the period in which these tax credits are considered reasonably assured to be recovered.</p>						
Future Income Tax	<p>The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in operations in the year in which the change occurs.</p>						
Foreign Currency Translation	<p>Foreign currency accounts are translated into Canadian dollars as follows:</p> <p>At the transaction date, each asset, liability, revenue and expense is translated into Canadian dollars by the use of the exchange rate in effect at that date. At the reporting date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate in effect at that date. The resulting foreign exchange gains and losses are included in income in the current period.</p>						

---

**Covalon Technologies Ltd.**  
**Notes to the Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

---

Financial instruments	<p>Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest and currency risks arising from its financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.</p> <p>All of the Company's cash is maintained by one of the major financial institutions.</p> <p>Short term investments consist of Ontario Savings Bonds (interest rate of 5.7% and maturing on December 1, 2008) and the carrying value approximates fair market value.</p> <p>As at March 31, 2008, two customers accounted for 96% (September 2007 – three customers for 95%) of the accounts receivable balance. These customers, who act as distributors of the Company's product, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers.</p>
Stock Based Compensation	<p>Direct awards of stock are based on the price of common stock measured at fair value at each reporting date, with the change in fair value reported in the statement of operations.</p> <p>The Company uses the fair value based method of accounting for all its stock-based compensation. Accordingly, the fair value method of accounting is applied for stock options granted to directors, officers, employees and consultants whereby the weighted average fair value of options granted is recognized in the financial statements over the vesting period. When the awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to options.</p>
Use of Estimates	<p>The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from management's best estimate as additional information becomes available in the future.</p>
Loss per Common Share	<p>Loss per common share has been computed by dividing the loss applicable to common shareholders by the weighted average number of shares of common stock outstanding during the respective years.</p>
Impairment of Long-Lived Assets	<p>An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes the assets' carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the asset and its carrying value. Management has determined that there is no impairment of long-lived assets.</p>

---

**Covalon Technologies Ltd.**  
**Notes to Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

---

**2. CHANGE IN ACCOUNTING POLICIES**

For the period ended March 31, 2008 Management is using CICA Handbook Section 3855, Financial Instruments – Recognition and Measurement, Section 3861, Financial Instruments – Disclosure and Presentation, Section 1530, Comprehensive Income, and Section 3251, Equity, as described in the December 31, 2007 Consolidated Financial Statements.

CICA Section 1400, Going Concern Amendments was issued in June 2007. This section requires Management to assess the Company's ability to continue as a going concern. Unless there is a plan to liquidate, cease trading or suspend operations, the financial statements are prepared on a going concern basis. Covalon is considered to be a going concern and as such, no provisions are made for the valuation of assets or the cost to discharge liabilities, other than in the normal course of operations. To sustain the business in the future, there must be profitable operations or support from shareholders and other financial parties.

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 by 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 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. Management is examining its practices regarding this Section.

For 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 six-month period ending March 31, 2008.

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.

Section 3031, *Inventories*, is effective for annual and interim periods beginning on or after

**Covalon Technologies Ltd.**  
**Notes to Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

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. 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.

**3. CAPITAL ASSETS**

	March 31, 2008		Audited September 30, 2007	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 162,089	\$ 59,967	\$ 160,295	\$ 50,458
Lab Equipment	739,918	330,726	734,849	285,543
Leasehold improvements	49,656	33,104	49,656	28,138
	<b>951,663</b>	<b>423,797</b>	944,800	364,139
Cost less accumulated amortization		<b>\$ 527,866</b>		\$ 580,661

**4. OTHER ASSETS**

	March 31, 2008	Audited September 30, 2007
Patents and technology rights (net of \$134,297 accumulated amortization; Sep 2007 - \$119,932)	<b>\$ 576,726</b>	\$ 484,368

**Covalon Technologies Ltd.**  
**Notes to Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

**5. DEFERRED DEVELOPMENT COSTS**

	<u>March 31, 2008</u>	<u>Audited September 30, 2007</u>
Cost	\$ 2,434,066	\$ 2,434,066
Less: accumulated amortization	<u>287,083</u>	<u>228,716</u>
	<u>\$ 2,146,983</u>	<u>\$ 2,205,350</u>

**6. DEFERRED REVENUE**

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

**7. SHARE CAPITAL**

a) **Authorized** - Unlimited number of Common Shares

b) **Issued** – Common shares and warrants

	<u>Number of Common Shares</u>	<u>Number of Warrants</u>	<u>Stated Capital</u>	<u>Warrants</u>
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	163,181		110,726	
Balance, March 31, 2008	<u>72,900,215</u>	<u>-</u>	<u>\$ 28,857,658</u>	<u>\$ -</u>

---

**Covalon Technologies Ltd.**  
**Notes to Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

---

**7. SHARE CAPITAL (continued)**

At March 31, 2008, 6,884,830 (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 188,181 common shares.

