

Covalon Technologies Ltd.

Consolidated Financial Statements

For the years ended

September 30, 2009 and 2008

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Auditors' Report

To the Shareholders of
Covalon Technologies Ltd.

We have audited the consolidated balance sheets of Covalon Technologies Ltd. as at September 30, 2009 and 2008 and the consolidated statements of operations and comprehensive loss, cash flows and shareholders' equity for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) "*BDO Canada LLP*"

Chartered Accountants, Licensed Public Accountants

Toronto, Ontario
January 27, 2010

Covalon Technologies Ltd.

Consolidated Balance Sheets

September 30	2009	2008
Assets		
Current assets		
Cash and cash equivalents	\$ 6,036,626	\$ 3,533,554
Short term investments	500,000	9,082,699
Accounts receivable	761,354	239,622
Inventories (Note 5)	341,587	278,256
Prepaid expenses	73,516	66,535
Total Current Assets	7,713,083	13,200,666
Capital assets (Note 6)	989,169	844,736
Other assets (Note 7)	655,254	671,048
Deferred developments costs (Note 8)	3,509,652	2,576,036
Total Assets	\$ 12,867,158	\$ 17,292,486
Liabilities and Shareholders' Equity		
Current		
Accounts payable and accrued liabilities	\$ 766,364	\$ 750,138
Deferred revenue (Note 9)	517,616	442,627
Total Current Liabilities	1,283,980	1,192,765
Deferred revenue (Note 9)	641,957	1,084,624
Total Liabilities	1,925,937	2,277,389
Shareholders' Equity		
Share Capital (Note 10 (b))	29,173,085	29,151,710
Contributed Surplus	362,625	329,004
Options (Note 10 (c))	2,347,028	1,601,091
Deficit	(20,941,517)	(16,066,708)
Total Shareholders' Equity	10,941,221	15,015,097
Total Liabilities and Shareholders' Equity	\$ 12,867,158	\$ 17,292,486

On behalf of the Board

(signed) "Martin C. Bernholtz" _____ Director

(signed) "Frank DiCosmo" _____ Director

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

Covalon Technologies Ltd.

Consolidated Statements of Operations and Comprehensive Loss

For the years ended September 30	2009	2008
Revenues		
Product sales and coating services	\$ 1,649,899	\$ 1,402,868
Licensing fee	442,627	443,850
Interest income	192,999	626,260
Total revenue	<u>2,285,525</u>	<u>2,472,978</u>
Operating Expenses		
Product	1,191,841	825,727
Operations	1,442,707	1,227,483
Research and development activities (Note 8)	1,094,505	1,219,968
Marketing	558,021	482,061
General and administrative (Notes 6 and 7)	2,873,260	2,458,586
Total operating expenses	<u>7,160,334</u>	<u>6,213,825</u>
Net loss and comprehensive loss for the year	\$ (4,874,809)	\$ (3,740,847)
Basic and diluted loss per share (Note 10 (d))	\$ (0.07)	\$ (0.05)

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

Covalon Technologies Ltd.

Consolidated Statements of Cash Flows

For the years ended September 30	2009	2008
Cash flows from operating activities		
Net loss for the year	\$ (4,874,809)	\$ (3,740,847)
Add (deduct) items not involving cash:		
Amortization of capital assets (Note 6)	223,394	167,399
Amortization of other assets (Note 7)	53,937	62,698
Amortization of deferred development costs (Note 8)	116,713	116,732
Gain on disposal of capital assets	(66,962)	-
Write-down of other assets (Note 7)	37,507	-
Stock compensation expense	779,558	777,525
Foreign exchange loss	5,948	7,109
Cash provided by operating activities before change in non-cash working capital balances	(3,724,714)	(2,609,384)
Change in non-cash working capital (Note 16)	(943,496)	(154,203)
	<u>(4,668,210)</u>	<u>(2,763,587)</u>
Cash flows from investing activities		
Purchase of capital assets	(686,212)	(431,474)
Proceeds on disposal of capital assets	385,347	-
Expenditure on deferred development costs	(1,050,329)	(487,418)
Purchase of other assets	(54,275)	(56,878)
Redemption of short term investments	8,582,699	169,404
	<u>7,177,230</u>	<u>(806,366)</u>
Cash flows from financing activities		
Net proceeds on issuance of share capital	-	192,719
Foreign exchange loss on cash held	<u>(5,948)</u>	<u>(7,109)</u>
Net Change in cash and cash equivalents during the year	2,503,072	(3,384,343)
Cash and cash equivalents, beginning of year	<u>3,533,554</u>	<u>6,917,897</u>
Cash and cash equivalents, end of year	<u>\$ 6,036,626</u>	<u>\$ 3,533,554</u>
Represented by		
Cash	\$ 79,140	\$ 81,124
Cash equivalents	5,957,486	3,452,430
	<u>\$ 6,036,626</u>	<u>\$ 3,533,554</u>

