

# Covalon Technologies Ltd.

Consolidated Financial Statements

For the period ended December 31, 2008

(Unaudited – prepared by management)

Contents

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**NOTICE OF NO REVIEW BY AUDITOR**

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

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# Covalon Technologies Ltd.

## Interim Consolidated Balance Sheets

As at December 31, 2008 and September 30, 2008

(Unaudited - prepared by management)

	December 31, 2008	Audited September 30, 2008
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 10,817,508	\$ 3,533,554
Short term investments	-	9,082,699
Accounts receivable	294,575	239,622
Inventories (Note 5)	382,427	278,256
Prepaid expenses	98,496	66,535
	<b>11,593,006</b>	<b>13,200,666</b>
<b>Capital assets (Note 6)</b>	<b>1,096,157</b>	<b>844,736</b>
<b>Other assets (Note 7)</b>	<b>692,496</b>	<b>671,048</b>
<b>Deferred developments costs (Note 8)</b>	<b>3,059,201</b>	<b>2,576,036</b>
	<b>\$ 16,440,860</b>	<b>\$ 17,292,486</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	\$ 1,090,009	\$ 750,138
Deferred revenue (Note 9)	442,627	442,627
<b>Total Current Liabilities</b>	<b>1,532,636</b>	<b>1,192,765</b>
<b>Deferred Revenue</b>	<b>973,967</b>	<b>1,084,624</b>
<b>Total Liabilities</b>	<b>2,506,603</b>	<b>2,277,389</b>
<b>Shareholders' Equity</b>		
Share Capital (Note 10 (b))	29,173,085	29,151,710
Contributed Surplus	360,034	329,004
Options (Note 10 (c))	1,815,310	1,601,091
Deficit	(17,414,172)	(16,066,708)
<b>Total Shareholders' Equity</b>	<b>13,934,257</b>	<b>15,015,097</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 16,440,860</b>	<b>\$ 17,292,486</b>

On behalf on the Board

\_\_\_\_\_  
Director

\_\_\_\_\_  
Director

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

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## Covalon Technologies Ltd.

### Interim Consolidated Statements of Operations and Comprehensive Loss

For the three months ended December 31, 2008 and December 31, 2007

(Unaudited - prepared by management)

	2008	2007
<b>Revenues</b>		
Product sales and coating services	\$ 248,013	\$ 607,335
Licensing fee	110,657	111,115
Interest income	103,497	212,443
Total revenue	<u>462,167</u>	<u>930,893</u>
<b>Operating Expenses</b>		
Product	237,040	338,408
Operations	415,971	233,274
Research and development	332,640	470,314
Marketing	167,885	104,362
General and administrative	656,095	460,542
Total operating expenses	<u>1,809,631</u>	<u>1,606,900</u>
<b>Net loss and comprehensive loss for the period</b>	<b>\$ (1,347,464)</b>	<b>\$ (676,007)</b>
<b>Basic and fully diluted loss per share (Note 10 (d))</b>	<b>\$ (0.02)</b>	<b>\$ (0.01)</b>

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

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# Covalon Technologies Ltd.

## Interim Consolidated Statements of Cash Flows

For the three months ended December 31, 2008 and December 31, 2007  
(Unaudited - prepared by management)

	2008	2007
<b>Cash flows from operating activities</b>		
Loss for the period	\$ (1,347,464)	\$ (676,007)
Add (deduct) items not involving cash:		
Amortization of capital assets	52,643	30,744
Amortization of patent and technology rights	9,535	7,080
Amortization of deferred development costs	29,183	29,183
Stock compensation expense	245,249	109,292
Foreign exchange loss	10,224	7,715
Cash provided by operating activities before change in non-cash working capital balances	(1,000,630)	(491,993)
Change in non-cash working capital (Note 15)	38,129	(134,704)
	<u>(962,501)</u>	<u>(626,697)</u>
<b>Cash flows from investing activities</b>		
Purchase of capital assets (net of disposals and investment tax credits)	(304,064)	(12,164)
Expenditure on deferred development cost	(512,348)	-
Purchase of patents and technology rights	(30,983)	(13,491)
	<u>(847,395)</u>	<u>(25,655)</u>
<b>Cash flows from financing activities</b>		
Net proceeds on issuance of share capital	21,375	35,500
	<u>(10,224)</u>	<u>(7,715)</u>
<b>Foreign exchange loss on cash held</b>		
	(10,224)	(7,715)
<b>Net Change in Cash Equivalents held to support operations during the period</b>	(1,798,745)	(624,567)
<b>Cash Equivalents held to support operations, beginning of period</b>	12,616,253	16,170,000
<b>Cash Equivalents held to support operations, end of period</b>	\$ 10,817,508	\$ 15,545,433

Cash Equivalents held to support operations consists of Cash and Cash Equivalents, and Short Term Investments. Both of these items on the Balance Sheet are held for the same purpose of sustaining the Company's operations as the Company moves from a Research and Development operation to a commercial operation.

