

## MANAGEMENT'S DISCUSSION & ANALYSIS

For the three and nine-month periods ended June 30, 2009

*August 28, 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 and nine month periods ended June 30, 2009. 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 the 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*

In 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](http://www.sedar.com) and in the investor relations section of our web site at [www.covalon.com/Investors](http://www.covalon.com/Investors).

### *Forward-looking Statements*

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

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

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## 1. Company Overview

Covalon Technologies Ltd. researches, develops, patents, and commercializes medical technologies. Its offices and laboratory are located in Mississauga, just outside of Canada's largest city, Toronto, Ontario.

The Company's strong scientific team is guided by Covalon President, Chief Executive Officer and Co-Founder, Dr. Frank DiCosmo, a former tenured professor at the University of Toronto. Eight of Covalon's researchers and scientists, out of a current total staff of twenty-eight, possess doctorate degrees.

Covalon's current strategy is to not sell its technologies directly to hospitals, clinics and doctors. Rather, Covalon's technologies are generally licensed to other medical companies and distributors who incorporate them into their own product offerings and then sell them to hospitals, clinics and doctors. This is referred to by the industry as an OEM sales model (original equipment manufacturer) as opposed to a direct sales model.

The OEM sales model means that the major cost of selling Covalon's technologies is borne by its customers. These customers are typically major medical companies and distributors who employ large sales staff in geographical locations where Covalon does not have staff or offices.

As a result, while some Covalon staff are, at times, involved in supporting sales activities, the Company's only full-time sales executive is William Jackson, Covalon's Chief Business Officer and Co-Founder.

The OEM sales model almost always involves a long sales cycle – from initial discussion, product evaluation, regulatory filings, contract negotiation and then to market roll-out. This process generally takes twelve to eighteen months – although there are from time-to-time exceptions both shorter and longer. On the other hand, once a company invests time and money in choosing Covalon's technology, it is likely to use it for some time to come.

Covalon's relationships with contract manufacturing organizations (CMO) provide it with additional resources, flexibility and expertise in production, without the burden of substantial committed facilities. While Covalon retains the manufacturing capability to make its products at a smaller commercial volume, it also has the ability to sub-contract higher volumes to experienced manufacturers.

Covalon is in the medical innovation business. It is a relatively small company especially when compared to the major medical companies and distributors it targets as clients. Many of these major medical companies and distributors have large laboratories that employ many scientists. However, the nature of innovation is such that it often occurs within small independent teams of researchers and scientists. Major medical companies and distributors are always scouting for new medical advances and breakthroughs they can license that will improve and differentiate their product offerings.

For a relatively small medical research and development company, Covalon has an extremely broad footprint of technologies it researches including:

- Advanced collagen dressings
- Specialized medical device coatings
- Genetic regeneration of damaged organs and tissue

Covalon's credibility was further enhanced in 2007 when Smith and Nephew Inc. announced its distribution contract for collagen dressings for wound care applications.

Consequently, Covalon's expertise and credibility have allowed access to engaging in discussions with many of the world's largest medical companies and distributors who are usually interested in learning how Covalon's technologies and associated patents can fit in their current and future product strategies.

These major medical companies and distributors are likely to be impressed with Covalon because of its:

- Respected team of medical researchers and scientists
- Broad footprint of technologies and associated patents and applications
- The ability to rapidly customize Covalon technologies for specific usage
- Flexibility in negotiating licensing terms and structures
- Ability to have its high quality products contract-manufactured in high volumes and low cost, if so desired by the client
- Strong balance sheet

Covalon is confident that as it succeeds in signing further new contracts with major medical companies and distributors, it will become a profitable and self-sustaining medical research and development company that will continue to discover new and exciting technologies that improve patient outcomes and save lives.

## 2. Covalon's Technologies

### *Advanced Collagen Dressings*

Covalon's advanced collagen dressings are essentially collagen-based matrices that can hold and release a variety of materials, and/or allow materials to pass through the matrix. These dressings begin from a collagen base, which is generally bio-compatible with the human body, and enable the release of beneficial materials into the surrounding area and/or enhance the removal of undesirable materials from the surrounding area. Variations in Covalon's underlying formulation yield different rates of release, duration of release and/or size of particles removed. By combining these factors with the many materials that can be embedded in the matrix, Covalon has a broad range of potential applications for this technology.

The Company's initial focus was to develop, get regulatory approval for and sell a series of CMO manufactured silver ion releasing collagen-based wound dressings. This resulted in FDA-approved product lines called ColActive™ and Biostep™ that improve wound care by removing wound bed enzymes that otherwise slow down healing in wounds. The ColActive™ Ag and Biostep™ Ag products add the release of silver into the wound as an anti-microbial agent to further improve the wound healing process. Both of these product lines are marketed and sold through an exclusive distribution contract with Smith & Nephew Inc.

The following product families have regulatory approval for sale in the USA and Canada:

Product	Distribution	Launch
ColActive™ Collagen Wound Dressing	Smith & Nephew Inc.	April 2007 US
ColActive Ag™ Collagen with Silver	Smith & Nephew Inc.	April 2007 US
Biostep™	Smith & Nephew Inc.	October 2007 US
Biostep™ Ag	Smith & Nephew Inc.	October 2007 US

The two BioStep™ product families have also received CE approval for the European markets.

Beyond the commercialized applications of Covalon's advanced wound dressing technology, the Company has been contacted by several medical companies to provide candidates to support their product strategies. Once a potential partner is satisfied with a basic prototype from the research and development team, Covalon will negotiate a development contract to commercialize the product. At this stage of the Company's evolution, this development contract ideally will involve financial support from our partner. Once the product is ready for use in the field, Covalon will have it manufactured and sold to our partner or will license the underlying technology to a distributor or medical device company.

