

Covalon Technologies Ltd.

Consolidated Financial Statements

For the years ended

September 30, 2008 and 2007

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Auditors' Report

To the Shareholders of Covalon Technologies Ltd.

We have audited the consolidated balance sheets of Covalon Technologies Ltd. as at September 30, 2008 and 2007 and the consolidated statements of operations and comprehensive loss, cash flows and shareholders' equity for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) "BDO Dunwoody LLP"

Chartered Accountants, Licensed Public Accountants

Toronto, Ontario
January 23, 2009

Covalon Technologies Ltd.

Consolidated Balance Sheets

September 30	2008	2007
Assets		
Current assets		
Cash and cash equivalents	\$ 3,533,554	\$ 6,917,897
Short term investments	9,082,699	9,252,103
Accounts receivable	239,622	320,239
Inventories (Note 5)	278,256	279,331
Prepaid expenses	66,535	204,512
Total Current Assets	13,200,666	16,974,082
Capital assets (Note 6)	844,736	580,661
Other assets (Note 7)	671,048	484,368
Deferred development costs (Note 8)	2,576,036	2,205,350
Total Assets	\$ 17,292,486	\$ 20,244,461

Liabilities and Shareholders' Equity

Current		
Accounts payable and accrued liabilities	\$ 750,138	\$ 673,357
Deferred revenue (Note 9)	442,627	450,653
Total Current Liabilities	1,192,765	1,124,010
Deferred Revenue (Note 9)	1,084,624	1,527,251
Total Liabilities	2,277,389	2,651,261
Shareholders' Equity		
Share Capital (Note 10 (b))	29,151,710	28,664,432
Contributed Surplus	329,004	329,004
Options (Note 10 (c))	1,601,091	925,625
Deficit	(16,066,708)	(12,325,861)
Total Shareholders' Equity	15,015,097	17,593,200
Total Liabilities and Shareholders' Equity	\$ 17,292,486	\$ 20,244,461

On behalf on the Board

(signed) "Martin C. Bernholtz" _____ Director

(signed) "Frank DiCosmo" _____ Director

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

Covalon Technologies Ltd.

Consolidated Statements of Operations and Comprehensive Loss

For the years ended September 30	2008	2007
Revenues		
Product sales and coating services	\$ 1,402,868	\$ 1,285,673
Licensing fee	443,850	249,999
Interest income	626,260	249,143
Total revenue	2,472,978	1,784,815
 Operating Expenses		
Product	825,727	856,406
Regulatory	1,227,483	588,833
Research and development activities	1,219,968	1,164,873
Marketing	482,061	220,046
General and administrative	2,458,586	2,031,034
Total operating expenses	6,213,825	4,861,192
 Net loss and comprehensive loss for the year		
	\$ (3,740,847)	\$ (3,076,377)
 Basic and fully diluted loss per share (Note 10 (d))		
	\$ (0.05)	\$ (0.05)

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

Covalon Technologies Ltd.

Consolidated Statements of Cash Flows

For the years ended September 30	2008	2007
Cash flows from operating activities		
Net loss for the year	\$ (3,740,847)	\$ (3,076,377)
Add (deduct) items not involving cash:		
Amortization of capital assets	167,399	110,959
Amortization of patent and technology rights	62,698	28,714
Amortization of deferred development costs	116,732	113,315
Loss on disposal of capital assets	-	9,218
Write-down of deferred development costs	-	91,524
Write-down of patents	-	7,620
Deferred revenue recognized	(450,653)	(364,011)
Stock compensation expense	777,525	566,880
Foreign exchange loss	7,109	53,269
Cash provided by operating activities before change in non-cash working capital balances	(3,060,037)	(2,458,889)
Change in non-cash working capital (Note 16)	296,450	2,312,679
	<u>(2,763,587)</u>	<u>(146,210)</u>
Cash flows from investing activities		
Purchase of capital assets (net of disposals and investment tax credits)	(431,474)	(260,227)
Expenditure on deferred development cost	(487,418)	-
Purchase of patents and technology rights	(56,878)	(218,679)
Redemption/(Purchase) of short term investments	169,404	(9,252,103)
	<u>(806,366)</u>	<u>(9,731,009)</u>
Cash flows from financing activities		
Net proceeds on issuance of share capital	192,719	11,836,743
Foreign exchange loss on cash held	(7,109)	(53,269)
Net Change in cash and cash equivalents during the year	(3,384,343)	1,906,255
Cash and cash equivalents, beginning of year	6,917,897	5,011,642
Cash and cash equivalents, end of year	\$ 3,533,554	\$ 6,917,897
Represented by		
Cash	\$ 81,124	\$ 681,320
Cash equivalents	3,452,430	6,236,577
	<u>\$ 3,533,554</u>	<u>\$ 6,917,897</u>

