

MANAGEMENT'S DISCUSSION & ANALYSIS

For the three month period ended December 31, 2008

February 26, 2009

The following discussion of Covalon Technology Ltd.'s ("Covalon" or the "Company") financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes for the three month period ending December 31, 2008. We have prepared these financial statements according to Canadian generally accepted accounting principles ("GAAP").

Management's Responsibility for Financial Reporting

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

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

Non-GAAP Measures

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

Additional Information

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

Forward-looking Statements

The MD&A contains forward-looking statements within the meaning of securities law. These statements relate to future events or future performance and reflect management's expectations and assumptions regarding future events such as growth, results in operations, performance and business prospects and opportunities of the Company. In some cases, the forward-looking statements can be identified by terminology such as "seek", "anticipate", "plan", "estimate", "expect", "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions concerning matters that are not historical facts. These forward-looking statements involve risk and uncertainties,

including the difficulty in predicting product approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Although the forward-looking statements contained in this discussion are based on what management considers to be reasonable assumptions based on the information currently available to it, there can be no assurance that actual results, performance or achievements will be consistent with these forward-looking statements. These forward-looking statements are subject to risks and uncertainties that could cause actual results or events to differ materially from expectations. These include but are not limited to the risk factors included in this MD&A (including those listed under the heading “Risks and Uncertainties”) in addition to the risks itemized in the Company’s ongoing securities filings. Readers are advised to review these risk factors for a detailed discussion of the risks and uncertainties affecting the Company’s business. Many risks are inherent in the industry; others are more specific to the Company. Readers should not place undue reliance on any forward-looking statements. Other than as required by applicable Canadian Securities Law, the Company does not update or alter any forward-looking statements whether as a result of new information, further events or otherwise.

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1. Vision and Strategy

Our vision and strategy statements have not changed since the release of our MD&A for the year ended September 30, 2008. For a review our vision and strategy please refer to the corresponding sections in the MD&A for the year ended September 30, 2008.

Specifically for the 2009 fiscal year, the Company's strategy is building a pipeline of product developments that can broaden the application of our Wound Care and Coatings technologies and spread the revenue risks across multiple customers and market segments. We plan to engage in increased Statement of Work (SOW) contracts that will provide short-term revenue streams. Most of these are expected to progress into production and/or licensing agreements that will provide long-term revenues in the future. These are intended to reduce our losses and cut into the cash burn rate while we commercialize.

2. Company Overview

Our company overview statements have not changed since the release of our MD&A for the year ended September 30, 2008. Therefore, to review our company overview, please refer to the corresponding sections in the MD&A for the year ended September 30, 2008.

The Company's complement has grown to 40 from 37 at the end of the 2008 fiscal year with the addition of production staff. We have moved from a single shift to 3 shifts on our coatings system to address current and projected demand for production and SOW projects. We anticipate that any new addition to employee complement in the current fiscal year will be related to growing demand from revenue-generating activities.

Structurally, we are contemplating leasing new space and adding to our physical production capacity, which is nearly fully used. Given that the lease on our premises expires in November 2009, we are evaluating the options of adding space on to our existing leased area vs. moving to a larger facility. In order to conserve cash by minimizing expenditures, we will proceed as cost-effectively as possible.

3. Investments and Capitalization

On October 1, 2008, the Company had 74,303,915 common shares issued and outstanding, including 1,025,000 issued in trust for planned distribution as milestones are met on the EPAS1 Project. In December 2008, 75,000 shares were released from escrow and distributed to Perfusion Inc. as the 3rd milestone on the EPAS1 development path was successfully reached.

The table below sets out the number of issued and outstanding common shares as well as the number of issued and outstanding options to purchase common shares, in each case as at December 31, 2008.

Common shares	74,303,915
Options to purchase common shares	4,121,925
Total diluted shares outstanding	78,425,840

4. Results of Operations

Highlights

Overall performance for the three month period ended December 31, 2008

- Total Revenues decreased by 50.4% or \$468,726 over the first quarter of 2008 to \$462,167;
- Total Product Sales and Coating Service Revenues declined by \$359,322 or 59% compared to the first quarter of 2008 to \$248,013;
- Gross profit as a percentage of sales was 4% on a low base of sales;
- Interest income is down for the 3 months ended December 31, 2008 due to the combined impact of lower capital invested in short-term investments and sharply reduced interest rates on these investments;
- Licensing Fee revenues remain stable as the vast majority of the total relates to the quarterly allocation of the upfront payment from the Smith & Nephew contract;
- Net loss before research and development expenses sat at just over \$1MM, up from \$234,876 in the prior year;
- Net loss increased to \$1,347,464 in the first quarter of the 2009 fiscal year from \$676,007 a year earlier;
- Loss per share of \$0.02 was increased from the first quarter of FY08.