The following list outlines several advanced wound dressing applications in active design phase:

- Hemostatic dressing – to stop bleeding in open wounds
- Anti-microbial film – to prevent infection in surgical or trauma sites
- Anti-microbial ocular dressing – to prevent infection following eye surgery
- Negative pressure wound therapy sponge – to prevent infection in treated wounds
- IV Clear – to prevent infection at the point of entry for IV lines into the body
- Drug-eluting dressing – to deliver a pain relief drug at wound site

Beyond the current activity driven by potential partner needs, the advanced wound dressing technology may also be a delivery system for Covalon's EPAS1 regeneration technology.

### ***Specialized Medical Device Coatings***

Covalon has developed an advanced proprietary coating platform for the medical device market. The technology uses a proprietary ultraviolet light-mediated process to create biocompatible surface coatings capable of carrying a number of therapeutics. The initial focus is to use the platform for delivery of anti-microbial ionic silver from medical devices, such as urological catheters, where the risk of catheter associated infection in hospitals is high. It has been widely estimated that 40% of all hospital-acquired infections are due to the use of urological catheters.

In the April 2008 issue of the Society of Urological Nurses and Associates, a study by St. Vincent Rehabilitation Hospital in Sherwood Arkansas, compared infection rates using uncoated urological catheters and urological catheters treated with Covalon's ionic silver coating. The study compared numbers and rates of catheter-associated urinary tract infections (CAUTI) from data they gathered during two periods. The first was a four-month period in 2006 using a standard latex catheter. The second was a six-month period using the catheters with Covalon's silver coating. The facility discovered ten hospital-acquired CAUTIs during the four-month period using the standard latex catheters. During the six-months of testing using Covalon's silver-coated catheters, the hospital found "no" hospital-acquired CAUTIs. Covalon hopes that more studies of this nature will be published.

The same technology can be applied to a number of post-surgical wound drains such as chest, abdominal gastric and orthopedic drains. Covalon has also successfully completed the development of its new anti-microbial / anti-thrombogenic coating to prevent blood clotting on blood access catheters and devices. The development allows the Company to market the technology for application on central venous lines, peripherally-inserted central catheters, IV lines, hemodialysis lines and implantable infusion ports where an anti-microbial and anti-thrombogenic coating would offer a clinical advantage in minimizing microbial contamination and thrombus formation, and may thus improve patient outcomes.

Coated anti-microbial central venous catheters (CVC) are expected to experience a growth rate approximately 5-fold greater than that of un-coated CVC. It is estimated that by 2009, sixty-nine percent (69%) of all CVC used will be anti-microbial (data from Frost and Sullivan, U.S. Anti-microbial Devices Markets, 2003). Hospital-acquired infections affect approximately 2 million people in the United States each year (data from Frost and Sullivan, U.S. Anti-microbial Coating Markets, 2006). These broad indicators make it worthwhile for Covalon to pursue medical device companies that sell into the anti-microbial devices market.

Covalon continues the development work to apply its anti-microbial coatings to metals for orthopedic implants and trauma products. The infections in orthopedics are relatively low but the damage caused by a bone infection (osteomyolitis) can lead to implant failure and a long and costly recovery for the patient. From a patient care and hospital cost perspective, this is a significant issue for orthopedic service providers.

Covalon has provided prototype, anti-microbial coated samples for a number of potential new customers for a variety of other applications including: peripherally-inserted central catheters, central venous lines, sutures, intravenous lines, feeding tubes, stomach anchors and metal for orthopedic applications. The Company is in "fee for service" co-development with a number of prospective customers for these coating applications and is considering other licensing opportunities.

The following list outlines the coating applications in the development pipeline:

- Hemodialysis lines
- Peripherally-inserted central catheter lines
- Central venous catheters
- Ports catheters
- IV lines/Securement device
- Urological catheters (new variants)
- Pain management catheter
- Surgical wound drains
- Orthopedic devices (metals)

Covalon's previous intention was to build and operate a high-volume manufacturing facility. The Company determined that a better option was to partner with an established manufacturer who could handle high-volume commercial production. As announced on April 24, 2009, Covalon entered into an agreement with an established manufacturer in the international medical device community, and discontinue its efforts to pursue high-volume manufacturing capacity. On May 4, 2009, Covalon was able to announce significant cost reductions as result of this change in direction.

The Company subsequently learned that some of its catheter-coating manufacturing procedures were not fully followed resulting in products that do not fully meet its quality standards, even though they do not impact the safety of the catheters under standard usage protocols. The Company is in the process of replacing the inventories of product affected and estimates the total cost of this operation to be \$110,000. These costs are included in the Product expenses for the third quarter of fiscal 2009. The Company is taking appropriate action to ensure that its procedures are fully followed in the future.

## Genetic Regeneration of Damaged Organs and Tissue

Covalon is developing a stem-cell engineering platform for heart regeneration in Congestive Heart Failure (CHF) patients who previously suffered a myocardial infarction (MI) or heart attack. This platform is based on the use of the EPAS1 gene to enhance the efficacy of cellular cardiomyoplasty (i.e. the injection of cells into the infarcted heart tissue). The technology aims to improve heart pumping function and blood flow of the diseased heart tissue in CHF patients by both restoring the elasticity of the damaged heart tissue with a cell therapy treatment and stimulating the growth of new blood vessels in the heart, through a process of therapeutic angiogenesis. New blood vessel formation is referred to as “angiogenesis” and/or “vasculogenesis”. The processes are integral to regenerative medicine, including wound healing, treating ischemic heart disease, peripheral vascular disease as well as other diseases related to poor blood flow to tissues and organs.