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

Covalon Technologies Ltd.

Consolidated Statements of Shareholders' Equity

For the years ended September 30, 2008 and 2007

	Share Capital		Contributed Surplus	Warrants	Options	Deficit	Total
	Number of Shares	Amount					
Balance, September 30, 2006	56,322,784	\$ 15,828,922	\$ 340,297	\$ 927,479	\$ 418,739	\$ (9,249,484)	\$ 8,265,953
Issue of warrants pursuant to the exercise of broker compensation warrants		(2,338,229)		2,338,229			-
Issue of common shares for cash pursuant to the exercise of warrants	15,888,056	14,907,819		(3,265,708)			11,642,111
Issue of common shares for cash pursuant to the exercise of stock options	501,194	265,920			(71,287)		194,633
Options reinstated to consultant			(23,693)		23,693		-
Stock based compensation					566,880		566,880
Expired stock options			12,400		(12,400)		-
Net loss and comprehensive loss						(3,076,377)	(3,076,377)
Balance, September 30, 2007	72,712,034	28,664,432	329,004	-	925,625	(12,325,861)	17,593,200
Issue of common shares for cash pursuant to the exercise of stock options	491,881	294,778	-	-	(102,059)	-	192,719
Issued for technology rights	75,000	192,500	-	-	-	-	192,500
Issued in trust	1,025,000	-	-	-	-	-	-
Stock based compensation	-	-	-	-	777,525	-	777,525
Net loss and comprehensive loss	-	-	-	-	-	(3,740,847)	(3,740,847)
Balance, September 30, 2008	74,303,915	\$ 29,151,710	\$ 329,004	\$ -	\$ 1,601,091	\$ (16,066,708)	\$ 15,015,097

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

Covalon Technologies Ltd. Summary of Significant Accounting Policies

September 30, 2008 and 2007

Nature of Business	<p>The Company is incorporated under the laws of Ontario and is engaged in the business of developing medical products. In prior years, up to and including the year ending September 30, 2005, the Company focused its efforts on research and development and the raising of capital to fund the development of medical products. Accordingly, the Company was considered to be in the development stage. The Company has now received regulatory approval on numerous products and is currently generating revenue. The Company's main business function continues to be research and development along with manufacturing and sales.</p>						
Going Concern	<p>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 partners.</p>						
Basis of Consolidation	<p>These financial statements have been prepared using the purchase method of consolidation. The assets and liabilities of the acquired companies are initially recorded at cost. The results of operations of the acquired companies are included from the dates of acquisition. All significant intercompany transactions and balances have been eliminated on consolidation.</p>						
Revenue Recognition	<p>Revenue is recognized on an accrual basis as follows:</p> <ul style="list-style-type: none">a) Revenue arising from product sales is recognized once the product has been shipped to the customer.b) Revenue arising from licensing fees and royalties is initially recorded as deferred revenue and recognized over the period of the relevant agreements.c) Revenue arising from interest is recognized as earned.						
Cash and Cash Equivalents	<p>Cash and cash equivalents are defined as highly liquid investments and consist of cash and money market instruments.</p>						
Inventories	<p>Raw materials and supplies are stated at the lower of average cost and replacement cost. Work in process and finished goods are stated at the lower average cost and net realizable value.</p>						
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						

