

MANAGEMENT'S DISCUSSION & ANALYSIS

For the year ended September 30, 2009

January 28, 2010

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 audited consolidated financial statements and related notes for the year ended September 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 and in the investor relations section of our web site at 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.

This MD&A is divided into the following sections:

Management’s Responsibility for Financial Reporting.....	1
Non-GAAP Measures	1
Additional Information	1
Forward-looking Statements.....	1
1. Company Overview.....	3
2. Covalon’s Technologies.....	5
Advanced Collagen Dressings and Natural Bio-polymers.....	5
Specialized Medical Device Coatings.....	6
Antimicrobials for Infection Control.....	8
Genetic Regeneration of Damaged Organs and Tissue.....	8
Patent Portfolio	10
3. Analysis of Operating and Financial Results.....	11
Highlights for the three month and year ended September 30, 2009.....	11
Revenues.....	11
Operating Margin	12
Interest Income	12
Expenses	13
4. Related Party Transactions.....	14
5. Critical Accounting Estimates	15
Deferred Development Costs	15
Stock Based Compensation	15
Impairment of Long-Lived.....	15
6. Summary of Quarterly Results and Financial Position.....	16
7. Liquidity & Capital Resources	17
Highlights	17
Commitments.....	17
Shares Outstanding	18
Stock Option Plan	18
8. Sources and Uses of Cash.....	20
Operating Activities.....	20
Investing Activities	22
Financing Activities	22
Off-Balance Sheet Arrangements.....	22
Financial Instruments.....	22
9. Subsequent Event.....	23
10. Risk and Uncertainties	24
11. Accounting Policies.....	28
Accounting Policies adopted in the 2009 Fiscal Year.....	28
International Financial Reporting Standards (IFRS).....	28
12. Disclosure Controls and Procedures and Internal Controls over Financial Reporting.....	29

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-five, 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, who has also been appointed as Chief Financial Officer and a member of the board of directors.

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 natural biopolymers including collagen dressings
- Specialized medical device coatings
- Antimicrobials for infection control
- 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 topical wound care applications.

Consequently, Covalon's expertise and credibility have allowed access to engaging in discussions and partnerships 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. Other major Covalon partners include;

- CR Bard, a leader in vascular access devices
- Medline Industries, a leading device and patient care distributor
- CareFusion, a leading specialty medical device manufacturer
- Amisno, a major contract manufacturer

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 and Natural Bio-polymers

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

BioStep™ 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 that are combinations of natural biopolymers, including collagen 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 a patented coating process for medical devices. This process results in a very thin coating on the medical device that will generally be slippery when moistened and can hold and release a variety of therapeutics. That is to say, the device can elute a variety of anti-microbial or other therapeutic agents while in use. The technology is already proven effective on many polymeric surfaces and is currently being tested and evaluated on other materials.

Covalon currently manufactures coated Foley Catheters with a silver-based anti-microbial agent for Medline Industries. The product is approved for sale in the USA through Medline Industries and is marketed as the Silvertouch Foley Catheter. The effectiveness of this technology is illustrated through the following study.

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 Foley catheters and Foley 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 uncoated Foley catheters. The second was a six-month period using Foley catheters with Covalon's silver coating. The facility discovered ten hospital-acquired CAUTIs during the four-month period using the uncoated catheters. During the six-months of testing using Covalon's silver-coated catheters, the hospital found "no" hospital-acquired CAUTIs.

In July 2009, the efficacy of our coatings technology was the subject of an article in Medical Product Manufacturing News. This reinforces the importance and relevance of the technology and speaks to the opportunities in the Medical Device market for the Company. A copy of the article can be found through a link on the Investor Relations page of Covalon's website or directly at www.devicelink.com/mpmn/archive/09/07/012.html.

