



MANAGEMENT'S DISCUSSION & ANALYSIS

For the three and six-month periods ended March 31, 2008

May 29, 2008

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

Management's Responsibility for Financial Reporting

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

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

Non-GAAP Measures

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

Additional Information

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

Forward-looking Statements

The MD&A contains forward-looking statements 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

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Over the past several months, we have evaluated our progress on achieving our goals. Through this assessment, we determined that we have the technology and technical expertise, personnel and strong Management to support the vision.

Our strategy is to leverage Covalon's technology platforms (coatings, topical tissue repair and regenerative medicine/cell therapy divisions) and focus our business on higher-value, higher-risk products addressing more complicated and unmet medical needs. Management is pleased that we continue to execute on this strategy.

2. Company Overview

Our Business

Covalon is a biotechnology company that has developed and patented advanced therapeutic biomaterials and medical coatings for advanced wound care, surgical applications and medical devices that inhibit microbial invasion to help reduce infections. As well, the Company has an ongoing research program on the use of cell therapy for regenerating damaged heart tissue for treating congestive heart failure. The Company's core competencies in polymer chemistry and surface coatings have been combined to generate several proprietary technologies that create a range of time-release drug delivery platforms that can be applied to many medical devices for treating unmet medical needs. The Company has thus identified unmet medical needs and developed products, received regulatory approvals and is manufacturing products that contain antimicrobial silver ion that have been shown to reduce microbial attachment and invasions, thereby helping to reduce hospital acquired infections. The anti-microbial silver ion-releasing technology has been shown to be effective against many microbes including antibiotic resistant bacteria such as methicillin-resistant *Staphylococcus aureus* (MRSA), vancomycin-resistant *Enterococcus* (VRE), *Pseudomonas aeruginosa*, *E. coli*, yeasts and other microbes. The Company intends to develop its collagen-based scaffolds to deliver other therapeutics and "biologicals" for inducing hemostasis, as well as treating problems related to ischemic diseases. The Company acquired EPAS1 technology that is intended to be used in developing a genetic-based approach to wound healing and congestive heart failure. EPAS1 technology relies on hypoxia inducible-factor-activity to stimulate angiogenesis (new blood vessel formation) for regenerative medicine. The innovative and powerful aspect of the technology lies in the ability of EPAS1 to initiate new blood vessel formation at the site of tissue damage since ischemic organs lack adequate blood supply. New blood vessels are essential in tissue regeneration or wound healing because any regenerating or healing tissue requires blood flow via newly formed blood vessels to deliver nutrients and oxygen to the tissue. The technology is complimentary to Covalon's wound healing program and research is ongoing at a world-renowned contact research facility specializing in coronary and angiogenesis research. Covalon's cell therapy program is designed to generate cells that express useful genes at a site of cell therapy for treating ischemic conditions, such as congestive heart failure, chronic wounds, peripheral vascular disease and other conditions. Numerous studies have shown that bone marrow-derived stem cells may assist in tissue repair and regeneration of many tissues including myocardium, heart valves, damaged bone, skin, blood vessels and other tissues. Optimum healing and tissue regeneration requires new blood vessel formation. The cell therapy technology aims to stimulate the growth of new blood vessels through a process of therapeutic angiogenesis. The work, wholly owned by Covalon, is part of a research contract issued to Dr. Jacques Galipeau, MD, FRCP(C), Associate Professor of Medicine and Oncology at the Sir Mortimer B. Davis Jewish General Hospital (McGill University), for isolation of cells required for Covalon's program in angiogenesis.



The Company has global distribution in place for its collagen wound products and US distribution for its antimicrobial foley catheter. There is a strong pipeline of increasingly sophisticated products using its coatings and collagen matrices.