Operating and Financial Results

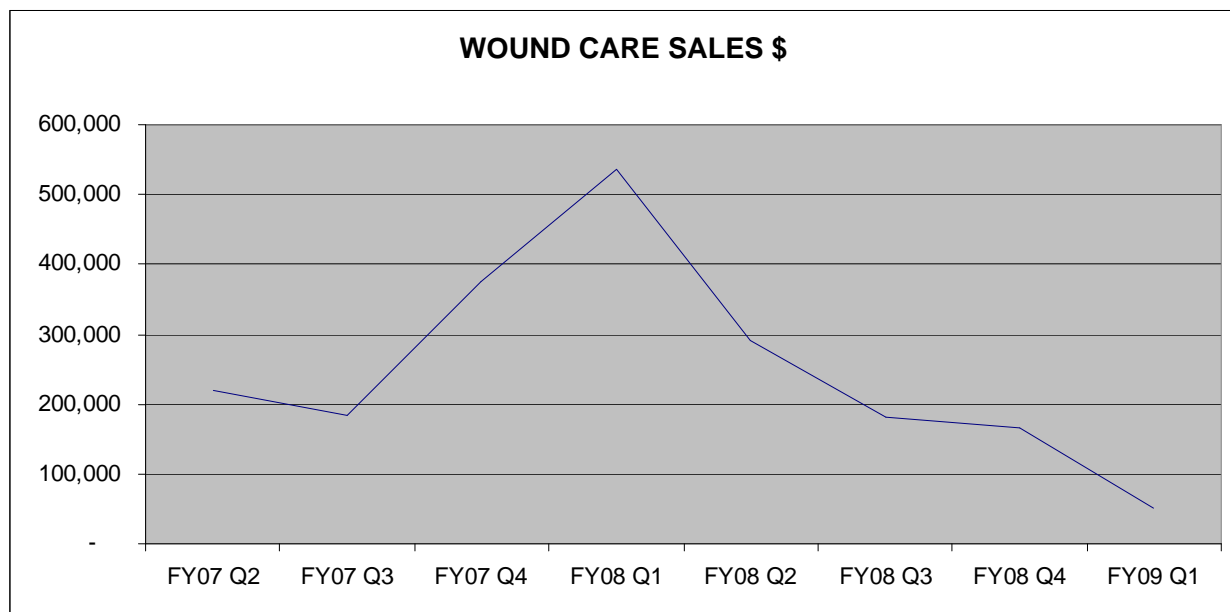
<i>(in Canadian \$)</i>	Three months ended December 31,	
	2008	2007
Product Sales		
Wound care	\$ 52,170	\$ 536,663
Coated catheters	170,812	56,954
Coating services	25,031	13,718
	\$ 248,013	\$ 607,335
Cost of goods sold	237,040	338,408
Gross Profit	\$ 10,973	\$ 268,927
Gross Profit %	4.4%	44.3%
Other Revenue		
Interest income	\$ 103,497	\$ 212,443
Licensing fee	110,657	111,115
Total Expenses	\$ 1,572,591	\$ 1,268,492
Net Loss	\$(1,347,464)	\$ (676,007)
Net Loss before research and development expenses	\$(1,014,824)	\$ (205,693)
Loss per share	\$ (0.02)	\$ (0.01)

Analysis of Operating and Financial Results
Three month period ending December 31, 2008

Revenue

Revenues in the first quarter were disappointing. The burst in the opening quarter of the 2008 fiscal year was not repeated in the current one. Most significantly, the jump in sales through Smith & Nephew a year ago was replaced by a quarter with a single shipment to the distributor. On the positive side, our volumes of anti-microbial catheters increased significantly and put pressures on our production capacity. However, the sales in antimicrobial urological catheters were insufficient to offset the drop in the wound dressing business.