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

September 30, 2008 and 2007

Other Assets	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.
Deferred Development Costs /Research and Development	<p>Prior to September 30, 2005, research costs were expensed as incurred. Development costs which meet generally accepted criteria, 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 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	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.
Future Income Tax	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.
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 an estimate 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 currently in effect. The resulting foreign exchange gains and losses are included in income in the current period.</p>

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

September 30, 2008 and 2007

Financial Instruments

The Company's cash and cash equivalents are classified as held for trading and measured at fair value; Subsequent changes in fair value are recorded to net income or loss. Short-term investments are classified as available for sale and initially measured at fair value with subsequent changes in fair value recorded in other comprehensive income. Receivables are classified as loans and receivables and are initially measured at fair value; subsequently measured at their amortized cost using the effective interest rate method. Accounts payable and accrued liabilities are classified as other liabilities and are initially measured at fair value; subsequently measured at their amortized cost using the effective interest rate method. The fair values of the financial assets and liabilities that are included in the balance sheet approximate their fair value due to their short term nature.

Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments. The company is exposed to currency risk arising from fluctuations in foreign exchange rates and the degree of volatility in those rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

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.

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

Stock Based Compensation

Direct awards of stock are based on the price of common stock measured at fair value at the date of grant and the corresponding expense is recognized 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.

Use of 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.

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

September 30, 2008 and 2007

Loss per Common Share

Loss per common share is computed using the weighted average number of common shares that are outstanding during the year. Diluted loss per common share is computed using the weighted average number of common and potential common shares outstanding during the year. Potential common shares consist of the incremental common shares issuable upon the exercise of stock options and warrants under the treasury stock method.

Impairment of Long-Lived Assets

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 no long-lived assets of the Company in the year ended September 30, 2008 have met the criteria for impairment. In the year ended September 30, 2007, \$99,144 was written off in impairment charges.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2008 and 2007

1. FINANCIAL RISK MANAGEMENT

Risk factors

The following is a discussion of market, credit and liquidity risks and related mitigation strategies that have been identified. This is not an exhaustive list of all risks, nor will the mitigation strategies eliminate all risks listed.

Credit risk

The Company's cash and cash equivalents and short term investments does not subject the Company to significant credit risk. The Company has discount note and provincial bonds, as per its practice of protecting its capital rather than maximizing investment yield, of \$12.5 million invested with two issuers; however, this risk is mitigated as the issuers are a major Canadian bank and the Province of Ontario.

The Company, in the normal course of business, is exposed to credit risk from its global customers in the medical device industry. The accounts receivable are subject to normal industry risks in each geographic region in which the Company operates. In addition, the Company is exposed to credit related losses on sales to customers outside North America and the European Union due to potentially higher risks of enforceability and collectability. The Company attempts to manage these risks by dealing with creditworthy customers; however, due to the limited number of potential customers in each market this is not always possible. As at September 30, 2008, two customers accounted for 100% (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 which are all to the United States billed in U.S. dollars. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers.

Pursuant to their collective terms, accounts receivable are aged as follows at September 30, 2008:

Current	\$239,622
31-60 days past due	-
	<u>\$239,622</u>

Liquidity risk

The Company has an ongoing need for substantial capital resources to research and develop, commercialize and manufacture its products and technologies. 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.

Interest rate risk

The Company is subject to interest rate risk on its cash and cash equivalents. The Company believes that interest rate risk is low as its cash and cash equivalents consists of low risk money market and fixed income securities with maturity dates of less than one year.