Covalon Collagen Materials

Covalon collagen materials are bioresorbable collagen-based devices developed by the Company for delivery of therapeutics ranging from antimicrobial silver technology to cell therapy. The technology allows the Company to produce a variety of advanced convergent drug-devices including anti-infective wound dressings as well as cellular scaffolds for tissue regeneration. The Company's initial focus with scaffolds is to develop, license and/or sell a series of CMO (contract manufacturing organization) manufactured silver ion releasing collagen-based wound dressings that reduce bacterial contamination of chronic wounds, such as diabetic ulcers, bed sores, trauma wounds, burns and other conditions in which a wound presents with recalcitrant healing. Improvements to the Company's wound dressings offerings have generated FDA-approved products that improve wound care by inactivating wound bed enzymes that are known to result in slow to heal wounds. Additionally, the products, Biostep™ and Biostep™ Ag are beneficial in the treatment of chronic and diabetic ischemic wounds. The Company expects adoption of the products in treating chronic and hard-to-heal wounds, as well as in other areas, such as burn and trauma treatments. The collagen technology platform is being used in R&D for a number of products for surgical interventions. It is expected that such products will enhance the Company's value proposition for the platform.

Current Collagen Products

Covalon has received regulatory approval for its collagen wound dressing, antimicrobial collagen wound dressing, antimicrobial collagen gel sheet and advanced wound dressings (Biostep™ and Biostep™ Ag) with matrix metalloprotease (MMP) inhibiting activity. Biostep™ and Biostep™ Ag, the latest products using Covalon's proprietary collagen technology for the treatment of chronic wounds were launched to the public at-large at the Clinical Symposium in Advanced Wound Care in Nashville, Tennessee, on October 11, 2007. The products were introduced by Covalon's commercial partner Smith & Nephew's (NYSE:SNN, LSE:SN) Advanced Wound Management division. Smith & Nephew Advanced Wound Management has an exclusive worldwide sales, marketing and distribution agreement with Covalon for its advanced range of collagen dressings, including CovaClear™. The agreement also grants access and distribution rights to an exciting and differentiated new product development portfolio in the field of advanced wound care.

The unique and innovative Biostep™ products create a moist wound healing environment, deactivate harmful wound proteases (MMPs) and promote tissue growth in chronic wounds, which affect an increasingly large number of patients and have a serious impact on their quality of life.

The following is a list of products developed by Covalon and approved for sale in the US and Canada. The table also includes products submitted for regulatory approval.



Product	Distribution	Launch
ColActive™ Collagen Wound Dressing	Hartmann-Conco (previous) Smith & Nephew Inc.	June 2005 US April 2007 US
ColActive Ag™ Collagen with Silver	Hartmann-Conco (previous) Smith & Nephew Inc.	June 2005 US April 2007 US
CovaClearAg Collagen with Silver Antimicrobial	Smith & Nephew Inc.	Projected Q4 2008
Collagran Wound Dressing and Collagran Ag Wound Dressing	Smith & Nephew Inc.	
Biostep™	Smith & Nephew Inc.	Q4 2007 US
Biostep™ Ag	Smith & Nephew Inc.	Q4 2007 US

Collagen Technology Pipeline

Covalon has identified a number of product applications for its collagen-based technology platform. The applications are increasingly more sophisticated over its current products in therapeutic delivery and functions. The Company's goal is to take advantage of the collagen platform as an advanced combination device for delivery of certain therapeutics and biologicals (e.g. biological growth factors and cells). The current pipeline of collagen devices includes topical hemostatic dressings, a rapid hemostatic trauma dressing, a biologics delivery device for hormones and growth factors, and EPAS1- engineered altered cells for modulating angiogenesis. Angiogenesis is integral to regenerative medicine, including wound healing, treating ischemic heart disease, peripheral vascular disease as well as having other applications related to new blood vessel growth.

The following chart outlines the various collagen applications under development.

Application	Design Phase	Prototype	Process / Production Scale up	Animal Testing	Regulatory Approval
Hemostatic dressing	Completed	Completed	Completed	In progress	-
Hemostatic dressing delivering PLT	In progress	-	-	-	-
Hemostatic delivering FNS	In progress	-	-	-	-
EPAS1 cells for tissue regeneration	In progress	-	-	-	-

Covalon has successfully achieved an important milestone with its EPAS1 technology that is expected to allow Covalon to engineer human mesenchymal stem cells (hMSCs) for increased expression of EPAS1, a hypoxia inducible factor. EPAS1 is a "master" gene that is a regulator of the expression of vascular endothelial growth factor and several other important angiogenic proteins crucial to new blood vessel growth required to deliver blood, oxygen and nutrients to regenerative tissues by cell transplantation.

This project has successfully produced porcine and human mesenchymal stem cells with EPAS1 and demonstrated that the transcription factor (EPAS1 protein) can effectively be expressed 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.