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

In the period, 163,181 options to purchase common shares with a value of \$32,085 were exercised for cash consideration of \$78,641.

**c) *Stock Option Plan***

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

**Covalon Technologies Ltd.**  
**Notes to Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

	<b>Number of Shares</b>	<b>Value</b>	<b>Exercise Price</b>
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	108,998	\$ 2.79
Granted to employees	360,000	135,676	\$ 2.93
Vested to related parties		149,809	\$ 1.01
Vested to employees		10,881	\$ 1.22
Exercised	(163,181)	(32,085)	
Balance March 31, 2008	4,161,207	\$ 1,298,904	

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.

---

**Covalon Technologies Ltd.**  
**Notes to Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

---

**7. SHARE CAPITAL (continued)**

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 \$108,998 vested, total value of options granted to employees during the period was \$609,900 of which \$135,676 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, 163,181 stock options with a value of \$32,085 were exercised for common shares for cash consideration of \$78,641.

As at March 31, 2008, 2,879,587(2007 – 2,468,707) options were available for exercise.

**(d) Loss per Share**

Loss per share is calculated using the weighted average number of common shares outstanding during the period ended March 31, 2008, which is 72,804,543 (2007 – 56,529,452) shares. As the Company experienced losses for the period ended March 31, 2008 and 2007, all potential common shares outstanding from dilutive securities are considered anti-dilutive and are excluded from the calculation of loss per share for those years.

Details of anti-dilutive potential securities outstanding not included in diluted EPS calculations at March 31, 2008 and 2007 are as follows:

---

Anti-dilutive potential securities	2008	2007
Common shares potentially assumable:		
- pursuant to warrants	-	14,752,328
- under stock options	<u>4,161,207</u>	<u>4,015,582</u>
	<u>4,161,207</u>	<u>18,767,910</u>

---

**8. RELATED PARTY TRANSACTIONS**

a) During the period the Company paid fees to related parties as follows:

(i) Management fees totaling \$300,011 (2007 – \$166,230) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$118,377 (2007 – \$11,230).

**Covalon Technologies Ltd.**  
**Notes to Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

**8. RELATED PARTY TRANSACTIONS (continued)**

- (ii) Directors fees include cash compensation of \$75,800 (2007 - \$73,866) paid to certain of the independent directors and stock option benefits that have been valued at \$125,609 (2007 – \$45,410).
- b) The management fees are paid pursuant to two separate management agreements, expiring September 30, 2008. The commitments for the 2008 fiscal year are \$330,000.

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

**9. COMMITMENTS**

The Company has entered into an operating lease for its premises at 405 Britannia, Mississauga commencing December 1, 2004 and expiring 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>

**10. SUPPLEMENTAL CASH FLOW INFORMATION**

	<u>2008</u>	<u>2007</u>
<b><i>Non-Cash Financing and Investing</i></b>		
Shares issued on payment of agent fee	\$ -	\$ 68,702
Issuance of shares for technology rights	\$ 82,500	\$ -

**Covalon Technologies Ltd.**  
**Notes to Interim Consolidated Financial Statements**  
**Unaudited – prepared by management**

**March 31, 2008 and 2007**

**11. CHANGE IN NON-CASH OPERATING WORKING CAPITAL ITEMS**

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

	Three months ending March 31,		Six months ending March 31,	
	<b>2008</b>	2007	<b>2008</b>	2007
Accounts receivable	<b>\$ (289,627)</b>	\$ 88,770	<b>\$ (266,647)</b>	\$ (4,138)
Inventory	<b>(63,366)</b>	(43,082)	<b>29,547</b>	(94,000)
Prepaid expenses	<b>21,400</b>	28,590	<b>59,344</b>	(38,992)
Accounts payable and accrued liabilities	<b>(48,907)</b>	(41,676)	<b>(226,334)</b>	21,636
Deferred revenue	<b>(111,116)</b>	2,264,828	<b>(222,231)</b>	2,263,467
	<b><u>\$ (491,616)</u></b>	<u>\$ 2,297,430</u>	<b><u>\$ (626,321)</u></b>	<u>\$ 2,147,973</u>