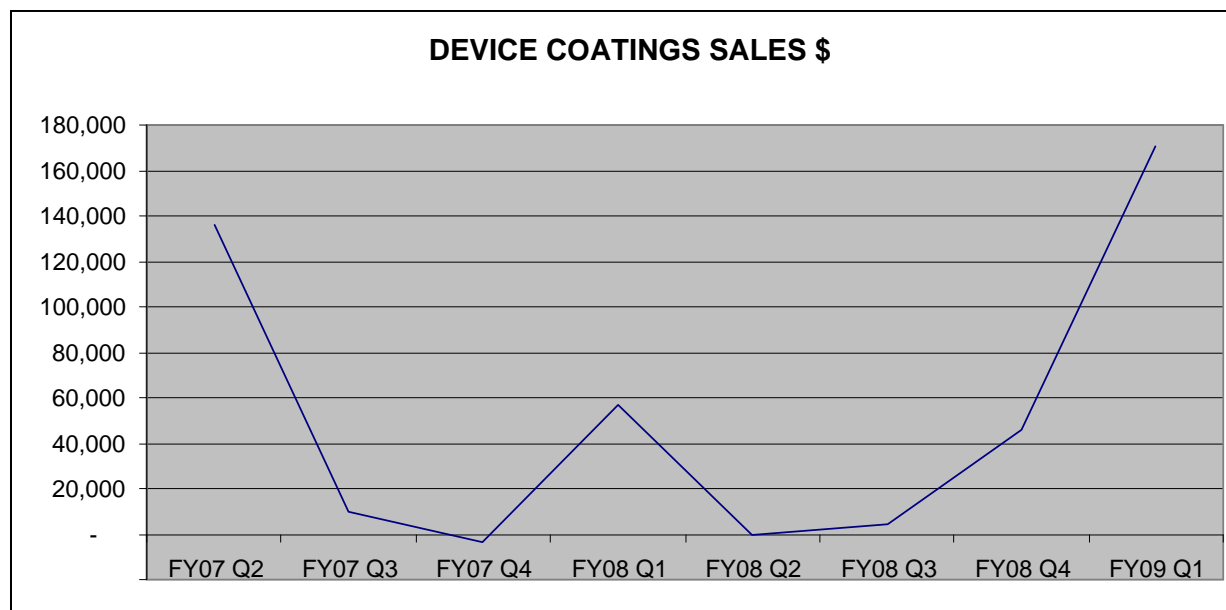
Wound Care Sales



A year ago, the Company experienced its best quarter for wound care sales. This was a result of the launch of BioStep™ and ColActive by Smith & Nephew. After both parties signed an exclusive distribution deal in March 2007 (FY07 Q2), wound care sales from Covalon to Smith & Nephew ramped up to their highest point in the first quarter of FY08. This volume was largely used to fill the distribution channels with product that began making its way to Smith & Nephew’s customers. The “launch volumes” declined after FY08 Q1 as volumes adjusted towards consumption levels.

The past 3 quarter sales have dropped to below what we believe the market’s consumption levels. The most recent quarter included a single shipment of the Company’s ColActive™ product which was offset by a credit for a lot of BioStep™. We expect that our distributor is working off their inventories and that demand to Covalon will rebound in the next few quarters. We continue to work with Smith & Nephew as much as we can to support market development and customer identification. Our relationship with Smith & Nephew remains strong. There is significant opportunity for our wound care products to grow.