Manufacturing high-volume levels of product has its challenges. Covalon spent much effort over the first half of the year working to extend its effective low-volume manufacturing capability into a cost-effective high-volume manufacturing facility. The Company concurrently researched the option of outsourcing its high-volume commercial production. As announced on April 24, 2009, Covalon concluded that it was better served by entering into an agreement with Amsino, an established manufacturer in the international medical device community, and began unwinding some of the expensive and capital intensive activities and strategies in motion at the time. The announcement of significant cost reductions on May 4, 2009 was the first step in that direction. These reductions now total in excess of \$1.5 million on an annualized basis. The Q4 financial statements highlight the immediate positive impact of the reductions. Compared to Q4 of 2008, expenses fell by \$644,564 and the Net loss declined by \$763,856 in Q4 2009. Management believes that its actions have the company well positioned for revenue growth in 2010 with a lower, more efficient cost structure.

The Company has learned that some of the processes that it put in place to increase production rates had an impact on product quality. While the efficacy of the product does not appear to be impacted, other product specifications were not met. Covalon has identified the mistakes it made that caused the quality issues and has amended its procedures to eliminate them. The Company is in the process of replacing the inventories of product affected by the quality issues and estimates the total cost of this operation to be \$110,000. These costs are included in Product expenses at September 30, 2009.

Covalon's new strategy is to provide its partners with short-term low-volume manufacturing support in the early stages of product launch. In the longer-term, technology transfers or third-party manufacturing will be the solution to high-volume cost-effective production. Our revenue streams will evolve into royalties or other technology licensing fees.

Under this new model, the commercialization process for specialized coated medical devices starts with a feasibility study on a partner's device. Once a coated prototype is achieved, Covalon will typically enter into a development contract that will at least subsidize its costs to translate the research success into a production-ready process. From there, a manufacturing or licensing contract will be the next step in the process to bring a product to the market. Finally, Covalon can provide regulatory services on an as-needed basis to gain regulatory approval in the markets its partners plan to enter. This complete process typically takes 12-18 months to complete, but can take longer or shorter on a given project.

In October 2009 Covalon announced a non-exclusive license agreement and supply agreement with a division of CR Bard for its coatings on a number of devices that are scheduled for launch in 2010.

Covalon is nearing completion of its work on several development contracts and is in negotiation on contracts to commercialize the products.

Covalon has provided prototype, anti-microbial coated samples for a number of potential new customers for a variety of other applications. It is also in discussion with several prospective medical device companies regarding devices that may have a "coating" solution.

The following list outlines several of the coating opportunities Covalon is currently evaluating:

- IV lines/Securement device – to prevent infections
- Pain management catheter – to deliver pain management drugs
- Surgical wound drain – to prevent infections
- Intra-Ocular Device – to create a slippery surface
- Orthopedic devices – to extend the coatings technology to metals

The significant activity level at early stages of commercialization keeps the Company busy and provides it with many opportunities for future revenues. Development service revenues may be seen in the near-term, but royalties or product sales will probably not be seen for the 12-18 months it takes to commercialize the projects.

Antimicrobials for Infection Control

Although Covalon is known for its novel photo stable silver ion antimicrobial technology which is used in wound dressings and in coatings for medical devices, the company's expertise is also being used to develop other unique combinations of antimicrobial compounds targeted at solving a number of infection control issues. Covalon has a fully equipped research and development lab with top research chemists that work at characterizing combinations of compounds that are extensively performance tested in its in-house microbiology lab.

The combination of antimicrobials allows Covalon to offer customization around customer set specifications. Infection control problems vary across the environment and applications so there is no one set solution for all problems. Some of the key issues addressed by combining antimicrobials are:

- Antimicrobial activation
- Speed at which it works
- Effectiveness
- Duration of effectiveness
- What microbes does it work on – MRSA

Each application that utilizes Covalon antimicrobials has specific design requirements. Covalon antimicrobials are being used for applications in the following areas:

- Medical device coatings
- Wound care products
- Polymer mixes for extrusion and molds
- Skin Sanitizers
- Surface Sanitizers
- Cosmetics
- Consumer products such as diapers and cloth

Covalon is in early discussions with a number of potential customers and management believes there are substantial opportunities for its technology for both the medical devices and consumer (OTC) markets.