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

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**Covalon Technologies Ltd.**

## Consolidated Statements of Shareholders' Equity

For the period ended September 30, 2008 and December 31, 2008

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	Share Capital		Contributed Surplus	Warrants	Options	Deficit	Total
	Number of Shares	Amount					
<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	491,881	294,778	-	-	(102,059)	-	192,719
Issue 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)
<b>Balance, September 30, 2008</b>	74,303,915	\$ 29,151,710	\$ 329,004	\$ -	\$ 1,601,091	\$ (16,066,708)	\$ 15,015,097
Issue for technology rights	75,000	\$ 21,375	-	-	-	-	21,375
Issued in trust	(75,000)	-	-	-	-	-	-
Stock based compensation	-	-	-	-	245,249	-	245,249
Expired options	-	-	31,030	-	(31,030)	-	-
Net loss and comprehensive loss	-	-	-	-	-	(1,347,464)	(1,347,464)
<b>Balance, December 31, 2008</b>	74,303,915	\$ 29,173,085	\$ 360,034	\$ -	\$ 1,815,310	\$ (17,414,172)	\$ 13,934,257

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

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**Covalon Technologies Ltd.**  
**Summary of Significant Accounting Policies**

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**December 31, 2008 and 2007, and September 30, 2008**

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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 continues to be research and development along with manufacturing and sales.
Going Concern	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.
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	Inventories are stated at the lower of average cost and net realizable value in accordance with Section 3031, which has been adopted in this quarter. There was no material impact on the financial statements from this adoption.
Capital Assets	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:  Furniture and fixtures - 20% diminishing balance basis Lab equipment - 20% diminishing balance basis Leasehold improvements - straight-line basis over 5 years

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**Covalon Technologies Ltd.**  
**Summary of Significant Accounting Policies**

**December 31, 2008 and 2007, and September 30, 2008**

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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>

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**Covalon Technologies Ltd.**  
**Summary of Significant Accounting Policies**

**December 31, 2008 and 2007, and September 30, 2008**

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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.

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.

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**Covalon Technologies Ltd.**  
**Summary of Significant Accounting Policies**

**December 31, 2008 and 2007, and September 30, 2008**

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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 period ended December 31, 2008 have met the criteria for impairment.

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# Covalon Technologies Ltd.

## Notes to Consolidated Financial Statements

December 31, 2008 and 2007, and September 30, 2008

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### 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 notes, as per its practice of protecting its capital rather than maximizing investment yield, of \$10 million invested with three issuers; however, this risk is mitigated as the issuers are major Canadian banks and financing companies.

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 December 31, 2008, two customers accounted for 88% (September 2008 – two customers for 100%) 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 December 31, 2008:

Current	\$110,631
61-90 days past due	<u>\$70,157</u>
	<u>\$180,788</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.

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**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**

**December 31, 2008 and 2007, and September 30, 2008**

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**1. FINANCIAL RISK MANAGEMENT (continued)**

**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.

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

	<u>December 2008</u>	<u>Audited September 2008</u>
Accounts receivable	\$ 180,788	\$ 121,223
Accounts payable	216,291	153,252
Exchange rate (\$USD / \$CAD)	1.218	1.064

**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.

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**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, 2008.

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**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**

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**December 31, 2008 and 2007, and September 30, 2008**

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**3. CHANGES IN ACCOUNTING POLICIES**

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.

Section 3064 does not require any change to the carrying values or disclosures on the Deferred Development Costs or Other Assets carried on the Balance Sheet at September 30, 2008. The amortization of accumulated costs to that date is also unaffected. The carrying value of these assets at December 31, 2008 reflects new spending and continuing amortization.

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 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.

Valuation of the Company's inventories complies with Section 3031. There were not any adjustments to income in the latest fiscal quarter resulting from adoption of this Section.

**4. RECENT ACCOUNTING PRONUCEMENTS**

In March 2006, the Accounting Standards Board of the CICA released its new strategic plan which will abandon 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.

**5. INVENTORIES**

	<b>Dec-08</b>	Audited Sep-08
Raw materials	\$ 218,593	\$ 202,492
Finished Goods	163,834	75,764
	<u>\$ 382,427</u>	<u>\$ 278,256</u>

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**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2008 and 2007, and September 30, 2008**

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**6. CAPITAL ASSETS**

	Dec-08		Audited Sep-08	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 373,506	\$ 97,101	\$ 293,844	\$ 84,650
Lab Equipment	1,228,572	436,789	1,005,016	402,420
Leasehold improvements	71,416	43,447	70,571	37,625
	<b>1,673,494</b>	<b>577,337</b>	1,369,431	524,695
Cost less accumulated amortization		<b>\$ 1,096,157</b>		<b>\$ 844,736</b>

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**7. OTHER ASSETS**

	Dec-08	Audited Sep-08
Patents and technology rights (net of \$192,165 accumulated amortization; Sep 2008 - \$182,630)	<b>\$ 692,496</b>	\$ 671,048
	<b>\$ 692,496</b>	\$ 671,048

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**8. DEFERRED DEVELOPMENT COSTS**

	Dec-08	Audited Sep-08
Cost	<b>\$ 3,433,833</b>	\$ 2,921,484
Less: accumulated amortization	<b>374,632</b>	345,448
	<b>\$ 3,059,201</b>	\$ 2,576,036

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**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.