Currency risk

The Company has suppliers and customers that are not based in Canada which gives rise to a risk that earnings and cash flows may be adversely affected by fluctuations in foreign currency exchange rates. The Company is primarily exposed to the US dollar. Part of the currency risk is mitigated by the fact that the Company has both purchases and sales in US dollars, creating a natural hedge. The Company believes the remaining risk is acceptable and does not use financial instruments to hedge these risks.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2008 and 2007

1. FINANCIAL RISK MANAGEMENT (continued)

Foreign currency balances expressed in Canadian dollars consist of the following:

	<u>2008</u>		<u>2007</u>
Accounts receivable	\$ 121,223	\$	175,412
Accounts payable	153,252		243,917
Exchange rate (\$USD / \$CAD)	1.064		0.995

Commodity risk

The Company is exposed to commodity risk related to purchases of key raw materials necessary for the manufacture of its bulk product from a limited number of suppliers around the world. The Company attempts to mitigate this risk by entering into long-term supply contracts at fixed pricing with capped annual increases. Silver is the Company's most significant cost subject to commodity risk. There is commodity risk for all other ingredients in each of the Company's products. The company attempts to mitigate these risks through the use of multiple suppliers and fixed price contracts but due to the nature of some of the chemicals required and the regulatory paths to approving new suppliers, this is not always possible.

2. MANAGEMENT OF CAPITAL

The Company defines capital that it manages as the aggregate of its cash and cash equivalents, short-term investments and equity comprising of share capital, contributed surplus and deficit. Its objectives when managing capital are to ensure that the Company will continue as a going concern, so that it can provide services to its customers and returns to its shareholders.

The Company manages its capital structure and makes adjustments to it in light of economic conditions. The Company, upon approval from its Board of Directors, will make changes to its capital structure as deemed appropriate under the specific circumstances. The Company's investment policy is to invest only in investment grade, highly liquid money market instruments.

The Company is not subject to any externally imposed capital requirements and the Company's overall strategy with respect to management of capital remains unchanged from the year ending September 30, 2007.

3. CHANGES IN 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 consolidated financial statements for the year ending September 30, 2008, however, it did result in expanded note disclosure (see note 1).

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 its 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 (see note 2).

The CICA amended Handbook Section 1400 to include requirements for management to assess and disclose an entity's ability to continue as a going concern. These standards are effective for interim and annual financial statements for the Company's reporting period beginning on or after October 1, 2008. The Company early adopted this standard and asserts that the Company is considered to be a going concern.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2008 and 2007

4. RECENT ACCOUNTING PRONUCEMENTS

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. 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 (IFRS). 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 is addressing this issue through research on the process and specific impact to Covalon Technologies. In the upcoming fiscal year, the company will identify the specific areas that will be impacted by the transition and will put any necessary systems in place to comply. The first year that Covalon plans to issue IFRS-compliant Financial Statements is the year ending September 30, 2012. To provide comparative information, an opening Balance Sheet will be necessary at October 1, 2010, so the company must be prepared in less than 2 years for the formal change. By September 30, 2009, the company will have identified the material issues related to the transition to IFRS and will have a plan to deal with them by the end of the following year and will need to disclose its plan in the MD&A.

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 is not expected to be material.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2008 and 2007

5. INVENTORIES

	2008	2007
Raw materials	\$ 202,492	\$ 175,412
Finished Goods	75,764	103,919
	\$ 278,256	\$ 279,331

6. CAPITAL ASSETS

	2008		2007	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 293,844	\$ 84,650	\$ 160,295	\$ 50,458
Lab equipment	1,005,016	402,420	734,849	285,543
Leasehold improvements	70,571	37,625	49,656	28,138
	1,369,431	524,695	944,800	364,139
Cost less accumulated amortization	\$ 844,736		\$ 580,661	

7. OTHER ASSETS

	2008	2007
Patents and technology rights (net of \$182,630 accumulated amortization; Sep 2007 - \$119,932)	\$ 671,048	\$ 484,368

8. DEFERRED DEVELOPMENT COSTS

	2008	2007
Cost	\$ 2,921,484	\$ 2,434,066
Less: accumulated amortization	345,448	228,716
	\$ 2,576,036	\$ 2,205,350

9. 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.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2008 and 2007

9. DEFERRED REVENUE (continued)

	2008	2007
Balance, beginning of year	\$ 1,977,904	\$ 20,715
Add:		
Exclusivity milestone payment	-	2,321,200
Less:		
Amortization of license and supply agreements	443,851	249,999
Offset of related costs	6,802	114,012
Balance, end of year	1,527,251	1,977,904
Amount to be recognized within one year	442,627	450,653
Long term balance	\$ 1,084,624	\$ 1,527,251

10. Share Capital

a) Authorized – Unlimited number of Common Shares

b) Issued – Common shares and warrants

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.