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

(Canadian \$)	Three month period ended		Year ended	
	September 30, 2009	2008	September 30, 2009	2008
Operating Revenues				
Advanced collagen dressings	\$ 318,627	\$ 167,039	\$ 804,352	\$ 1,175,667
Specialized medical device coatings	174,631	93,781	845,547	227,201
Licensing fee	110,656	110,657	442,627	443,850
Total Operating Revenues	603,914	371,477	2,092,526	1,846,718
Product expenses	301,787	\$ 226,250	1,191,841	825,727
Operating Margin	\$ 302,127	\$ 145,227	\$ 900,685	\$ 1,020,991
Operating Margin %	50.0%	39.1%	43.0%	55.3%
Other Revenue				
Interest income	\$ 10,635	\$ 48,243	\$ 192,999	\$ 626,260
Total Other Expenses	\$ 1,157,221	\$ 1,801,785	\$ 5,968,493	\$ 5,388,098
Net Loss	\$ (844,459)	\$ (1,608,315)	\$ (4,874,809)	\$ (3,740,847)
Loss per share	\$ (0.01)	\$ (0.02)	\$ (0.07)	\$ (0.05)

Highlights for the three month and year ended September 30, 2009

Results improved for Q4 2009 due actions taken by management.

- Total Operating Revenues increased by 63% to \$603,914 over the fourth quarter of 2008 and by 13% to \$2,092,526 over the year ended September 30, 2008;
- Operating Margin as a percentage of sales was 50%, a 10.9% increase over the fourth quarter in 2008;
- Total Other Expenses decreased by \$644,564 or 35.7% to \$1,157,221 over the fourth quarter of 2008;
- Net loss decreased by \$763,856 or 47.5% to \$844,459 from \$1,608,315 over the fourth quarter of 2008
- Loss per share is \$0.01 in the fourth quarter of 2009 compared to \$0.02 in the fourth quarter of 2008.

Revenues

Covalon's total operating revenues increased by 63% in the three months ended September 30, 2009 over the same period in 2008. Cumulative operating revenues for the 2009 fiscal year have surpassed those in the same period in 2008. 38% of the cumulative operating revenues in the 2009 fiscal year are derived from advanced collagen dressings compared with 64% in the previous year. 40% of the cumulative operating revenues in the 2009 fiscal year are derived from specialized medical device coating compared to 12% in the 2008 fiscal year. This progress achieves one of the 2009 AGM goals which was to expand the customer base and decrease the dependency on any individual customer and product.

In the fourth quarter of 2009, revenues from advanced collagen dressings increased by \$151,588 over the same period in 2008. Revenues from specialized medical device coatings increased by 86% in the fourth quarter of fiscal 2009 compared to the same period in 2008. Revenues from specialized medical device coatings for the year ended September 30, 2009 are 272% or \$618,346 higher than those in the same period of 2008.

Licensing fees remain unchanged over the three month and year ended September 30, 2009 and September 30, 2008.

Operating Margin

Product expenses amounted to \$301,787 in the fourth quarter of 2009 and \$1,191,841 for the year ended September 30, 2009 compared to \$226,250 and \$825,727 for the same periods last year. Operating margin as a percentage of operating revenues was 50% in the fourth quarter of 2009 compared to 39% for the same period last year and 43% and 55% for the year ended September 30, 2009 and September 30, 2008, respectively.

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

- A decrease in the mix of BioStep™ compared to ColActive™ products caused in part by Covalon related efforts to assist Smith & Nephew in the Part B reimbursement market
- An increase in the value of coating service revenues as a result of increased services to Medline Industries and new customers

Interest Income

Interest income decreased to \$10,635 from \$48,243 during the fourth quarter of 2009 and to \$192,999 from \$626,260 for the year ended September 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