According to the American Heart Association, CHF afflicts over 5.4 million Americans with approximately 550,000 new cases annually. The prevalence of CHF is expected to grow in industrialized countries as the population ages and as a result of re-perfusion therapy leading to more patients surviving acute myocardial infarction with diminished cardiac capacity. In Europe, the estimate of current CHF patients approaches 7 million cases. Current pharmacological therapies reduce symptoms and slow progression of the disease and half of all CHF patients will nonetheless die within five years of diagnosis.

It is estimated that about half of CHF cases result from a MI, which can lead to necrosis of a zone of the heart (scarred muscle tissue). It is those post-MI patients that are expected to be targeted for Covalon’s EPAS1 cell therapy technology.

This project has successfully produced porcine and human mesenchymal stem cells (MSC) with EPAS1 and demonstrated that the transcription factor (EPAS1 protein) can effectively be produced in both human and porcine MSCs. The pre-clinical results show the ability of porcine and human MSCs to over-produce the transcription factor and that it binds DNA (regulatory genetic material) in the nucleus of modified cells. The transcription factor is known to act as a molecular switch that regulates production of vascular endothelial growth factor and several other angiogenic factors required for new blood vessel growth to deliver blood, oxygen and nutrients to regenerating tissues.

Covalon’s genetically engineered cells that produce EPAS1 protein have been shown to “switch-on” in these cells, the production of vascular endothelial growth factor (VEGF), Angiopoietin, Erythropoietin, as well as several other growth factors that are essential for the growth and maturation of new blood vessels. EPAS1-engineered cells have been used in pre-clinical experiments using a mouse model to mimic ischemic (scar tissue) heart conditions. In the pre-clinical animal model EPAS1-cells were shown to induce the formation of new blood vessels that matured into healthy vessels. Furthermore, the animals treated with EPAS1-cells demonstrated significant improvement in heart-pumping efficiency over that of animals that were either untreated or treated with non-EPAS1-cells.

In using Covalon’s EPAS1 cell therapy, therapeutic angiogenesis within the scar is possible because the implanted cells are used as a delivery system for the “master” angiogenic gene EPAS1. Covalon’s proprietary EPAS1 gene is a biological “switch” able to turn on many genes essential for producing new blood vessels resulting in a more robust response. Furthermore, EPAS1 significantly turns on genes involved in cell survival and cardio-protection. The functional outcome of EPAS1 gene therapy is a significant improvement in heart function recovery compared to cell therapy alone. Although the implantation of EPAS1-cells can be performed as

part of bypass surgery, the technology is ultimately intended to be administered by a less invasive endovascular route using an injection catheter. The expected goal is to load precursor cells with Covalon's proprietary gene construct that stimulates blood vessel growth (EPAS1). The altered cells are intended to stimulate blood vessel growth and improve cardiac function in a model of MI. The demonstration of the EPAS1 protein to bind nuclear DNA in MSCs is an important milestone toward the objective since it demonstrates that cells can be effectively and efficiently manipulated at the genetic level to produce essential growth factors that may contribute to improved angiogenesis and tissue regeneration required for increased and improved heart function.

Covalon has already established the increased angiogenic potential of EPAS1-modified cells and shown that EPAS1 significantly stimulated VEGF synthesis in many cell types such as skeletal myoblasts, dermal fibroblasts, human mesenchymal stem cells and bone marrow mononuclear cells.

Pre-clinical results demonstrated that EPAS1-modified cells delivery improves both perfusion and cardiac function better than cells alone. More specifically, EPAS1 modified cells support an important production of large blood vessels within the scar tissue, allowing for a better blood flow in the area. Furthermore and importantly, EPAS1-cells delivery improves heart function recovery following cell therapy. In our rodent model, cardiac function improvement more than doubled in the EPAS1 group. The expected goal is to load precursor cells with Covalon's proprietary gene construct that stimulates blood vessel growth (EPAS1). An efficacy study in a porcine model and a series of safety studies have been designed and are ongoing.

Covalon's program offers the potential for a minimally invasive alternative to open heart surgery for those suffering from congestive heart failure. Furthermore, the technology has broad application in areas where improved blood flow is required. The initial target patient population for EPAS1-cell therapy is expected to be moderate CHF patients (classes II and III) who initially suffered myocardial infarction.

### **Patent Portfolio**

Covalon currently has patents approved or pending in various jurisdictions around the world. A summary of these patents is included below:

- *Method of Making Antimicrobial Polymeric Surfaces*
  - patent in USA, EU, Australia, other jurisdictions patent pending
- *Drug Delivery via Therapeutic Hydrogels*
  - patent in USA, Canada, EU and Australia
- *Antimicrobial Photo-stable Coating Composition*
  - USA and International patent applications filed.
- *Non-Adhesive Elastic Gelatin Matrices*
  - USA, EU, Eurasia, Canada and other jurisdictions patent applications filed
- *EPAS1 Gene Transfer to Improve Cell Therapy*
  - USA, EU, Canada, and International patent applications filed
- *Hypoxia inducing factors and uses thereof for inducing Angiogenesis and improving muscular functions*
  - USA, EU and Canada patent applications filed