Device Coatings Sales

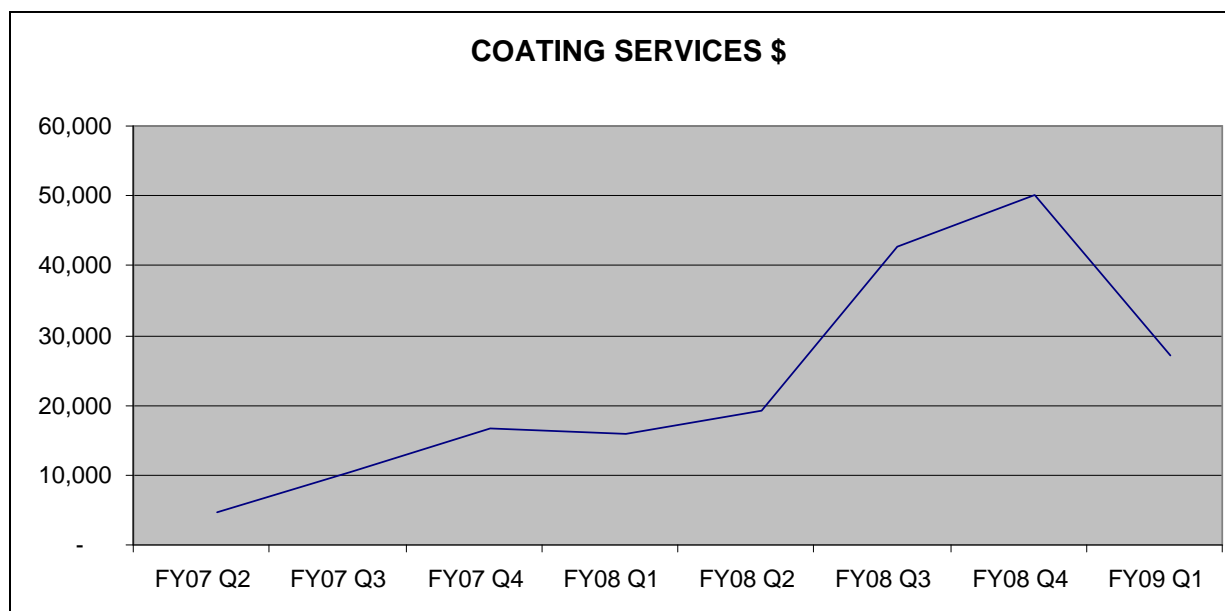


Sales of our antimicrobial-coated urological catheters have been languishing for most of the past two years. After an encouraging finish to the 2008 fiscal year at \$45,712 in sales, we saw demand increase significantly in the first quarter of 2009. Sales of \$170,812 represented our highest level for any quarter, and exceeded the total sales for the past year. Revenues almost quadrupled over the same quarter last year. We were unable to produce to Medline's increasing volume requests in the first quarter. To reduce our backorders to Medline, we moved to 3 production shifts in December.

The main driver of this increase is the Centers for Medicare and Medicaid Services (CMS) ruling that updates the USA hospital inpatient prospective payment system for 2008. The new ruling requires that hospitals and other patient care facilities identify conditions present at admission. Guidelines were provided that emphasized that re-imbursement payment would not be made for certain conditions determined to be hospital-acquired, including catheter-associated urinary tract infections, central venous line infections and pressure ulcers. Healthcare facilities in the USA are urgently looking for products to prevent infections from being acquired while treating their patients. Covalon's coated catheters provide a competitive product that has been shown to deter urinary tract infections. With anti-microbial catheter use estimated at less than 10% of total catheter use, there is large potential for growth on this product alone.

The CMS ruling has prompted renewed interest for antimicrobial coatings from several device manufacturers/distributors and we are discussing such opportunities as they arise. In many cases, application of Covalon's patented process to medical devices presents opportunities for commercialization that are expected to be in the 12-18 month range. For others, significant research and development is required. In either situation, the Company offsets the associated costs with revenues from SOW's. From the Company's perspective, there is a pipeline of opportunities with expressed customer interest as opposed to good ideas that will have to be cultivated into commercial products. There is good reason to expect new Covalon-coated devices making it to market in the near term, as well as the long-term.

Coating Services



During the past year, we have announced several new coating service contracts with device partners. Activity in this area continues in earnest and revenues trends are increasing. However, in this past quarter, the revenue dollars actually decreased after 3 consecutive quarters of increases. The biggest factor in this decline was scope creep on one of the contracts – we were working steadily through the quarter on this contract, but our billings for these services did not cover the underlying costs. This issue has been addressed and should not recur on future contracts. Most importantly, this element of our business continues to develop and is expected to provide a source of revenue to the Company well before the product commercialization stage.

With the demand for device coatings spurred on by the CMS ruling, this portion of our business should shift from being a subsidizing factor to a revenue center. We continue to learn about costs and risks on the effort and are building those elements into current negotiations and new contracts. Coating Services revenue for the first quarter of the current fiscal year was \$25,031, up 82% over the prior year's level of \$13,718.

Cost of Goods Sold and Gross Profit

Cost of goods sold dollars are expectedly down 30% from last year as product sales and coating service revenues are also down. However, the gross profit percentage is very low due to a credit on a BioStep™ sale, mix factors and some ramp up costs.

Historically, our wound dressings have held margins in the 40+% range and coated devices has been well below that. In the quarter just completed, the mix shifted significantly towards the coatings business – only 21% of product sales were wound dressings compared to 88% a year ago. In addition, the wound dressing sales were all non-Ag ColActive products that carry lower prices than the premium Ag versions, and the BioStep™ credit had no associated cost of sales. Finally, some costs related to the move to 3 shifts (training efficiencies, spoilage, etc) contributed to reducing coated catheter margins. Spoilage impacted the wound dressing line as well. Combining all factors yielded a weak margin on a slow quarter. Margin rates are expected to rebound in future quarters.

Interest Income

The average of Cash, Cash Equivalents and Short Term Investments in the current quarter was \$11,716,881 compared to \$15,857,717 the previous year, a drop of 26%. In addition, the average return over the quarter was 3.5%, down from 5.4% the prior year.

All investments are made in accordance with the Company's audit committee investment guidelines – they are held in low risk instruments focused on preserving capital. The rates of return on these instruments continue to fall as the global credit crisis works its way through the world's economies.