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

Covalon Technologies Ltd.

Consolidated Statements of Shareholders' Equity

For the years ended September 30, 2009 and 2008

	Share Capital		Contributed Surplus	Options	Deficit	Total
	Number of Shares	Amount				
Balance, September 30, 2007	72,712,034	\$ 28,664,432	\$ 329,004	\$ 925,625	\$ (12,325,861)	\$ 17,593,200
Issue of common shares for cash pursuant to the exercise of stock options	491,881	294,778	-	(102,059)	-	192,719
Issue of common shares for technology rights	75,000	192,500	-	-	-	192,500
Issued in trust (Note 10(b))	1,025,000	-	-	-	-	-
Stock based compensation	-	-	-	777,525	-	777,525
Net loss and comprehensive loss	-	-	-	-	(3,740,847)	(3,740,847)
Balance, September 30, 2008	74,303,915	29,151,710	329,004	1,601,091	(16,066,708)	15,015,097
Issue of common shares for technology rights	75,000	21,375	-	-	-	21,375
Released from trust (Note 10(b))	(75,000)	-	-	-	-	-
Stock based compensation	-	-	-	779,558	-	779,558
Expired options	-	-	33,621	(33,621)	-	-
Net loss and comprehensive loss	-	-	-	-	(4,874,809)	(4,874,809)
Balance, September 30, 2009	74,303,915	\$ 29,173,085	\$ 362,625	\$ 2,347,028	\$ (20,941,517)	\$ 10,941,221

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

Covalon Technologies Ltd. Summary of Significant Accounting Policies

September 30, 2009 and 2008

Nature of Business	<p>The Company is incorporated under the laws of Ontario and is engaged in the business of developing, licensing and selling medical technologies. The Company has now received regulatory approval on numerous products and is currently generating revenue. The Company has adopted a business model that contracts the manufacturing and distribution of its commercialized products through partners. The Company generates its revenues through development contracts, licensing agreements and distribution contracts and sales. The Company operates in one primary segment.</p>
Going Concern	<p>Covalon is considered to be a going concern and as such, no provisions are made for the valuation of assets or the cost to discharge liabilities, other than in the normal course of operations. The Company has an accumulated deficit of \$20.9 million. The Company's ability to continue as a going concern will depend on management's ability to successfully execute its business plan and achieve profitable operations.</p>
Basis of Consolidation	<p>These consolidated financial statements include the accounts of the Company and its wholly owned subsidiary and have been prepared using the purchase method of consolidation. The assets and liabilities of the acquired companies are initially recorded at cost. The results of operations of the acquired companies are included from the dates of acquisition. All significant intercompany transactions and balances have been eliminated on consolidation.</p>
Use of Estimates	<p>The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from management's best estimate as additional information becomes available in the future.</p> <p>Significant estimates made by management include useful lives of long-lived assets, expected future cash flows used in evaluating long-lived assets for impairment and recoverability and annual volatility used in estimating the fair values of stock-based compensation. Management reviews its estimates periodically and any adjustment is reported in the year in which it becomes known.</p>