In fiscal 2006, Covalon acquired technology from Perfusion Therapeutics Inc. for 1,100,000 fully paid non-assessable common shares of Covalon Technologies Ltd., issued in escrow to be released on various success milestones. At September 30, 2008, 75,000 shares valued at \$192,500 have been released from escrow. The remaining balance of 1,025,000 shares are still being held in escrow.

In fiscal 2008, 491,881 options to purchase common shares with a value of \$102,059 were exercised for cash consideration of \$192,719.

At September 30, 2008, 6,640,502 (2007 – 8,335,599) shares are held in escrow.

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 Consolidated Financial Statements

September 30, 2008 and 2007

10. Share Capital (continued)

	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	\$ 1.22
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	302,629	\$ 2.79
Granted to employees	380,000	310,880	\$ 2.83
Vested to related parties		278,634	\$ 1.03
Vested to employees		15,911	\$ 1.22
Exercised	(491,881)	(102,059)	
Forfeited	(164,332)	(130,529)	
Balance, September 30, 2008	3,688,175	\$ 1,601,091	

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 (100,000) 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: average risk-free rate of interest – 3.5%, dividend rate NIL, average volatility – 77% and a term of 5 years.

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10. Share Capital (continued)

Total value of options granted to related parties during the fiscal 2008 was \$698,401 of which \$302,629 vested, total value of options granted to employees during fiscal 2008 was \$693,684 of which \$310,880 vested. Stock options granted to related parties during fiscal 2008 expire on March 31, 2013. Stock options granted to employees during fiscal 2008 expire on September 30, 2012 (100,000), March 31, 2013 (260,000) and on September 3, 2013 (20,000). 164,332 of these options granted to employees valued at \$130,529 with expiry dates of September 30, 2012 and March 31, 2013 were forfeited in fiscal 2008.

491,881 stock options with a value of \$102,059 were exercised for common shares for cash consideration of \$192,719.

As at September 30, 2008, 3,042,131 (2007 – 2,474,431) options were available for exercise.

(d) Loss per Share (to be updated for escrowed shares)

Loss per share is calculated using the weighted average number of common shares outstanding during the year ended September 30, 2008, which is 73,726,681 (2007 – 59,987,216) shares. As the Company experienced losses for the years ended September 30, 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 are as follows:

Anti-dilutive potential securities	2008	2007
Common shares potentially assumable:		
- under stock options	3,688,175	3,589,388

11. Related Party Transactions

- a. During the year the Company paid fees to related parties as follows:
 - (i) Management fees totaling \$619,013 (2007 – \$527,994) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$248,680 (2007 – \$217,994).
 - (ii) Directors fees include cash compensation of \$145,708 (2007 - \$140,057) paid to certain of the independent directors and stock option benefits that have been valued at \$298,285 (2007 – \$308,391).

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11. Related Party Transactions (continued)

- b. Management fees are paid pursuant to two separate management agreements, expiring September 30, 2008. New agreements were signed for the 2009 fiscal year for commitments totaling \$400,000.

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

Subsequent to the signing of the distribution agreement with Smith & Nephew, Dr. DiCosmo signed a consulting agreement with the same. The agreement called for Dr. DiCosmo to speak on behalf of Smith & Nephew at conferences, sales meetings and customer presentations for the promotion of Covalon's products. Dr. DiCosmo received total payments of \$26,500 from Smith & Nephew according to the contract terms. In 2008, the Company determined that this arrangement was in conflict with its policies. Smith & Nephew agreed to the cancellation of the contract and Dr. DiCosmo agreed to repay the \$26,500 to Covalon as a deduction from his remuneration in the 2009 fiscal year.