License Revenues

Licensing revenues remain stable as the \$110,657 in the first quarter of fiscal 2009 represents the amortization of the upfront payment from Smith & Nephew on its distribution agreement with the Company. This is marginally down from the prior year due to some adjustments for upfront contract costs.

Expenses

Covalon's expenses slowed in their growth compared to the prior year's quarter over quarter pace of 88%, but they did grow \$302,717 to \$1,572,209 in the 2009 fiscal year. This increase reflects the Company's intention to building its internal capability to support product commercialization and provide potential partners with credible in-house expertise. We believe this is a key requirement for signing licensing and production contracts.

The expenses for the three month period and year ended December 31 for 2008 and 2007 are summarized below.

<i>(in Canadian \$)</i> Expenses	3 Months Ended December 31	
	2008	2007
<u>Operations</u>		
Wages and Benefits	\$ 341,030	\$ 170,303
Consulting fees	34,120	24,836
Other	<u>40,821</u>	<u>38,135</u>
Total Regulatory	\$ <u>415,971</u>	\$ <u>233,274</u>
<u>Research and Development</u>		
Wages and Benefits	\$ 235,572	\$ 148,035
Consulting and Outside Testing	38,218	246,853
Amortization of Deferred Development Costs	29,183	29,183
Other	<u>29,667</u>	<u>46,243</u>
Total Research and Development	\$ <u>332,640</u>	\$ <u>470,314</u>
<u>Marketing</u>		
Wages & Benefits	\$ 139,498	\$ 68,515
Travel	17,456	2,280
Investor Relations	4,112	22,508
Other	<u>6,819</u>	<u>11,059</u>
Total Marketing	\$ <u>167,885</u>	\$ <u>104,362</u>
<u>General and Administrative</u>		
Wages & Benefits	\$ 257,433	\$ 185,519
Directors' Compensation	90,301	79,148
Professional Fees	80,713	42,179
Depreciation and Amortization	61,795	37,824
Facility	42,348	40,840
Other	<u>123,505</u>	<u>75,032</u>
Total General and Administrative	\$ <u>656,095</u>	\$ <u>460,542</u>
Total Expenses	\$ 1,572,591	\$ 1,268,492

Operations

The Operations department encompasses many functions within the Company. The technology transfer function takes prototypes from Research & Development and scales the process up to commercial level. At that point, they are passed on to the Production team that is responsible for manufacturing products for our distribution partners. The Quality Control group tests raw products coming into and leaving the Company, while the Quality Assurance team provides oversight and establishes systems to make sure we adhere to processes we rely on. The Regulatory staff is responsible for submitting, gaining and maintaining licenses from regulatory bodies in the countries our products are sold into. They do work directly in-house and can support our partners' efforts as well.

These teams are still lean, and we have developed a capability to do much more internally. This has enhanced our image with our partners as a quality company. Wages & Benefits in the department have doubled in the first quarter to \$341,030, but the additional \$170,727 has yielded a team with answers and processes that comply with regulatory requirements. While not evident in the first quarter comparison, this development of infrastructure has yielded less dependent reliance on outside consultants (and cost savings in this area in fiscal 2008 compared to fiscal 2007). Compensation represents the vast majority of the increased spending in this function.

Research & Development

As with the Operations team, the Research & Development group has built its internal strength with some growth in headcount. Its current complement stands at 10 people and the team is being sub-divided into Coatings and Wound Care teams with the goal of delivering prototypes to the Marketing group on a more systematic fashion. With the broad list of opportunities in both the Coatings and Wound Care divisions of the Company, we need to get more tangible results out to our prospective partners. This is the philosophy behind the increased spending on Wages and Benefits. Within the \$87,537 increase in spending from the first quarter of fiscal 2008 to the current quarter, \$34,311 relate to options expense for members of the department and \$15,000 relate to an accrual for an estimate of annual bonuses (bonuses had been recorded only upon award in previous years), so the base wages and benefits have only been a portion of the growth.

In the last 3 months of calendar 2007, there were 3 significant R&D projects being run through outside facilities. In the current year's opening quarter, there were several small projects using lab resources beyond our capability, so costs declined in the year over year comparison by \$208,635. While this does not signal the end of expensive work done outside our lab (animal tests are still more cost-effectively run externally), it does reflect improved self-sufficiency.

Other costs within the department also decreased quarter over quarter, offsetting the increase in compensation, so overall the department's costs declined by 21% to \$332,640.

Costs related to the EPAS1 Project are still deferred as the work is still in the development stage. Spending on this program totaled \$512,348 for the quarter (no spending in the equivalent period of the prior year) with a second stage of pig studies beginning in the current fiscal year. This all falls into the planned \$1.5MM expenditures for the fiscal year. Further discussion of the activities and achievements on the project follow later in the MD&A.