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**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2008 and 2007, and September 30, 2008**

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**9. DEFERRED REVENUE** (continued)

	<b>Dec-08</b>	<b>Audited Sep-08</b>
Balance, beginning of period	<b>\$ 1,527,251</b>	\$ 1,977,904
Less:		
Amortization of license and supply agreements	<b>110,657</b>	443,851
Offset of related costs	-	6,802
Balance, end of period	<b>1,416,594</b>	1,527,251
Amount to be recognized within one year	<b>442,627</b>	442,627
Long term balance	<b>\$ 973,967</b>	\$ 1,084,624

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**10. Share Capital**

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

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

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.

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 December 31, 2008, 150,000 shares valued at \$213,875 have been released from escrow. The remaining balance of 950,000 shares is still being held in escrow.

At December 31, 2008, 4,492,402 (2007 – 6,884,830) 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**

**December 31, 2008 and 2007**

**10. Share Capital** (continued)

	<b>Number of Shares</b>	<b>Value</b>	<b>Exercise Price</b>
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	
Granted to related parties	200,000	48,293	\$ 0.75
Granted to employees	250,000	41,652	\$ 0.75
Vested to related parties		104,422	\$ 1.92
Vested to employees		50,882	\$ 2.17
Expired	(16,250)	(31,030)	
Balance December 31, 2008	4,121,925	\$ 1,815,310	

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.

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.

During the three month period ended December 31, 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 – 3.0%, dividend rate NIL, average volatility – 88% and a term of 2 and 5 years respectively.

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**Covalon Technologies Ltd.**  
**Notes to Consolidated Financial Statements**

**December 31, 2008 and 2007**

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**10. Share Capital** (continued)

Total value of options granted to related parties during the three month period ended December 31, 2008 was \$68,200 of which \$48,293 vested. Stock options granted to related parties expire on October 15, 2010. During the three month period ended December 31, 2008, options valued at \$124,500 were granted to employees of which \$41,652 vested. Stock options granted to employees expire on October 15, 2013.

During the three month period ended December 31, 2008, 16,250 stock options valued at \$31,030 expired.

As at December 31, 2008, 3,254,415 (2007 – 2,603,181) options were available for exercise.

**(d) Loss per Share**

Loss per share is calculated using the weighted average number of common shares outstanding (excluding shares issued in trust) during the three months ended December 31, 2008, which is 73, 228,915 (2007 – 72,750,784) shares. As the Company experienced losses for the period ended December 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 December 31, 2008 and 2007 are as follows:

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Anti-dilutive potential securities	2008	2007
Common shares potentially assumable:		
- under stock options	4,121,925	3,624,388

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**11. Related Party Transactions**

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

(i) Management fees totaling \$192,346 (2007 – \$135,786) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$96,010 (2007 – \$38,012). \$5,300 of the total \$26,500 to be deducted from Dr. DiCosmo was transacted in the current quarter, and is reflected in the total management fees above.

(ii) Directors fees include cash compensation of \$35,848 (2007 - \$33,504) paid to certain of the independent directors and stock option benefits that have been valued at \$54,453 (2007 – \$45,644).

b. Management fees are paid pursuant to two separate management agreements, expiring September 30, 2009. The commitments for the 2009 fiscal year for commitments are \$400,000.

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## Covalon Technologies Ltd.

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

#### 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:

2010	\$ 21,541
2011	5,724
2012	5,724
2013	5,724
2014	-
	<u>\$ 38,713</u>

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#### 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. SUPPLEMENTAL CASH FLOW INFORMATION

	<u>2008</u>	<u>2007</u>
<b><i>Non-Cash Financing and Investing</i></b>		
Issuance of shares to Perfusion Therapeutics Inc. for technology rights	\$ 21,375	\$ 82,500

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

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

For the 3 months ended December 31	2008	2007
Accounts receivable	\$ (54,952)	\$ 22,980
Inventory	(104,170)	92,913
Prepaid expenses	(31,963)	37,944
Accounts payable and accrued liabilities	339,871	(177,426)
Deferred revenue	(110,657)	(111,115)
	<u>\$ 38,129</u>	<u>\$ (134,704)</u>

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**16. COMPARATIVE FIGURES**

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