### 3. Analysis of Operating and Financial Results

	Three month period ended June 30,		Nine month period ended June 30,	
	2009	2008	2009	2008
Operating Revenues				
Advanced collagen dressings	\$ 335,684	\$ 291,504	\$ 816,436	\$ 1,340,409
Specialized medical device coatings	66,153	45,758	671,176	134,832
Total Operating Revenues	\$ 401,837	\$ 337,262	\$ 1,488,612	\$ 1,475,241
Product Expenses				
	289,109	113,070	890,054	599,476
Operating Margin	\$ 112,728	\$ 224,192	\$ 598,558	\$ 875,765
Operating Margin %	28.1%	66.5%	40.2%	59.3%
Other Revenue				
Interest income	\$ 25,539	\$ 130,477	\$ 182,364	\$ 578,017
Total Other Expenses	\$ 1,339,495	\$ 853,618	\$ 4,811,272	\$ 3,586,314
Net Loss	\$ (1,201,228)	\$ (498,949)	\$ (4,030,350)	\$ (2,132,532)
Loss per share	\$ (0.02)	\$ (0.01)	\$ (0.05)	\$ (0.03)

#### Highlights for the three month period ended June 30, 2009

- Total Operating Revenues increased by 19% to \$401,837 over the third quarter of 2008;
- Operating Margin as a percentage of sales was 28.1%, a 21.9% decrease over the second quarter in 2009;
- Total Other Expenses decreased from \$1,899,186 in the second quarter in 2009 to \$1,339,495;
- Net loss of \$1,201,228 was a \$285,430 decrease from the loss in the second quarter of fiscal 2009;
- Loss per share of \$0.02 was the same as the loss per share in the second quarter of fiscal 2009.

#### Revenues

Covalon's total operating revenues increased by 19% in the three months ended June 30, 2009 over the same period in 2008. Cumulative operating revenues for the nine months ended June 30, 2009 have now surpassed those in the same period in 2008. 45% of the cumulative operating revenues in the 2009 fiscal year are derived from specialized medical device coating compared to 9% in the 2008 fiscal year. 13% of the cumulative operating revenues in the 2009 fiscal year are derived from development services compared with 5% in the previous year.

In the third quarter of 2009, revenues from advanced collagen dressings increased by \$17,255 over the corresponding revenues in the second quarter of 2009. Revenues from advanced collagen dressings for the nine months ended June 30, 2009 are \$523,973 lower than those in the same period of 2008. The 2009 revenues include \$330,710 in revenues from the licensing

fees paid by Smith & Nephew Inc. at the signing of its contract with Covalon. The comparable figure for 2008 was \$330,925.

Revenues from specialized medical device coatings increased by 45% in the third quarter of fiscal 2009 compared to the third quarter of fiscal 2008. The 2009 year-to-date increase was almost four times the revenues for nine months ended June 30, 2008. Revenues from the sale of coated catheters represented \$487,285 of the specialized medical device coatings revenues for the nine months ended June 30, 2009 and \$61,169 for the same period in 2008.

### ***Operating Margin***

Product expenses amounted to \$289,109 in the third quarter of 2009 and \$890,054 for the nine-month period ended June 30, 2009 compared to \$113,070 and \$599,476 for the same periods last year. Operating margin as a percentage of operating revenues was 28.1% in the third quarter of 2009 compared to 66.5% for the same period last year and 40.2% and 59.3% for the nine-month periods ended June 30, 2009 and June 30, 2008, respectively.

Major factors in the changes from the 2008 fiscal year to the 2009 fiscal year were:

- Cost of replacing coated-catheter inventories (see page 7 of the MD&A)
- A decrease in the proportion of advanced collagen dressing revenues
- A decrease in the mix of BioStep™ compared to ColActive™ products
- An increase in the value of coating service revenues

### ***Interest Income***

Interest income decreased to \$25,539 from \$130,477 during the third quarter of 2009 and to \$182,364 from \$578,017 for the nine-month period ended June 30, 2009 compared to the same periods last year. The decrease is primarily a result of the dramatic drop in interest rates since October 2008. In addition, the reduction in cash and cash equivalents over the past two years has had an impact. All investments are made in accordance with the Company's audit committee investment guidelines of investing Covalon's capital in low-risk interest-bearing instruments.

## Expenses

<i>(in Canadian \$)</i>	3 months ended June 30,		9 months ended June 30,	
<b>Expenses</b>	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>Research and Development</b>				
Wages and Benefits	\$ 196,129	\$ 155,896	\$ 686,426	\$ 467,283
Consulting and Outside Testing	5,677	( 306,234)	49,807	138,573
Amortization of Def. Dev. Costs	29,173	29,183	87,539	87,549
Other	15,226	( 164)	75,442	41,169
Total Research and Development	\$ 246,205	\$ ( 121,319)	\$ 899,214	\$ 734,574
<b>Operations</b>				
Wages and Benefits	\$ 327,907	\$ 169,071	\$ 1,011,549	\$ 535,875
Consulting fees	37,596	34,290	98,273	73,723
Other	23,548	36,881	131,041	124,286
Total Operations	\$ 389,051	\$ 240,242	\$ 1,240,863	\$ 733,884
<b>Marketing</b>				
Wages & Benefits	\$ 63,701	\$ 63,228	\$ 347,954	\$ 197,738
Travel	10,788	9,676	53,806	21,515
Investor Relations	26,471	8,284	75,306	63,269
Other	3,767	3,428	22,384	18,994
Total Marketing	\$ 104,727	\$ 84,616	\$ 499,450	\$ 301,516
<b>General and Administrative</b>				
Wages & Benefits	\$ 235,709	\$ 222,878	\$ 723,302	\$ 715,017
Directors' Compensation	58,543	118,343	258,402	319,753
Professional Fees	92,659	83,713	547,360	248,484
Depreciation and Amortization	77,385	59,818	205,767	135,367
Write off Abandoned Patent			38,857	
Facility	43,449	44,875	132,241	129,938
Other	91,767	120,453	265,816	267,781
Total General and Administrative	\$ 599,512	\$ 650,080	\$ 2,171,745	\$ 1,816,340
<b>Total Expenses</b>	<b>\$ 1,339,495</b>	<b>\$ 853,619</b>	<b>\$ 4,811,272</b>	<b>\$ 2,466,440</b>

*(Note: Certain comparative details were reallocated to match the current year's presentation format)*

The expenses for the three and nine month periods ended June 30 for 2009 and 2008 are summarized above. Total expenses for the three months ended June 30, 2009 have decreased 29.5% compared to the three months ended March 31, 2009. A major contributor to that decrease was the headcount reduction disclosed in the Company's previous MD&A. A reduction of \$281,330 in professional fees was the other major factor in the decrease compared to the previous quarter.