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

September 30, 2009 and 2008

Revenue Recognition	<p>Revenue is recognized on an accrual basis as follows:</p> <ul style="list-style-type: none">a) Revenue arising from product sales is recognized once the product has been shipped to the customer.b) Revenue arising from licensing fees and royalties is initially recorded as deferred revenue and recognized over the period of the relevant agreements.c) Revenue arising from development contracts is recognized once specific milestones are achieved.d) Revenue arising from interest is recognized as earned. <p>In all cases, revenue is recognized only when the amounts are fixed and determinable and when the Company can be reasonably assured of collection.</p>						
Cash and Cash Equivalents	<p>Cash and cash equivalents are defined as highly liquid investments and consist of cash and short-term interest bearing instruments that are cashable at any time without penalty.</p>						
Inventories	<p>Raw materials and supplies are stated at the lower of average cost and net realizable value. Work in process and finished goods are stated at the lower of average cost and net realizable value. During the year, the Company adopted Section 3031, and there was no material impact on the financial statements.</p>						
Capital Assets	<p>Capital assets are recorded at cost less related investment tax credits. Amortization is based on the estimated useful life of the asset and is calculated as follows:</p> <table><tr><td>Furniture and fixtures</td><td>- 20% diminishing balance basis</td></tr><tr><td>Lab equipment</td><td>- 20% diminishing balance basis</td></tr><tr><td>Leasehold improvements</td><td>- straight-line basis over 5 years</td></tr></table>	Furniture and fixtures	- 20% diminishing balance basis	Lab equipment	- 20% diminishing balance basis	Leasehold improvements	- straight-line basis over 5 years
Furniture and fixtures	- 20% diminishing balance basis						
Lab equipment	- 20% diminishing balance basis						
Leasehold improvements	- straight-line basis over 5 years						
Other Assets	<p>Other assets include expenditures related to obtaining patents and technology rights associated with the patents and are stated at cost less accumulated amortization. Amortization is being provided on a straight-line basis over the remaining life of the patent being 20 years less the number of years since application for the patent.</p>						
Deferred Development Costs / Research Development	<p>Development costs which meet generally accepted criteria, are deferred and amortized from the beginning of commercial production and sales. Deferred development costs for each technology platform are amortized when the product regulatory approval to sell related products is received, on a straight-line basis over the years remaining on the patent.</p> <p>Annually, the Company reviews the recoverability of deferred development costs through evaluation of the expected future cash inflows from commercialization of the associated products to determine if there is an impairment in the carrying value.</p>						

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

September 30, 2009 and 2008

Investment Tax Credits	Investment tax credits arising from qualifying research and experimental development costs are recorded as a reduction of deferred development costs or capital asset purchases in the period in which these tax credits are considered reasonably assured to be recovered.
Future Income Tax	The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in operations in the year in which the change occurs.
Foreign Currency Translation	<p>Foreign currency accounts are translated into Canadian dollars as follows:</p> <p>At the transaction date, each asset, liability, revenue and expense is translated into Canadian dollars by an estimate of the exchange rate in effect at that date. At the reporting date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate currently in effect. The resulting foreign exchange gains and losses are included in income in the current period. Included in General and Administrative costs are foreign exchange losses of \$110,420 (2008 - \$7,108)</p>
Financial Instruments	<p>The Company's cash and cash equivalents are classified as held for trading and measured at fair value. Short-term investments are classified as held for trading and measured at fair value. Subsequent changes in fair value are recorded to net income or loss. Accounts receivable are classified as loans and receivables and are initially measured at fair value; subsequently measured at their amortized cost using the effective interest rate method. Accounts payable and accrued liabilities are classified as other liabilities and are initially measured at fair value, subsequently measured at their amortized cost using the effective interest rate method. The fair values of the financial assets and liabilities that are included in the balance sheet approximate their fair value due to their short term nature.</p> <p>Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments. The Company is exposed to currency risk arising from fluctuations in foreign exchange rates and the degree of volatility in those rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.</p>