Marketing

Again, there has been growth in the staff complement in the Marketing area. In addition to our Chief Business Officer identifying and developing new opportunities with potential partners, we have an internal resource in Mississauga working with our existing customer base – improving the relationship and supporting our mutual success. We also have a business development VP based in New Jersey that is also building new opportunities for the Company.

Travel costs are up to \$17,456 in 2008 from \$2,280 in 2007 reflecting a much higher level of travel from the group in the current year. The increase is due to having 3 people travelling and having more deal-making effort in the current year. The quarter last year was dominated with satisfying Smith and Nephew's wound dressing production requirements, so less business development travel occurred.

In the first quarter of this year, we did not have an Investor Relations agent employed by the Company. As such, the costs incurred were exclusively related to compliance issues. In comparison to the prior year, there was a decrease in expense of just over \$18,000.

In total, the Marketing department spent \$63,523 more in the current quarter than it did in the previous quarter. As a result, we have better coverage of existing customers and prospects and this should translate into future deals.

General and Administration

As was the case with the Research and Development department, the majority of the cost increase in the General and Administrative department was the combination of accrued bonuses and stock compensation expenses making up a total of \$49,303 of the increase. In addition, there has been an increase in the headcount in General and Administrative expenses with the inclusion of a CFO for the full quarter in the current fiscal year. A CFO was hired back in December 2007, so was only on the payroll for half a month in the quarter.

Director compensation was also up due to an increase in the stock compensation expense reported in the quarter. Actual cash compensation to the directors was up only \$2,345 for the quarter.

Professional Fees increased by about \$38,500 in the current quarter, predominantly due to placement fees for the hiring of the new CFO. The balance of costs is for legal and accounting services which are running fairly consistently quarter over quarter.

Depreciation and amortization cost increases are driven by the capital additions made in the 2008 fiscal year. The biggest factors contributing to the \$23,929 jump in costs are the upgrade of the Company's production equipment for coating technology in the spring/summer of 2008 and for ongoing upgrades in the company's IT and communications equipment.

Other General and Admin costs have risen with the addition of staff – communication costs, insurance expense, general travel costs and the like have seen an increase as our staff levels have grown. Facility costs have remained steady as we are still in the same space as we have been over the past 4 years.

In total, General and Administrative costs are up to \$656,095 for the quarter.

Net Loss

The Company had a net loss of \$1,347,464 or \$0.02 per share during the first quarter of 2009 compared to net loss of \$676,007 or \$0.01 per share during the same period in 2008. While improved revenues were realized in the Coatings division of the Company, the results in the Wound Dressing division were very disappointing. Reduced Gross Margins in the current year combined with increased expenses meant a loss almost twice as high as the first quarter of 2008. This does not change the Company's plan of execution geared at eliminating financial losses within the next two to three years, but we need a significant rebound in Wound Dressing sales and we must continue to build on the momentum in the Coatings Division.

Summary of Quarterly Results

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

<i>(in Canadian \$)</i>	2009 First Quarter	2008 Fourth Quarter	2008 Third Quarter	2008 Second Quarter	2008 First Quarter	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter
Revenue (1)	\$462,167	\$419,721	\$467,739	\$654,625	\$930,893	\$372,768	\$560,241	\$461,511
Net loss	\$(1,347,464)	\$(1,608,315)	\$(498,949)	\$(957,576)	\$(676,007)	\$(1,425,046)	\$(742,064)	\$(507,356)
Net loss per share	\$(0.02)	\$(0.02)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.02)	\$(0.01)	\$(0.01)

(1) Includes All Revenues

Despite a significant disappointment in the Wound Care revenues for the first quarter of 2009, the Company's Total Revenue was near its highest level since the second quarter of last year. The difficulty now is that the current infrastructure necessitates growing revenue streams to approach a break-even bottom line. The Company's challenge remains nurturing its existing contracts and bringing in new business with improving margins. We remain committed to these goals and expect milestones on this journey to be met in the upcoming quarters.

Other Performance Indicators

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

	2009 First Quarter	2008 Fourth Quarter	2008 Third Quarter	2008 Second Quarter	2008 First Quarter	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter
Current Ratio	7.6	11.1	17.7	7.0	6.9	6.4	3.0	2.5
Net Working Capital	\$10,086,580	\$12,007,901	\$13,652,270	\$13,274,549	\$13,832,958	\$14,322,821	\$5,341,353	\$4,364,329

The Current Ratio is a model for measuring the liquidity of the Company by calculating the ratio between all current assets and all current liabilities. It is an indicator of the Company's ability to pay short-term obligations. Current assets includes cash and cash equivalents, short term investments, accounts receivable, refundable investment tax credits, inventories and prepaid expenses. Current liabilities include accounts payable and accrued liabilities and deferred revenue. Net Working Capital is calculated as current assets minus current liabilities.