(in Canadian \$)	Three month period ended September 30,		Year ended September 30,	
Expenses	2009	2008	2009	2008
Operations				
Wages and benefits	\$ 177,030	\$ 479,124	\$ 1,188,579	\$ 970,726
Consulting fees	6,054	9,930	104,327	83,653
Other	18,760	48,620	149,801	173,104
Total Operations	<u>\$ 201,844</u>	<u>\$ 537,674</u>	<u>\$ 1,442,707</u>	<u>\$ 1,227,483</u>
Research and Development activities				
Wages and benefits	\$ 151,516	\$ 266,894	\$ 837,942	\$ 734,177
Consulting and outside Testing	2,612	1,386	52,419	115,151
Amortization of def. dev. costs	29,173	29,183	116,712	116,733
Abandoned development costs	-	145,800	-	145,800
Other	11,990	41,537	87,432	108,107
Total Research and Development	<u>\$ 195,291</u>	<u>\$ 484,800</u>	<u>\$ 1,094,505</u>	<u>\$ 1,219,968</u>
Marketing				
Wages and benefits	\$ 43,025	\$ 90,255	\$ 390,979	\$ 295,678
Travel	10,944	48,522	64,750	94,100
Investor relations	1,837	11,479	77,143	74,749
Other	2,765	1,130	25,149	17,534
Total Marketing	<u>\$ 58,571</u>	<u>\$ 151,386</u>	<u>\$ 558,021</u>	<u>\$ 482,061</u>
General and Administrative				
Wages and benefits	\$ 192,032	\$ 114,768	\$ 892,751	\$ 866,462
Director's compensation	46,141	124,240	304,543	443,993
Advisor expense	183,363	-	205,946	-
Professional fees	114,018	157,742	661,378	406,226
Depreciation and amortization	71,564	94,730	277,331	230,097
Write-off abandoned patent	(1,351)	-	37,506	-
Gain on disposal of capital asset	(66,962)	-	(66,962)	-
Facility	42,693	45,305	174,934	175,243
Other	120,017	91,140	385,833	336,565
Total General and Administrative	<u>\$ 701,515</u>	<u>\$ 627,925</u>	<u>\$ 2,873,260</u>	<u>\$ 2,458,586</u>
Total Expenses	<u>\$ 1,157,221</u>	<u>\$ 1,801,785</u>	<u>\$ 5,968,493</u>	<u>\$ 5,388,098</u>

The expenses for the three month and year ended September 30 for 2009 and 2008 are summarized above. Total expenses for the three month period ended September 30, 2009 have decreased by 35.8% or \$644,564 from the same period in 2008. One of the major contributors to that decrease was the headcount reduction disclosed in the Company's previous MD&A. Total wages and benefits excluding stock option expense for the three month period ended September 30, 2009 was \$574,607 compared to \$862,673 for the three month period ended September 30, 2008. In addition, the company had no write-downs of deferred development costs. Legal fees have also decreased.

The company recorded \$205,946 as advisor expense during the year ended September 30, 2009. This is a non-cash expense and represents the vesting expense related to options granted during 2009.

The Company is party to a legal proceeding. Although the result of this litigation cannot be predicted with certainty, management is of the opinion that this proceeding has no merit and will not result in a material loss to the Company.

4. Related Party Transactions

- 1) During the year, the Company paid fees to related parties as follows:
 - a) Management fees totaling \$595,307 (2008 – \$619,013) were paid 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). The management fees are paid pursuant to two separate management agreements, expiring August 31, 2010.
 - b) Directors fees include cash compensation of \$136,000 (2008 - \$145,708) paid to certain of the independent directors. Stock option benefits have been valued at \$168,543 (2008 – \$298,285).

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.

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 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.

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.

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.

Impairment of Long-Lived

An impairment charge is recognized for long-lived assets, including Assets 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).

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 Fourth Quarter	2009 Third Quarter	2009 Second Quarter	2009 First Quarter	2008 Fourth Quarter	2008 Third Quarter	2008 Second Quarter	2008 First Quarter
Revenue (1)	\$614,549	\$427,376	\$781,433	\$462,167	\$419,721	\$467,739	\$654,625	\$930,893
Net loss	\$844,459	\$1,201,228	\$1,481,658	\$1,347,464	\$1,608,315	\$498,949	\$957,576	\$676,007
Net loss per share	\$(0.01)	\$(0.02)	\$(0.02)	\$(0.02)	\$(0.02)	\$(0.01)	\$(0.01)	\$(0.01)
Cash and Cash Equivalents	\$6,036,626	\$7,788,427	\$9,038,878	\$10,817,508	\$3,533,544	\$13,886,375	\$5,412,708	\$6,296,374
Net Working Capital	\$6,429,103	\$7,141,868	\$8,482,245	\$10,060,370	\$12,007,901	\$13,652,270	\$13,274,549	\$13,832,958
Current Ratio	6.0	6.1	6.2	7.6	11.1	17.7	7.0	6.9