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

September 30, 2009 and 2008

Financial Instruments (cont'd)	<p>Short term investments consists of Ontario Savings Bonds (step up interest rates of .75%, 1.5%, 2.5%, 3.5% and 4.5% in each respective year, redeemable every 6 months and maturing on June 21, 2014) and the carrying value approximates fair market value.</p> <p>All of the Company's cash is maintained by one of the major financial institutions.</p>
Stock Based Compensation	<p>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.</p> <p>The Company uses the fair value based method of accounting for all its stock-based compensation. Accordingly, the fair value method of accounting is applied for stock options granted to directors, officers, employees and consultants whereby the weighted average fair value of options granted is recognized in the financial statements over the vesting period. When the awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to options.</p>
Loss per Common Share	<p>Loss per common share has been computed by dividing the loss applicable to common shareholders by the weighted average number of shares of common stock outstanding during the respective years. Diluted loss per common share is computed using the weighted average number of common and potential common shares outstanding during the year. Potential common shares consist of the incremental common shares issuable upon the exercise of stock options and warrants under the treasury stock method.</p>
Impairment of Long-Lived Assets	<p>An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes the assets' carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the asset and its carrying value. In the year ended September 30, 2009, \$37,507 relating to patents was written off in impairment charges (2008 – Nil).</p>

Covalon Technologies Ltd.

Notes to Consolidated Financial Statements

September 30, 2009 and 2008

1. FINANCIAL RISK MANAGEMENT

Risk factors

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

Credit risk

The Company's cash and cash equivalents does not subject the Company to significant credit risk. The Company has guaranteed investment certificates and provincial bonds, as per its practice of protecting its capital rather than maximizing investment yield, of \$6.5 million invested with two issuers; however, this risk is mitigated as the issuers are a major Canadian bank and the Province of Ontario.

The Company, in the normal course of business, is exposed to credit risk from its global customers in the medical device industry. The accounts and other receivable are subject to normal industry risks in each geographic region in which the Company operates. The Company attempts to manage these risks by dealing with creditworthy customers; however, due to the limited number of potential customers in each market this is not always possible. As at September 30, 2009, three customers accounted for 83% (September 2008 – two customers for 100%) of the accounts receivable balance. These customers, who are distributors and strategic partners of the Company, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers. The Company has not had a history of bad debts and as such management has not recorded a significant allowance.

Pursuant to their collective terms, accounts receivable are aged as follows:

	2009	2008
Current	\$215,679	\$239,622
31-60 days past due	91,121	-
Over 60 days past due	454,554	-
	<u>\$761,354</u>	<u>\$239,622</u>

Liquidity risk

The Company has an ongoing need for substantial capital resources to research and develop, commercialize and manufacture its products and technologies. The Company believes that it has the capital resources and liquidity necessary to meet its commitments, support its operations and finance its current growth strategies.

Interest rate risk

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

Currency risk

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

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2009 and 2008

1. FINANCIAL RISK MANAGEMENT (continued)

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

	<u>2009</u>	<u>2008</u>
Accounts receivable	\$ 734,659	\$ 121,223
Accounts payable	127,018	153,252
Cash	58,112	2,888
Exchange rate (\$USD / \$CAD)	1.0707	1.064

An increase of 5% and 10% in the US dollar exchange rate would result in a decrease of the net loss by approximately \$18,000 and \$37,000 respectively.

Commodity risk

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

2. MANAGEMENT OF CAPITAL

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

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

The Company is not subject to any externally imposed capital requirements and the Company's overall strategy with respect to management of capital remains unchanged from the year ending September 30, 2008.

3. CHANGES IN ACCOUNTING POLICIES

Section 3031, Inventories, is effective for annual and interim periods beginning on or after January 1, 2008. This new section requires inventory to be measured at the lower of cost or net realizable value and provides guidance on the methodology used to assign costs to inventory, it disallows the use of the last-in first-out inventory costing methodology and requires that, when circumstances which previously caused inventories to be written down below cost no longer exist, the amount of the write-down is to be reversed. There was no impact on adoption of this pronouncement.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2009 and 2008

3. CHANGES IN ACCOUNTING POLICIES (CONTINUED)

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets, effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. Section 3064, which replaces Section 3062, Goodwill and Other Intangible Assets, and section 3450, Research and Development Costs, establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets. This new standard is effective for the Company's fiscal year commencing October 1, 2008. There was no impact on the adoption of these new pronouncements.

CICA Handbook Section 1000, Financial Statement Concepts has been amended to focus on the capitalization of costs that truly meet the definition of an asset and de-emphasizes the matching principle. The revised requirements are effective for annual and interim financial statements relating to fiscal years beginning on or after October 1, 2008. There was no impact on the adoption of this pronouncement.