The exercise of the warrants in the fourth quarter of 2007 has significantly strengthened the liquidity of the Company and consequently allows us to invest in research and development, build infrastructure in our operations and support our Sales & Marketing efforts to contract new business for the Company.

5. Liquidity & Capital Resources

Financial Position

(Canadian \$)	As at	
	December 31, 2008	September 30, 2008
Total assets	\$ 16,467,070	\$ 17,292,486
Deferred revenue	\$ 1,416,594	\$ 1,527,251

Total Assets

Total assets at December 31, 2008 were \$16,467,070 compared to \$17,292,476 at September 30, 2008. The decrease is due to decreases in cash and cash equivalents and short term investments which were drawn down to fund the Company's operations, offset by increased investment in capital assets, deferred development costs and patents and technology rights.

Deferred Revenue

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

Liquidity

The Company follows a policy of investing its surplus cash resources in high quality, liquid, short-term notes. Cash equivalents at the end of the current quarter all had less than three months' maturity. As at December 31, 2008 there were no restrictions on the flow of these funds nor have any of these funds been committed in any way. The Company believes that it has the capital resources and liquidity necessary to meet its commitments, support its operations and finance its current growth strategies.

Commitments

The Company has entered into an operating lease for its premises at 405 Britannia, Mississauga commencing December 1, 2004 and expiring November 30, 2009. The annual rental payments of \$91,855 are payable in monthly installments 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 three years are as follows:

2010	\$ 21,541
2011	5,724
2012	<u>5,724</u>
	<u>\$ 32,989</u>

The Company intends to continue to use its capital resources to fund research and development activities, including EPAS1. The amount of capital resources to be allocated to these activities will depend upon the scale of programs undertaken and a number of factors, such as the terms of our partnering agreement, input from outside experts and regulatory authorities on clinical programs. The Company has agreed to fund the development of EPAS1 through various milestones and has committed \$1,491,000 for the twelve month period ending September 30, 2009. During the three month period ended December 31, 2008, \$512K has been spent on EPAS 1, all according to the planned schedule.

Changes in Capital Structure

During the first quarter of fiscal 2009, the only transaction affecting the Company's capital structure was the issuance of 75,000 shares to Perfusion Therapeutics Inc. for value of \$21,375 as a result of their reaching the 3rd milestone on the Company's EPAS1 Project. 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

Stock Option Plan

The Company recognized a total of \$245,249 in stock compensation expense in its operations for the 3 months ended December 31, 2008. The majority of this expense related to grants made prior to September 30, 2008 that vested in the current quarter. The exercise price for these previously issued and recently vested options average about \$2.00. Thus, \$155,304 of the reported expense for the quarter represent options that are currently well above the recently traded stock price.

The 450,000 stock options issued in the 1st quarter of fiscal 2009 have an exercise price of \$0.75 and are valued at \$192,700. Of that total value, \$89,945 was recorded as expense, reflecting the amount vested in the quarter.

In addition, 16,250 options expired during the quarter and \$31,030 was credited to Contributed Surplus. These were the shares issued to and vested with the Company's former CFO.

Sources and Uses of Cash

	Three month period ended December 31,	
	2008	2007
Cash Provided By (Used in)		
Operating Activities		
Cash flow from operating activities before change in non-cash working capital	\$ (1,000,630)	\$ (491,993)
Change in non-cash working capital	38,129	(134,704)
	\$ (962,501)	\$ (626,697)
Investing Activities		
Purchase of capital assets	\$ (304,064)	\$ (12,164)
Expenditure on deferred development cost	(543,331)	(13,491)
	\$ (847,395)	\$ (25,655)
Financing Activities		
Issuance of share capital, net	\$ 21,375	\$ 35,500
Foreign exchange gain (loss) on cash held	\$ (10,224)	\$ (7,715)
Net change in cash	\$ (1,798,745)	\$ (624,567)

Operating Activities

Cash flow used in operations for the first quarter of 2008 was (\$962,501) compared to (\$626,697) for the same period last year. The net increase in the first quarter of 2009 compared to the first quarter of 2008 is mainly due to the higher loss during the three months ended December 31, 2008, net the effect of the changes in non-cash working capital items.