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 myocardial infarction. The demonstration of the transcription factor 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 function. 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.

Coatings

Covalon has developed an advanced proprietary coating platform for the emerging combination device market. The technology uses a proprietary ultraviolet light-mediated process to create biocompatible surface coatings capable of carrying a number of therapeutics. The initial focus is to use the platform for delivery of antimicrobial ionic silver from medical devices, such as urinary (Foley) catheters where the risk of catheter associated infection in hospitals is high. It has been widely estimated that 40% of all hospital-acquired infections are due to the use of Foley catheters. Covalon recently announced that it has successfully completed the development of its new anti-microbial / anti-thrombogenic coating to prevent blood clotting on blood access catheters and devices. The development allows the Company to market the technology for application on vascular access catheters, IV lines, hemodialysis lines and pain management ports where an antimicrobial and anti-thrombogenic coating would offer a clinical advantage in minimizing microbial ingress.

Covalon's antimicrobial and low-thrombogenic coating can be applied to a wide variety of in-dwelling, blood contacting devices for reducing the incidence of hospital acquired infection as well as reducing thrombogenicity. Effective antimicrobial and low-thrombogenic coated catheters may reduce infection and thrombus formation thus improving patient outcome.

Antimicrobial CVC are expected to experience a growth rate approximately 5-fold greater than that of un-coated CVC. It is estimated that by 2009, sixty-nine percent (69%) of all CVC used will be antimicrobial (data from Frost and Sullivan, U.S. Antimicrobial Devices Markets, 2003). Hospital-acquired infections affect approximately 2 million people in the United States each year, and cost over \$11 billion to the U.S. healthcare system (data from Frost and Sullivan, U.S. Antimicrobial Coating Markets, 2006). The total antimicrobial catheters market is projected to attain revenues of US \$ 375 million by 2009 (Frost and Sullivan 2006).

Current Coating Products

FDA 510(K) approval for the silver ion releasing coating for Foley catheters was received on February 16, 2006. The Company provides coating services for Medline Industries, Inc., one of the largest distributors in the US. Medline launched the "Silvertouch" Foley catheter in June 2006. In 2007, Medline has initiated a number of in-market case studies to show the efficacy of the coating. It is anticipated that these studies will show the coatings advantage over other antimicrobial coatings and accelerate adoption in the market.

Coating pipeline

Covalon has provided prototype, antimicrobial coated samples for a number of new customers for a variety of other applications including: peripherally inserted central catheters, central venous lines, sutures, intravenous lines, feeding tubes, stomach anchors, stents and metal for



orthopedic applications. The Company is in “fee for service” co-development with a number of customers for these coating applications and is considering other exclusive licensing opportunities.

The chart below outlines the status of coating applications under development.

Application	Design Phase	Prototype	Process / Production Scale up
Central venous lines	Completed	Completed	-
PICC lines	Completed	Completed	-
Sutures	Completed	Completed	-
IV lines	In progress	Completed	-
Catheter ports	In progress	Completed	In progress
Metals for orthopedics	In progress	-	-

3. Investments and Capitalization

Covalon became a publicly listed company on the Toronto Venture Exchange (TSXV) on December 21, 2004, trading under the symbol (COV). At the beginning of the current fiscal year, October 1, 2007, the Company had 72,712,034 common shares issued and outstanding. The table below sets out the number of issued and outstanding common shares as well as the number of issued and outstanding options to purchase common shares, in each case as at March 31, 2008.

Common shares	72,900,215
Options to purchase common shares	4,161,207
Total diluted shares outstanding	77,061,422

On October 24, 2006, Covalon completed the acquisition of a therapeutic cell engineering platform for improving blood vessel development (“angiogenesis”) for improving outcomes for patients with congestive heart failure from Perfusion Therapeutics Inc. of Montreal. The technology is envisaged to improve the long-term outcomes for patients with congestive heart failure. As well the cell therapy is expected to be applicable to etiologies related to angiogenesis, such as peripheral vascular disease and chronic wound healing. Covalon acquired the technology in exchange for 1,100,000 of its common shares to be released upon the completion of various milestones. The technology uses the endothelial PAS domain protein 1 (EPAS1). Covalon’s EPAS1 technology is the subject of several US and European patent applications that Covalon has assumed through the acquisition.