4. FUTURE ACCOUNTING PRONOUNCEMENTS

International financial reporting standards (IFRS)

In 2005, the Accounting Standards Board of Canada ("AsCB") announced that the accounting standards in Canada are to converge with IFRS. In February of 2008 the CICA confirmed the change over date from Canadian GAAP to IFRS to be January 1, 2011. To meet the change over date Covalon is required to issue its first IFRS-compliant consolidated Financial Statements for the year ending September 30, 2012. To provide comparative information, an opening consolidated Balance Sheet will be necessary at October 1, 2010, so the company must be prepared in less than 2 years for the conversion.

5. INVENTORIES

Inventories consist of the following:

	<u>2009</u>	<u>2008</u>
Raw materials	\$ 210,142	\$ 202,492
Finished Goods	131,445	75,764
	<u>\$ 341,587</u>	<u>\$ 278,256</u>

Product expenses include \$869,968 in inventoried materials in 2009 (2008 - \$712,654).

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2009 and 2008

6. CAPITAL ASSETS

	2009		2008	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 425,051	\$ 136,863	\$ 293,844	\$ 84,650
Lab equipment	1,240,791	544,989	1,005,016	402,420
Leasehold improvements	71,416	66,237	70,571	37,625
	1,737,258	748,089	1,369,431	524,695
Cost less accumulated amortization		\$ 989,169		\$ 844,736

Amortization expense of \$223,394 is included in General and administrative expense (2008 - \$167,399).

7. OTHER ASSETS

	2009	2008
Patents and technology rights	\$ 929,328	\$ 853,678
Less: Accumulated amortization	236,567	182,630
	\$ 692,761	\$ 671,048
Less: Write down (net of \$5,874 accumulated amortization; 2008 - Nil) See Note (a) below.	37,507	-
	\$ 655,254	\$ 671,048

Amortization expense of \$53,937 is included in General and administrative expense (2008 - \$62,698).

- (a) Management has done an extensive evaluation of the market potential for products utilizing the patent application for Elastic Gelatin Matrices. The evaluation determined that the cost of any products made using this technology would be uncompetitive. It was determined that the costs of continuing the patent application were greater than the potential value that could be earned. The patent application has been abandoned and all related costs written off.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2009 and 2008

8. DEFERRED DEVELOPMENT COSTS

	2009	2008
Cost	\$ 3,971,813	\$ 2,921,484
Less: accumulated amortization	462,161	345,448
	\$ 3,509,652	\$ 2,576,036

Amortization expense of \$116,713 is included in Research and development activities (2008 - \$116,732).

9. DEFERRED REVENUE

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

During the year ended September 30, 2009, the Company recorded an up front technology transfer services fee from C.R. Bard, Inc. as deferred revenue of Cdn. \$74,949. This fee will be recognized as revenue when the services are rendered.

For the years ended September 30,	2009	2008
Balance, beginning of year	\$ 1,527,251	\$ 1,977,904
Add:		
Up front payment for technology transfer services	74,949	-
Less:		
Amortization of license and supply agreements	442,627	443,851
Offset of related costs	-	6,802
Balance, end of year	1,159,573	1,527,251
Amount to be recognized within one year	517,616	442,627
Long term balance	\$ 641,957	\$ 1,084,624

Covalon Technologies Ltd. Notes to Consolidated Financial Statements

September 30, 2009 and 2008

10. SHARE CAPITAL

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

b) **Issued – Common shares**

In fiscal 2006, Covalon acquired technology from Perfusion Therapeutics Inc. for 1,100,000 fully paid non-assessable common shares of Covalon Technologies Ltd., issued in escrow to be released on various success milestones. At September 30, 2009, 150,000 (2008 – 75,000) shares valued at \$213,875 (2008 - \$192,500) have been released from trust. The remaining balance of 950,000 shares are still being held in trust.