(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 fourth quarter of the 2009 fiscal year were \$614,549 and the average quarterly revenues for the past two years were \$594,813. Net loss in the fourth quarter of the 2009 fiscal year was \$844,459 and the average quarterly net loss for the past two years was \$1,076,957. Management intends to continue to manage expenses tightly while focusing on increasing revenues in an effort to improve results.

Covalon currently has \$6.04MM of cash and cash equivalents. Management believes it has taken and continues to take measures to reduce cash outflows through a combination of expense management and increased revenues.

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 September 30, 2009, the Company has 6.0 times the current assets needed to pay its current liabilities

7. Liquidity & Capital Resources

<i>(Canadian \$)</i>	As at	
	September 30, 2009	September 30, 2008
Cash and Cash Equivalents	\$ 6,036,626	\$ 3,533,544
Total assets	\$ 12,867,158	\$ 17,292,486
Deferred revenue	\$ 1,159,573	\$ 1,527,251

Highlights

On September 30, 2009, cash and cash equivalents amounted to \$6,036,626. The Company follows a policy of investing its surplus cash resources in high quality, liquid, short-term notes. Cash equivalents as of September 30, 2009 and September 30, 2008 had less than one year to maturity and are cashable without penalty. As at September 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 September 30, 2009 were \$12,867,158 compared to \$17,292,486 at September 30, 2008. Cash and Cash equivalents make up almost 47% of this balance at September 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 \$367,678 to \$1,159,573 at September 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 and an upfront fee for technology transfer services from C.R. Bard Inc. which was recorded in the fourth quarter of fiscal 2009.

Commitments

Covalon has signed an offer to lease for its premises at 405 Britannia Road East, Mississauga commencing December 1, 2009 and expiring on November 30, 2014. The annual rental payments 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 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	\$88,807
2011 Fiscal Year	\$86,443
2012 Fiscal Year	\$90,988
2013 Fiscal Year	\$95,965
2014 Fiscal Year	\$91,627

Shares Outstanding

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

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 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	Weighted Average Exercise Price
Balance, September 30, 2007	3,589,388	\$ 925,625	\$ 0.76
Granted	755,000	613,509	\$ 2.81
Vested		294,545	\$ 1.04
Exercised	(491,881)	(102,059)	
Forfeited	(164,332)	(130,529)	
Balance, September 30, 2008	3,688,175	1,601,091	\$ 1.14
Granted	1,800,000	398,950	\$ 0.53
Vested		443,592	\$ 1.96
Expired	(19,582)	(33,621)	
Forfeited	(197,920)	(62,984)	
Balance, September 30, 2009	5,270,673	\$ 2,347,028	\$ 0.91

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 \$669,980. 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 year ended September 30, 2009, 197,920 options were forfeited before they vested as a result of the staff reductions announced May 4, 2009 and the elimination of the Chief Operating Officer position. The value credited back to income of these options was \$62,984.