Total expenses for the three months ended June 30, 2009 increased \$485,876 over total expenses for the three months ended June 30, 2008. The most significant factor in that increase was a credit of \$401,028 in the 2008 expenses for costs on the EPAS1 Project that were transferred to deferred development costs on the balance sheet.

Wages and benefits for the three months ended June 30, 2009 totalled \$823,446, and included approximately \$41,000 in severance costs for the staff terminated in April 2009. Wages and benefits for the three months ended March 31, 2009 totalled \$967,181. Wages and benefits for the three months ended June 30, 2008 were \$611,073.

Investor relations costs for the three months ended June 30, 2009 were \$26,471 and included \$18,750 as a termination payment on the contract announced on January 26, 2009.

The Company is party to 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 losses resulting from the underlying actions, will be charged to operations in the period the loss is determined.

#### 4. Related Party Transactions

- 1) During the nine months ended June 30, 2009, the Company paid fees to related parties as follows:
  - a) Management fees totaling \$473,043 (2008 – \$426,804) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$178,043 (2008 – \$162,672).
  - b) Directors fees include cash compensation of \$110,500 (2007 - \$110,708) paid to certain of the independent directors and stock option benefits that have been valued at \$147,902 (2008 – \$209,045).
- 2) 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.

In April 2009, the final \$5,300 installment of the repayments from Dr. DiCosmo was transacted.

Effective June 1, 2009, Mr. Williams has chosen to forgo his retainer fees of \$5,000 per month as Chairman of the Board of Directors.

## 5. Critical Accounting 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. Management believes that the estimates and assumptions upon which the Company relies are reasonable based upon information available at the time these estimates and assumptions are made. Estimates and assumptions may be revised as new information is acquired, and are subject to change. Areas of significant estimates include deferred development costs and stock based compensation.

### *Deferred Development Costs*

Development costs which meet generally accepted criteria, including reasonable assurance regarding recoverability, are deferred and amortized from the beginning of commercial production and sales. Annually the Company reviews the recoverability of deferred development costs through evaluation of the expected future cash inflows from commercialization of the associated products to determine if there is impairment in the recoverable amount.

Development costs for each product project are amortized when the regulatory approval to sell the resulting product is received, on a straight-line basis over the years remaining on the patent.

### *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.

## 6. Summary of Quarterly Results and Financial Position

The quarterly financial information presented below represents eight quarters of operating results and financial position:

<i>(in Canadian \$)</i>	2009 Third Quarter	2009 Second Quarter	2009 First Quarter	2008 Fourth Quarter	2008 Third Quarter	2008 Second Quarter	2008 First Quarter	2007 Fourth Quarter
Revenue (1)	427,376	781,433	\$462,167	\$419,721	\$467,739	\$654,625	\$930,893	\$372,768
Net loss	\$1,201,228	\$1,481,658	\$1,347,464	\$1,608,315	\$498,949	\$957,576	\$676,007	\$1,425,046
Net loss per share	\$(0.02)	\$(0.02)	\$(0.02)	\$(0.02)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.02)
Cash and Cash Equivalents	\$7,788,427	\$9,038,878	\$10,817,508	\$12,616,253	\$13,886,375	\$14,495,407	\$15,545,433	\$16,170,000
Net Working Capital	\$7,251,543	\$8,482,245	\$10,060,370	\$12,007,901	\$13,652,270	\$13,274,549	\$13,832,958	\$14,322,821
Current Ratio	6.1	6.7	7.6	11.1	17.7	7.0	6.9	6.4

(1) Includes Other Revenues

There have been no consistent trends in Revenues and Net Loss over the past 2 years. This reflects the facts that the Company has few customers, has few products approved for commercial use and has seen inconsistent ordering patterns from its distributors. A more meaningful trend may emerge as new contracts are signed and new products are approved for commercial use. Total revenues in the third quarter of the 2009 fiscal year were \$427, 376 and the average quarterly revenues for the past two years were \$564,590. Net loss in the third quarter of the 2009 fiscal year was \$1,201,228 and the average quarterly net loss for the past two years was \$1,135,821.

Covalon currently has \$7.8MM of cash and cash equivalents. If the Company continues to use cash at the pace it has in the past quarter, then it has approximately 6 quarters before its cash and cash equivalents are consumed.

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. At June 30, 2009, the Company has 6.1 times the current assets needed to pay its current liabilities

## 7. Liquidity & Capital Resources

<i>(Canadian \$)</i>	June 30, 2009	As at	September 30, 2008
Cash and Cash Equivalents	\$ 7,788,427		\$ 12,616,253
Total assets	\$ 13,736,242		\$ 17,292,486
Deferred revenue	\$ 1,195,281		\$ 1,527,251

### Highlights

On June 30, 2009, cash and cash equivalents amounted to \$7,788,427. The Company follows a policy of investing its surplus cash resources in high quality, liquid, short-term notes. Cash equivalents as of June 30, 2009 and September 30, 2008 had less than three months maturity or were cashable without penalty. As at June 30, 2009 there were no restrictions on the flow of these funds nor have any of these funds been committed in any way. Management believes that the Company has the capital resources and liquidity necessary to meet its current commitments, support its operations and finance its current growth strategies.