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

At September 30, 2009, 3,369,302 (2008 – 6,640,502) shares are held in escrow.

c) **Stock Option Plan**

The Company has Stock Option Agreements with its employees, directors and consultants, granting options to them exercisable in whole or part as determined by the Board. Under the Stock Option Plan, the Company may grant options to purchase up to an aggregate of 10% of the issued and outstanding share capital with a maximum term of five years. Common shares have been reserved for fully exercisable stock options on the following basis:

	Number of Shares	Value	Weighted Average Exercise Price
Balance, September 30, 2007	3,589,388	\$ 925,625	\$ 0.76
Granted to related parties	375,000	302,629	\$ 2.79
Granted to employees	380,000	310,880	\$ 2.83
Vested to related parties		278,634	\$ 1.03
Vested to employees		15,911	\$ 1.22
Exercised	(491,881)	(102,059)	
Forfeited	(164,332)	(130,529)	
Balance, September 30, 2008	3,688,175	1,601,091	\$ 1.14
Granted to related parties	250,000	72,807	\$ 0.71
Granted to consultants	1,300,000	237,985	\$ 0.45
Granted to employees	250,000	88,158	\$ 0.75
Vested to related parties		310,311	\$ 1.91
Vested to employees		133,281	\$ 2.17
Expired	(19,582)	(33,621)	
Forfeited	(197,920)	(62,984)	
Balance, September 30, 2009	5,270,673	\$ 2,347,028	\$ 0.91

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2009 and 2008

10. SHARE CAPITAL (continued)

Range of Exercise Prices	Number of Options Outstanding	Weighted Average Exercise Price \$	Weighted Average Remaining Contractual Life (years)
\$0.30 - \$0.50	2,853,175	0.41	2.03
\$0.56 - \$0.75	826,248	0.72	1.86
\$1.22 - \$1.53	1,075,000	1.50	1.49
\$1.54 - \$2.79	516,250	2.79	3.50
	<u>5,270,673</u>	<u>\$ 0.91</u>	<u>2.04</u>

In fiscal 2008, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 3.5%, dividend rate NIL, average volatility – 77% and a term of 5 years.

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

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

During the fiscal year ended September 30, 2009, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 2.5%, dividend rate NIL, volatility – 88% to 109% and a term of 2 and 5 years respectively.

Total value of options granted to related parties during the year ended September 30, 2009 was \$77,480 of which \$72,807 vested. Stock options granted to related parties expire as follows: 200,000 on October 15, 2010, 50,000 on March 4, 2014, and 1,200,000 on March 30, 2014. During the year ended September 30, 2009, 1,300,000 options valued at \$468,100 were granted to consultants of which \$237,985 vested. Stock options granted to consultants expire on May 22, 2014. During the year ended September 30, 2009, options valued at \$124,400 were granted to employees of which \$88,158 vested. Stock options granted to employees expire on October 15, 2013.

During the year ended September 30, 2009, 19,582 stock options valued at \$33,621 expired.

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10. SHARE CAPITAL (continued)

During the year ended September 30, 2009, 197,920 options were forfeited. 100,000 of these options with an expiry date of February 25, 2014 and value of \$1,771 were granted to related parties; 37,502 options with an expiry date of October 15, 2013 and value of \$9,448 were granted to employees and 43,750 options with an expiry date of March 31, 2013 and value of \$47,631 were granted to employees, 16,668 options with an expiry date of September 3, 2013 and value of \$4,134 were granted to employees.

As at September 30, 2009, 3,550,640 (2008 – 3,042,131) options with a weighted average exercise price of \$0.93 were available for exercise.

(d) Loss per Share

Loss per share is calculated using the weighted average number of common shares outstanding during the year ended September 30, 2009, which is 74,303,915 (2008 – 73,726,681) shares. As the Company experienced losses for the years ended September 30, 2009 and 2008, all potential common shares outstanding from dilutive securities are considered anti-dilutive and are excluded from the calculation of loss per share for those years.

Details of anti-dilutive potential securities outstanding not included in diluted EPS calculations at September 30, 2009 are as follows:

Anti-dilutive potential securities	2009	2008
Common shares potentially assumable:		
- under stock options	<u>5,270,673</u>	<u>3,688,175</u>

11. RELATED PARTY TRANSACTIONS

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

- (i) Management fees totaling \$595,307 (2008 – \$619,013) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$200,307 (2008 – \$248,680).
- (ii) Directors fees include cash compensation of \$136,000 (2008 - \$145,708) paid to certain of the independent directors and stock option benefits that have been valued at \$168,543 (2008 – \$298,285).

b. The management fees are paid pursuant to two separate management agreements, expiring August 31, 2010. The commitments for the 2010 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.