4. Results of Operations

Highlights

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

- Total Revenues increased by 42% or \$193,114 over the second quarter of 2007 to \$654,625;
- Gross profit as a percentage of sales was 52.0% in the second quarter of 2008, a 4.9% improvement compared to the same period last year;

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- Regulatory investments increased by \$127,880 or 97% over the second quarter of 2007 to \$260,368;
- Research and Development investments increased by \$144,595 or 68% over the second quarter of 2007 to \$356,396;
- Net loss increased by 89% over the second quarter of 2007 to \$957,576;
- Loss per share of \$0.01 was the same as the second quarter of 2007;
- The Company has identified 22 product opportunities for its two product platforms and is in varying stages of development and partnering discussions.

Operations

The Company is undertaking a strategic improvement in our platform pilot manufacturing process for the therapeutic antimicrobial coating of catheters and polymeric devices. The process improvement is being carried out in two phases whereby in the first phase, design configuration of some of the equipment has been achieved and in the second phase, automation of the system is scheduled. The process optimization will allow an improvement in our yield rates of coating products and implement a leaner process for coating various catheters with Covalon's proprietary antimicrobial coating. The activities are in-line with the Company's strategy to conduct contract research and development in applying its antimicrobial coating on a number of medical devices. Further, the Company has transferred an optimized lyophilization cycle for the wound care products to the contract manufacturer with the objective of improving yields and consequently profitability. The Company expects the process improvements to positively impact our financial results.

Research and Development

The Company's research and development activities continue to progress on all fronts. The Company is currently in three development relationships and we continue to identify applications for our technology platforms. Considerable success has been achieved in applying antimicrobial coatings to various materials and devices, such as Foley catheters and various vascular access systems. The coatings have the added advantage of being non-thrombogenic, or of low thrombogenicity, which should increase the range of potential clinical applications. Coatings have also progressed to antimicrobial coatings on stainless steel and other metals. The work is designed to yield effective antimicrobial coatings for orthopedic applications. A number of devices have been coated with a silver-ion laden coating. Antimicrobial activity has been demonstrated in vitro, in preclinical investigations at Covalon. The next step is to obtain a silver coating with an extended period of antimicrobial activity as required by the application and the specific device.



Substantial progress has also been made with respect to the development of new wound care and tissue repair products. An innovative and proprietary tissue covering has been shown to possess greater hemostatic activity than current market leaders in the hemostatic dressing field. Further, in vitro and in vivo, preclinical tests are expected to confirm the positive initial results. In addition, the biomaterials scaffold technology is being expanded into innovative surgical applications for soft and bone tissue repair.

Development of Covalon's new blood vessel formation program for tissue regeneration using its therapeutic cell therapy (EPAS-1 technology) continues to progress as expected and according to Management's expectations. A recent important milestone using swine is the ability to extract, purify, genetically engineer mesenchymal stem cells with EPAS1, freeze, store, thaw and use the cells for myocardial preservation following loss of blood flow due to coronary vessel occlusion by therapeutic cell transplantation. The accomplishment now permits the progression of the program to the next critical phase involving a pilot study, adenovirus-EPAS1 infection tests, and an animal in vivo angiogenesis study.

Patents and Trademark Registration Update

On March 20, 2008, Covalon received a Notice of Allowance for a Canadian patent entitled: Drug delivery via therapeutic hydrogels (Patent Application No. 2,286,644). The technology can be used for site-specific delivery of several drugs in a time-release fashion from combination medical devices. The patent augments and strengthens Covalon's technology position in the expanding area of combination medical devices. The devices that may benefit from the technology include implantable medical devices, wound closure systems and wound dressings that can contain a variety of active agents like antibiotics, hormones, growth factors and other therapeutics that are beneficial for the medical condition under management.