Total assets at June 30, 2009 were \$13,736,242 compared to \$17,292,486 at September 30, 2008. Cash and Cash equivalents make up almost 57% of this balance at June 30, 2009. Of the remaining assets, the Company's accounts receivable and inventory are fairly liquid with collection periods and turnover ratios in the 60 to 180 day range. The balance of our assets is comprised of capital assets and the Company's intangible assets. These have low liquidity but represent much of the intellectual property assets that are used to generate Covalon's revenue streams.

Deferred revenue decreased by \$331,971 to \$1,195,281 at June 30, 2009 from the end of the 2008 fiscal year. The reduction in deferred revenue relates to the amortization of the initial funds received from Smith & Nephew Inc. upon signing its exclusive distribution contract with Covalon.

### Commitments

Covalon has an operating lease for its premises at 405 Britannia Road East, Mississauga expiring on November 30, 2009. The annual rental payments for the first two years were \$68,627 payable monthly and \$91,855 payable monthly for the remaining portion of the lease. The Company is currently negotiating with the intent of signing an extension. The Company has also entered into an operating lease for some of its office equipment. The equipment is leased at \$477 per month under a lease expiring in 2013.

The minimum annual lease payments for the next 5 fiscal years are:

2010 Fiscal Year	\$21,541
2011 through 2013 years	\$ 5,724 annually

Completion of the current safety and efficacy study related to the genetic regeneration of damaged organs and tissue technology (expected to occur near the end of the fiscal year) will cost an estimated additional \$335,000.

### Shares Outstanding

	Number of Common Shares	Stated Capital
Balance, September 30, 2007	72,712,034	\$ 28,664,432
Issued pursuant to the exercise of stock options	491,881	294,778
Issued in trust for technology rights	1,025,000	
Issued for technology rights	<u>75,000</u>	<u>192,500</u>
Balance September 30, 2008	74,303,915	\$ 29,151,710
Issued for technology rights (75,000 from trust)		<u>21,375</u>
Balance June 30, 2009	<u>74,303,915</u>	<u>\$ 29,173,085</u>

In fiscal 2008, there were 491,881 shares issued as result of stock option exercises. This generated cash of \$192,719 to the Company. In addition, there were 1,100,000 shares issued in trust as the result of Covalon acquiring rights from Perfusion Therapeutics for the EPAS1 technology. These shares will be issued to Perfusion Therapeutics as specific milestones in the technology development program are met. Shares issued to Perfusion as milestones are achieved are recorded at the then current market price. 75,000 shares were issued in fiscal 2008 and another 75,000 have been issued in the first half of fiscal 2009. The balance of 950,000 shares remains in trust pending achievement of future milestones.

### Stock Option Plan

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

	Number of Shares	Value	Exercise Price
Balance, September 30, 2007	\$ 3,589,388	\$ 925,625	
Granted in the Year	755,000	613,509	\$2.81
Vested in the Year		294,545	\$1.04
Exercised in the Year	( 491,881)	( 102,059)	
Forfeited in the Year	<u>( 164,331)</u>	<u>( 130,529)</u>	
Balance, September 30, 2008	\$ 3,688,175	\$ 1,601,091	
Granted in the 9-Month Period	1,800,000	210,563	\$0.53
Vested in the 9-Month Period		381,901	\$1.99
Forfeited in the 9-Month Period	( 116,668)	( 5,905)	
Expired in the 9-Month Period	<u>( 16,250)</u>	<u>( 31,030)</u>	
Balance June 30, 2009	<u>\$ 5,355,257</u>	<u>\$ 2,156,620</u>	

In fiscal 2008, there were 755,000 options issued to employees, directors and related parties. The average exercise price of the options issued was \$2.81 and the value assigned to these options was \$1,392,085. In the 2009 fiscal year, Covalon has issued 1,800,000 options with an average exercise price of \$0.53 and a value of \$394,820. The lower valuation of the fiscal 2009 options is predominantly a result of the lower share price in effect when these options were granted.

In the three months ended June 30, 2009, 116,668 options were forfeited before they vested as a result of the staff reductions announced May 4, 2009. The value credited back to income of these options was \$5,905.

## 8. Sources and Uses of Cash

	Three month period ended June 30,		Nine month period ended June 30,	
	2009	2008	2009	2008
<b>Cash Provided By (Used in)</b>				
<b>Operating Activities</b>				
Cash used in operating activities before change in non-cash working capital	\$ (911,100)	\$ (210,494)	\$ (3,062,237)	\$ (1,304,665)
Change in non-cash working capital	(20,727)	208,529	(293,762)	(417,790)
	<b>\$ (931,827)</b>	<b>\$ (1,965)</b>	<b>\$ (3,355,999)</b>	<b>\$ (1,722,455)</b>
<b>Investing Activities</b>				
Purchase of capital assets, net	\$ (171,440)	\$ (251,600)	\$ (652,261)	\$ (259,989)
Expenditures on deferred development cost	(88,509)	(436,328)	(734,802)	(436,328)
Purchase of patents and technology rights	(25,484)	(23,259)	(56,467)	(47,482)
	<b>\$ (285,433)</b>	<b>\$ (711,187)</b>	<b>\$ (1,443,530)</b>	<b>\$ (743,799)</b>
<b>Financing Activities</b>				
Issuance of share capital, net	\$	\$ 109,110	\$ 21,375	\$ 187,752
Foreign exchange loss on cash held	\$ (33,191)	\$ (4,990)	\$ (49,672)	\$ (5,123)
Increase (decrease) in cash and cash equivalents	<b>\$ (1,250,451)</b>	<b>\$ (609,032)</b>	<b>\$ (4,827,826)</b>	<b>\$ (2,283,625)</b>

### Operating Activities

Cash used in operating activities before change in non-cash working capital amounts to approximately \$1.1MM per quarter in the first 2 quarters of fiscal 2009 and decreased to \$911,100 in the third quarter of 2009.