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12. COMMITMENTS

The Company has signed an offer to lease for its premises at 405 Britannia Rd, Mississauga commencing December 1, 2009 and expiring November 30, 2014. The annual rental payment for the first year is \$80,719 and increases annually over the term of the lease.

The Company has also entered into an operating lease for its equipment. The equipment is leased at \$477 per month under a lease expiring in 2013.

The minimum annual lease payments for the next five years are as follows:

2010	\$	88,807
2011		86,443
2012		90,988
2013		95,965
2014		91,627
	\$	<u>453,830</u>

13. CONTINGENCIES

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

14. INCOME TAXES

(a) Reconciliation between statutory rate and actual rate

	<u>2009</u>	<u>2008</u>
Income tax recovery computed at statutory combined basis rate of 33% (2008 - 34%)	\$ (1,608,700)	\$ (1,271,900)
Permanent differences	262,300	268,400
Expiring losses	290,500	233,100
Change in future tax rates	683,200	274,600
Prior year adjustment for R & D claim	29,600	161,900
Other	(94,000)	133,600
Valuation allowance	437,100	200,300
	<u>\$ -</u>	<u>\$ -</u>

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14. INCOME TAXES (continued)

(b) Future tax assets

The tax effect of the temporary differences that gives rise to future tax assets (liabilities) as of September 30, 2009 and 2008 is presented below. No benefit has been recorded in these financial statements as there is no assurance that the Company will generate taxable income to utilize these differences.

	2009	2008
Non-capital loss carry forwards	\$ 3,070,600	\$ 2,691,500
Capital loss carry forwards	127,800	148,300
Capital and other assets	221,500	165,400
Deferred development costs	265,200	89,700
Deferred revenue	289,900	443,000
Valuation allowance	(3,975,000)	(3,537,900)
	\$ -	\$ -

- (c) The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2009 of approximately \$12,282,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

Year	Amount
2010	\$ 844,000
2014	787,000
2015	1,996,000
2026	1,494,000
2028	3,078,000
2029	4,083,000
	\$ 12,282,000

- (d) The Company has capital losses carry forward for income tax purposes as at September 30, 2008 of approximately \$1,022,000 which are available to reduce taxable capital gains in future years. These losses do not expire.

- (e) The Company is eligible for a 20% federal credit on its SR&ED expenditures which can only be used to offset against income taxes payable. The Company is also eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% and refundable in cash to the Company.

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14. INCOME TAXES (continued)

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

Under the Income Tax Act of Canada, certain expenditures are classified as SR&ED expenditures and for tax purposes are grouped into a pool, which is 100% deductible in the year incurred. This SR&ED expenditure pool can also be carried forward indefinitely and deducted in full in any subsequent year. The balance of the SR&ED expenditure pool at September 30, 2009 is \$3,519,980 (2008 - \$2,814,387).

At September 30, 2009, the Company has \$513,306 (2008 - \$359,685) of unclaimed investment tax credits available to reduce federal income taxes payable in future years. If not utilized, these investment tax credits will start expiring in 2013.

15. SUPPLEMENTAL CASH FLOW INFORMATION

	2009	2008
<i>Non-Cash Financing and Investing</i>		
Issuance of shares for technology rights	\$ 21,375	\$ 192,500

16. CHANGE IN NON-CASH OPERATING WORKING CAPITAL ITEMS

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

	2009	2008
Accounts receivable	\$ (521,732)	\$ 80,617
Inventory	(63,330)	1,075
Prepaid expenses	(6,981)	137,977
Accounts payable and accrued liabilities	16,228	76,781
Deferred revenue	(367,681)	(450,653)
	\$ (943,496)	\$ (154,203)

17. SEGMENTED INFORMATION

The Company operates in one primary operating segment. All of the Company's sales are generated in US Dollars from customers in the United States. Product sales and coating services includes sales from advanced collagen dressings of \$804,352 (2008 - \$1,178,315) and specialized medical device coatings of \$845,547 (2008 - \$224,553). All of the Company's assets are located in Canada.

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18. COMPARATIVE FIGURES

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