Investing Activities

Cash used in investing activities was \$847,395 in the first quarter of fiscal 2009, compared to \$25,655 in the first quarter of fiscal 2007. This is as a result of higher capital expenditure activities relating to capital assets, deferred development cost and patents and technology rights. The majority of the spending (\$512,348) relates to investments in the EPAS1 technology. The balance represents additions to the Company's information system, a deposit on new production equipment and updating/replacing research and development equipment. There was little investment activity in the prior year.

Financing Activities

Cash flow from financing activities for the first quarter of 2008 was \$21,375 compared to \$35,500 for the same period last year. The source in 2008 was 75,000 shares valued at \$21,375 issued to Perfusion Therapeutics Inc. and released from escrow with respect to milestone 3 of their agreement with Covalon.

Off-Balance Sheet Arrangements

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

Financial Instruments

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

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

For the three months ended December 31, 2008, two customers accounted for 88% (two customers, September 30, 2008 – 100%) of the year end accounts receivable balance. These customers, who act as distributors of the Company's product, represent the majority of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers.

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

6. Risk and Uncertainties

Our risk and uncertainties statements have not changed since the release of our MD&A for the year ended September 30, 2008. Therefore, to review our risk and uncertainties please refer to the corresponding sections in the MD&A for the year ended September 30, 2008.

7. 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).
 - (ii) Directors fees include cash compensation of \$35,848 (2007 - \$33,504) paid to the four independent directors and stock option benefits that have been valued at \$54,453 (2007 – \$45,644).
- b) The management fees are paid pursuant to two separate management agreements, expiring September 30, 2009. The commitments for the 2009 fiscal year are \$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. The Board of Directors' Compensation Committee has reviewed and approved these contracts.

8. Critical Accounting Estimates

Our critical accounting estimates statements have not changed since the release of our MD&A for the year ended September 30, 2008. Therefore, to review our critical accounting estimates, please refer to the corresponding sections in the MD&A for the year ended September 30, 2008.

9. Accounting Policies

Accounting Policies adopted in the 2009 Fiscal Year

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.

Accounting Policies Not Yet Implemented

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. 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.

10. Opportunities

Our opportunities statements have not changed materially since the release of our MD&A for the year ended September 30, 2008. Therefore, to review our opportunities, please refer to the corresponding sections in the MD&A for the year ended September 30, 2008.

The Company has \$10.8MM in cash and cash equivalents at the end of the 2008 calendar year. Compared to many of our competitors, we are well funded and can sustain our operations for about 2 years at our current spending rate. The Company expects that its plan to increase the volume of its SOW's will provide revenues earlier in the product commercialization process. We will also conserve cash at every opportunity as we progress on our plan.

While there are many opportunities available to the Company to capitalize on its technology platforms and become profitable and cash flow positive, the company must progress in each of its three divisions. The general timeframe to achieve positive cash flow and profitability is the 2-3 year timeframe, with the cash flow goal likely achieved earlier than the profitability target.

Key events that are expected to occur in the current fiscal year within that plan include:

- Signing of at least 2 contracts in the antimicrobial coatings division with device partners
- Revitalizing the wound care sales through the Company's distribution partner
- Achieving milestones in the EPAS1 Project

11. Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Effective as of December 15, 2008, the Ontario Securities Commission approved the revised *National Instruments 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings* ("NI 52-109"). The revised NI 52-109 extends the exemption for venture issuers from certifications relating to the establishment and maintenance of disclosure controls and procedures ("DC&P) and internal controls over financial reporting ("ICFR"), as defined in NI 52-109. Additional risks to the quality, reliability, transparency and timeliness of the Company's interim and annual filings may result from the inherent limitations on management's ability to design and implement on a cost effective basis DC&P and ICFR. The Company recognizes the importance of DC&P and ICFR, and will endeavour to have sufficient controls in place to ensure financial statements are materially correct and sufficiently disclosed.

The Company continues to formalize procedures and control measures that are already in place and to introduce new ones to ensure good evaluation and control practices. As of September 30, 2008, the Company's management evaluated the effectiveness of the design and operation of its disclosure controls and procedures as defined under the rules. The evaluation was performed under the supervision, and with the participation, of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on the evaluation of the DC&P, the CEO and the CFO have concluded that, subject to the fact that an evaluation of controls can provide only reasonable, not absolute, assurance that all control issues and instances of fraud or error, if any, within the Company have been detected, the Company's DC&P are effective in providing reasonable assurance that material information relating to the Company is made known to management. Changes and new controls are evaluated and implemented as required to provide greater business control.

The design of ICFR within the Company is management's responsibility to provide reasonable assurance that the reliability of financial reporting and that the preparation of financial statements for external purposes follow Canadian generally accepted accounting principles.