Accounts receivable have decreased to \$273,271 at June 30, 2009 from \$561,544 at March 31, 2009. The decline of 51% is primarily due to a decrease in the receivable amount related to specialized medical device coatings sales for the third quarter of fiscal 2009 compared to the second quarter of fiscal 2009.

Inventories have decreased from \$457,915 at the end of the second quarter of fiscal 2009 to \$370,895 and the end of the third quarter of 2009. More finished goods inventory was sold in the quarter than was produced.

Accounts payable and accrued liabilities at the end of March 31, 2009 totalled \$1,198,991 and included several large balances for legal services, capital equipment and production costs. At June 30, 2009, these balances were generally smaller and accounts payable and accrued liabilities totalled only \$878,280.

### ***Investing Activities***

Purchases of capital assets falls into 3 main areas in fiscal 2009:

- Lab and Production equipment
- Information System Licenses and Implementation Costs
- Research and Development and Testing equipment

Expenditures on deferred development costs were exclusively for the EPAS1 project.

### ***Financing Activities***

The only activity in fiscal 2009 has been the issuance of 75,000 shares out of trust to Perfusion Therapeutics as a result of a project milestone achieved in December 2008.

### ***Off-Balance Sheet Arrangements***

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

### ***Financial Instruments***

The fair values of the Company's financial instruments approximate their carrying values.

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

At March 31, 2009, two customers accounted for 64% (September 30, 2008 – 100%) of the 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. It would be further mitigated by the addition of new customers.

The Company has not entered into any futures or forward contracts or other derivative instruments as at the date of this MD&A.

## 9. Subsequent Events

On August 27, 2009, The Company announced the departure of Dr. Sonia Sanhueza as Chief Operations Officer. The Company feels that it can be more efficient and further reduce its expenses by not continuing to have someone hold such a position at this time given the decision taken to not build its own custom manufacturing facility.

In July 2009, Covalon completed the sale of certain equipment it had acquired. The equipment was sold at a non-material gain on disposal, covering its costs of design, build and delivery.

## 10. Risk and Uncertainties

An investment in the securities of the Company is speculative due to the proposed nature of the Company's business and the fact that Covalon Technologies Ltd. has not yet achieved an annual profit. Consequently, an investment in the Company is subject to certain risks and investors should not invest in securities of the Company unless they can afford to lose their entire investment. In addition to the factors disclosed elsewhere in this MD&A, investors should consider the following risk factors in assessing the investment merits of such securities.

Medical Device and Biotechnology companies in the early revenue stage are subject to a number of risks and uncertainties that are inherent to the development of any new technology. General business risks include, among other things, uncertainty in product development and related clinical trials, the regulatory environment including delays or denial of approval to market products, the impact of technological change and competing technologies, the ability to protect and enforce its patent portfolio and intellectual property assets, the availability of capital to finance continued and new product development, the ability to secure strategic collaborators and its reliance on these collaborators for the development, regulatory approval, testing, manufacturing, commercialization and/or distribution of its products and the risk of product liability claims. In addition, market prices for securities of biotechnology companies are generally volatile, and may or may not move in a manner consistent with the progress being made by such company.

Without limiting the foregoing, the following risks are discussed in more detail:

***Covalon has a history of net losses and may not achieve or maintain profitability.***

Covalon has not yet achieved profitability and there is no guarantee that Covalon will be able to achieve profitability in the future. Covalon has never paid a dividend on its common shares and does not expect to do so in the foreseeable future. Covalon's business and prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in new and rapidly evolving markets such as healthcare.

Covalon cannot predict if profitability will ever be achieved and, if it is, whether or not it will be sustainable on a quarterly or an annual basis. Even if Covalon is not able to successfully further commercialize its products, Covalon believes that it has sufficient capital to fund its business and operations through at least 2010. However, Covalon may need to raise additional capital in the future. Additional financing may not be available, and even if available, may not be on acceptable terms.

***Any failure to obtain or protect intellectual property could adversely affect Covalon.***

Covalon's success depends, in part, on its ability to obtain patents, or licenses to patents, maintain trade secret protection and enforce its rights against others. Covalon has filed and is actively pursuing patent applications in Canada, the United States and other jurisdictions. Covalon may not be able to obtain patent protection for key elements of its technology.

There can be no assurance that:

- patent applications will result in the issuance of patents;
- additional proprietary products developed will be suitably protected from infringement;

- patents issued will provide adequate protection or any competitive advantages;
- patents will not be successfully challenged by any third parties; or
- patents of others will not impede Covalon's ability to commercialize its technology.

Covalon may need to obtain licenses for the development of its products. Licenses may not be available on satisfactory terms or at all. If available, these licenses may obligate Covalon to exercise diligence in bringing its technology to market and may obligate it to make minimum guarantee or milestone payments. These diligence and milestone payments may be costly and could seriously harm Covalon's business. Covalon may also be obligated to make royalty payments on the sales, if any, of products resulting from licensed technology and may be responsible for the costs of filing and prosecuting patent applications. These costs could affect Covalon's results of operations and decrease its earnings.