12. Commitments

The Company has entered into an operating lease for its premises at 405 Britannia Rd, Mississauga commencing December 1, 2004 and expiring November 30, 2009. The annual rental payment for the remaining period of the lease is \$94,900 payable monthly.

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>

13. Contingencies

The Company is party to a number of legal proceedings arising out of the normal course of business. The results of these litigations cannot be predicted with certainty, and management is of the opinion that the outcome of these proceedings is not determinable. Any loss resulting from these proceedings, will be charged to operations in the period the loss is determined.

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14. Income Taxes

(a) Reconciliation between statutory rate and actual rate

	2008	2007
Income tax recovery computed at statutory combined basis rate of 34% (2007 - 36%)	\$(1,271,900)	\$ (1,107,500)
Permanent differences	268,400	207,400
Expiring losses	233,100	162,800
Change in future tax rates	274,600	87,900
Prior year adjustment for R & D claim	161,900	-
Other	133,600	81,800
Valuation allowance	200,300	567,600
	\$ -	\$ -

(b) Future tax assets

The tax effect of the temporary differences that gives rise to future tax assets (liabilities) as of September 30, 2008 and 2007 is presented below. No benefit has been recorded in these financial statements as there is no assurance that the Company will generate taxable income to utilize these differences.

	2008	2007
Non-capital loss carry forwards	\$ 2,691,500	\$ 2,457,000
Capital loss carry forwards	148,300	166,200
Capital and other assets	165,400	114,000
Deferred development costs	89,700	(50,100)
Deferred revenue	443,000	642,800
Other	-	7,700
Valuation allowance	(3,537,900)	(3,337,600)
	\$ -	\$ -

(c) The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2008 of approximately \$9,281,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

<u>Year</u>	<u>Amount</u>
2009	\$ 880,000
2010	844,000
2014	787,000
2015	1,963,000
2026	1,494,000
2027	235,000
2028	3,078,000
	\$ 9,281,000

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2008 and 2007

14. Income Taxes (continued)

- (d) The Company has capital losses carry forward for income tax purposes as at September 30, 2008 of approximately \$1,022,000 which are available to reduce taxable capital gains in future years. These losses do not expire.
- (e) The Company is eligible for a 20% federal credit on its SR&ED expenditures which can only be used to offset against income taxes payable. The Company is also eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% and refundable in cash to the Company.

The refundable tax credits ultimately received by the Company are subject to review by Canada Revenue Agency and the Ontario Ministry of Finance.

Under the Income Tax Act of Canada, certain expenditures are classified as SR&ED expenditures and for tax purposes are grouped into a pool, which is 100% deductible in the year incurred. This SR&ED expenditure pool can also be carried forward indefinitely and deducted in full in any subsequent year. The balance of the federal SR&ED expenditure pool at September 30, 2008 is \$2,814,387 (2007 - \$1,556,672) and \$2,856,498 for Ontario tax purposes (2006 - \$2,382,512).

At September 30, 2008, the Company has \$359,685 (2007 - \$17,119) of unclaimed investment tax credits available to reduce federal income taxes payable in future years. If not utilized, these investment tax credits will start expiring in 2013.

15. SUPPLEMENTAL CASH FLOW INFORMATION

	2008	2007
<i>Non-Cash Financing and Investing</i>		
Issuance of shares to Perfusion Therapeutics Inc. for technology rights	\$ 192,500	\$ -

16. CHANGE IN NON-CASH OPERATING WORKING CAPITAL ITEMS

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

For the years ended September 30	2008	2007
Accounts receivable	\$ 80,617	\$ (88,086)
Inventory	1,075	(9,932)
Prepaid expenses	137,977	(142,541)
Accounts payable and accrued liabilities	76,781	166,638
Deferred revenue	-	2,321,200
Refundable tax credits	-	65,400
	\$ 296,450	\$ 2,312,679

17. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the method of presentation adopted for the current year.