8. Sources and Uses of Cash

	Three month period ended		Year ended	
	September 30,		September 30,	
	2009	2008	2009	2008
Cash Provided By (Used In)				
Operating Activities				
Cash used in operating activities before change in non-cash working capital	\$ (662,477)	\$ (1,415,376)	\$ (3,724,714)	\$ (2,609,384)
Change in non-cash working capital	(649,734)	374,244	(943,496)	(154,203)
	\$ (1,312,211)	\$ (1,041,132)	\$ (4,668,210)	\$ (2,763,587)
Investing Activities				
Purchase of capital assets, net	\$ (33,951)	\$ (171,485)	\$ (686,212)	\$ (431,474)
Proceeds on disposal of capital assets	385,347	-	385,347	-
Expenditure on deferred development cost	(315,527)	(50,091)	(1,050,329)	(487,418)
Purchase of other assets	(19,183)	(9,396)	(54,275)	(56,878)
Redemption of short term investments	-	169,404	8,582,699	169,404
	\$ 16,686	\$ (61,568)	\$ 7,177,230	\$ (806,366)
Financing Activities				
Net proceeds on issuance of share capital	\$ -	\$ 83,610	\$ -	\$ 192,719
	\$ -	\$ 83,610	\$ -	\$ 192,719
Foreign exchange gain (loss) on cash held	\$ 43,724	\$ (2,119)	\$ (5,948)	\$ (7,109)
Increase (decrease) in cash and cash equivalents	\$ (1,251,801)	\$ (1,021,209)	\$ 2,503,072	\$ (3,384,343)

Operating Activities

Cash used in operating activities before change in non-cash working capital has decreased to \$662,477 in the fourth quarter of fiscal 2009 from approximately \$1.0MM per quarter in each of the first 3 quarters of fiscal 2009.

Accounts receivable have increased to \$761,354 at September 30, 2009 from \$273,271 at June 30, 2009. The increase is primarily due to the sale of production equipment to our strategic alliance partner and an increase in sales from the third quarter of 2009.

Inventories have remained relatively constant from the third quarter of 2009 to the fourth quarter of 2009.

Accounts payable and accrued liabilities decreased to \$766,364 at September 30, 2009 from \$948,280 at June 30, 2009.

Investing Activities

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

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

During the fourth quarter of fiscal 2009, the Company sold production equipment to Amsino International, Inc. as part of the Manufacturing and Distribution Agreement announced on October 22, 2009. The equipment was sold at a non-material gain on disposal, covering its costs of designing, building and delivering it to its customer.

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

Approximately \$6.0MM of the \$8.6MM short term investments redeemed was re-invested in investments with maturities of less than one year. At September 30, 2009, the Company holds \$500,000 in short term investment and approximately \$5.96MM in investments with less than one year to maturity.

Financing Activities

There were no financing activities during the fiscal year ended September 30, 2009.

Off-Balance Sheet Arrangements

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

Financial Instruments

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

Short term investments 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.

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

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 Event

In October 2009, the Company announced the appointment of William Jackson as Chief Financial Officer and a member of the board of directors. Mr. Jackson succeeded Mr. Peter Hobbes who resigned from the Company.

In October 2009, Covalon announced that they have entered into a manufacturing agreement with Amsino International Inc. a business unit of Amsino Medical Group, a leading global manufacturer of single use medical devices. The successful completion of this manufacturing agreement confirms the commitment of the two companies to the global strategic marketing alliance previously announced on April 24, 2009.

In October 2009, Covalon announced that it has signed a License Agreement as well as a Services and Supply Agreement with a division of C. R. Bard, Inc.

In October 2009, Covalon announced that they have entered into a development agreement with CareFusion Corporation, the new specialty products company recently spun off by Cardinal Health.

In October 2009, Covalon held a question and answer conference call for Investors

In January of 2010, the Company announced the resignations of Mr. Brad Williams and Mr. David McFaul from the Board of Directors and the appointments of Dr. Murray Miller and Mr. Brian Pedlar. Mr. Martin Bernholtz has been appointed Chairman of the Board and Mr. Pedlar has been appointed Chair of the Audit Committee.

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

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.

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.

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 01, 2011. To meet the change over date Covalon is required 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.

Management has addressed this issue by researching methods to identify the items materially impacted on Covalon's consolidated Financial Statements. Management has selected appropriate analytical software that will assist it in the conversion and will purchase the software in Q2 of the 2010 fiscal year. The Analysis will be completed and a plan to implement the conversion will be devised by the end of Q2 of the 2010 fiscal year. Management expects to complete the conversion in Q4 of the 2010 fiscal year and believes it has the necessary financial and personnel resources available.

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, 2009, 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.