Covalon's intellectual property includes trade secrets and know-how that may not be protected by patents. There can be no assurance that Covalon will be able to protect its trade secrets. To help protect its rights, Covalon requires employees, consultants, advisors and collaborators to enter into confidentiality agreements. These agreements may not adequately protect Covalon's trade secrets, know-how or other proprietary information in the event of any unauthorized use or disclosure.

***Covalon's development programs and products subject it to the risk of product liability claims for which Covalon may not be able to obtain adequate insurance coverage.***

Human therapeutic products and medical devices involve the risk of product liability claims and associated adverse publicity. Covalon's principal risks relate to the sales of its products and currently their use in clinical trials. Claims may be made by consumers, healthcare providers, third party strategic collaborators or others selling Covalon's products. There can be no assurance that Covalon will be able to obtain or maintain sufficient and affordable insurance coverage for any of these claims. Without sufficient coverage, any claim, any threat of such a claim or any product withdrawal could seriously harm Covalon's business.

***Covalon may incur substantial costs as a result of litigation or other proceedings relating to patent and other intellectual property rights.***

Covalon's future success and competitive position depends in part on its ability to obtain and maintain certain proprietary intellectual property rights used in its principal products. Any such success may be achieved in part by prosecuting claims against others who Covalon believes are infringing its rights and by defending claims of intellectual property infringement brought by its competitors and others. Covalon's involvement in intellectual property litigation could result in significant expense, adversely affecting the development of product candidates or sales of the challenged product or intellectual property and diverting the efforts of its technical and management personnel, whether or not such litigation is resolved in its favour. Some of Covalon's competitors may be able to sustain the costs of complex patent litigation more effectively than it can because they have substantially greater resources. Uncertainties resulting from the initiation and continuation of any litigation could affect Covalon's ability to continue its operations.

In the event of an adverse outcome as a defendant in any such litigation, Covalon may, among other things, be required to:

- pay substantial damages

- cease the development, manufacture, use or sale of product candidates or products that infringe upon the intellectual property of others
- expend significant resources to design around a patent or to develop or acquire non-infringing intellectual property
- discontinue processes incorporating infringing technology
- obtain licenses to the infringed intellectual property

If third-parties file patent applications, or are issued patents claiming technology also claimed by Covalon in pending applications, Covalon may be required to participate in interference proceedings with the U.S. Patent and Trademark Office, or other proceedings outside the United States, including oppositions, to determine priority of invention or patentability, which could result in substantial cost to Covalon even if the eventual outcome were favourable.

***Covalon must receive regulatory approval for each of its product candidates before they can be sold commercially in North America or internationally, which can take significant time and be very costly.***

The development, manufacture and sale of medical devices and human therapeutic products in Canada, the United States and internationally is governed by a variety of statutes and regulations.

These laws require, among other things:

- approval of manufacturing facilities and practices
- adequate and well-controlled research and testing of products in pre-clinical and clinical trials
- review and approval of submissions containing manufacturing, pre-clinical and/or clinical data in order to obtain marketing approval based on establishing the safety and efficacy of the product for each use sought, including adherence to good manufacturing practices during production and storage
- control of marketing activities, including advertising and labeling

Some product candidates currently under development by Covalon will require significant development, pre-clinical and clinical testing, pre-market review and approval, and investment of significant funds prior to their commercialization. The process of completing clinical testing and obtaining such approvals (if required) is likely to take many years and require the expenditure of substantial resources, and Covalon does not know whether any clinical studies by it will be successful, that regulatory approvals will be received, or that regulatory approvals will be obtained in a timely manner. Despite the time and resources expended by Covalon, regulatory approval is never guaranteed.

***Even if some of Covalon's products and manufacturing facilities receive regulatory approval, those products and facilities may still face subsequent regulatory difficulties.***

If Covalon receives regulatory approval to sell any of its products, regulatory agencies will limit the approval to certain diseases, conditions or categories of patients who can use them. In addition, regulatory agencies subject a marketed product, its manufacturer and the manufacturer's facilities to ongoing regulatory requirements. Regulatory agencies may also require expensive post-approval studies. Any adverse effects associated with Covalon's products must also be reported to regulatory authorities. If new data are developed, previously

unknown adverse experiences with a product occur, deficiencies in Covalon's manufacturing and laboratory facilities are discovered, or it fails to comply with applicable post-market regulatory requirements, a regulatory agency may impose restrictions on that product or on Covalon including the requirement to withdraw the product from the market, close the facility, suspend manufacturing, change the product's label or pay substantial fines.

***Covalon's success is partly dependent on its partners' success and the relationship with partners is governed by contracts.***

Covalon is reliant on partners to execute certain key business processes. If its partners do not perform to Covalon's expectations, Covalon may be unable to enforce a change due to contractual terms. This may significantly impact Covalon's ability to generate revenues and profits.

Examples of such issues include:

- Manufacturing may be prioritized other than as Covalon's customers desires
- Production quality measures may not be achieved
- Sales expectations are not achieved
- New products are not launched expeditiously

***If Covalon fails to hire and retain key management, scientific and technical personnel, it may be unable to successfully implement its business plan.***

Covalon is highly dependent on its senior management and its scientific and technical personnel for their domain knowledge and technical expertise. The competition for qualified personnel in the healthcare field is intense, and Covalon relies heavily on its ability to attract and retain qualified managerial, scientific and technical personnel. Covalon's ability to manage growth effectively will require continued implementation and improvement of its management systems and the ability to recruit and train new employees. Covalon may not be able to successfully attract and retain skilled and experienced personnel, which could harm its ability to develop product candidates and generate revenues.

## 11. 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. The Company intends to disclose its plan in the MD&A for the year ending September 30, 2009.

## 12. 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.