Further, Covalon also received a trademark Certificate of Registration in Australia in respect of COLACTIVE™ and COVACOAT™. COLACTIVE™ and the term of the trademark registration in Australia is 10 years from registration date of May 10, 2007, accordingly, the renewal deadline is May 10, 2017. Obtaining registrations in Australia for these dressings is an important milestone. Covalon can now expand sales by entering the Australian acute care and chronic care markets, with an increased product offering across a greater range of treatment indications which include: pressure ulcers, diabetic ulcers, ulcers caused by mixed vascular etiologies, venous ulcers, first and second degree burns, donor and graft sites, abrasions and lacerations, dehisced surgical wounds, traumatic wounds healing by secondary intention. According to the 2000 Clinica Reports "New Developments in Wound Care", the wound care market, world wide, exceeds \$3.5 Billion US per year. With COVACOAT™ the term of the trademark registration in Australia is 10 years from registration date of June 27, 2007 and accordingly, the renewal deadline is June 27, 2017. COVACOAT is the name applied to Covalon's proprietary coating process.

Board of Directors

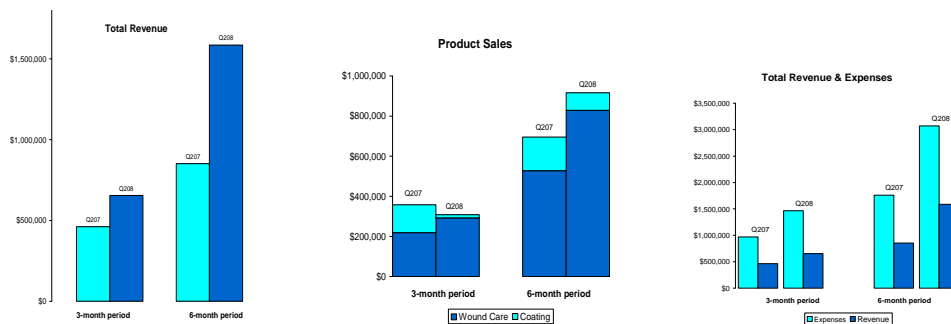
At Covalon's Annual General Meeting, March 7th, 2008, two new members were elected to the Covalon Board of Directors, being Mr. Abe Schwartz and Mr. Joseph Cordiano. Mr. William Jackson did not stand for re-elections and two members were not re-elected, being ~~Mr. William Jackson, Mr. John Andrew~~ and Dr. Greg Merrell. The two newly elected directors had not been nominated as candidates by the previous board, nor listed in the proxy circular by the company's management. Rather, Mr. Schwartz and Mr. Cordiano were nominated at the meeting by shareholders present at the meeting and subsequently voted on to the Board of Directors.



Management, including the President and CEO, Dr. Frank DiCosmo, as well as the Chairman of the Board, Mr. Bradford Williams is pleased to report that Covalon's new board is working hard as a team. Management intends to work with the new board to move Covalon into higher levels of performance for the near term, as well as make growth-enhancing plans for the future. Significant value-enhancing contributions are expected and many challenging goals lie ahead. As a team, management and the board feel confident in executing our plans to continue to build sustainable value in your investments at Covalon.

Operating and Financial Results

	Three month period ended March 31,		Six month period ended March 31,	
	2008	2007	2008	2007
Product Sales				
Wound care	\$ 291,662	\$ 218,944	\$ 828,325	\$ 527,493
Coated catheters	(445)	135,989	56,509	165,207
Coating services	17,196	2,468	30,914	2,468
	\$ 308,413	\$ 357,401	\$ 915,748	\$ 695,168
Cost of goods sold	147,998	189,077	486,406	387,844
Gross Profit	\$ 160,415	\$ 168,324	\$ 429,342	\$ 307,324
Gross Profit %	52.0%	47.1%	46.9%	44.2%
Other Revenue				
Interest income	\$ 235,097	\$ 47,737	\$ 447,540	\$ 98,904
Licensing fee	111,115	56,373	222,231	57,734
Total Expenses	\$ 1,464,203	\$ 779,790	\$ 2,732,694	\$ 1,372,689
Net Loss	\$ (957,576)	\$ (507,356)	\$ (1,633,581)	\$ (908,727)
Net Loss before research and development expenses	\$ (601,180)	\$ (295,555)	\$ (836,054)	\$ (581,470)
Loss per share	\$ (0.01)	\$ (0.01)	\$ (0.02)	\$ (0.02)



Analysis of Operating and Financial Results Three and six-month period ending March 31, 2008



Revenue

Covalon's total revenue increased by \$193,114 to \$654,625 during the second quarter of 2008 and by \$733,713 to \$1,585,519 for the six-month period ended March 31, 2008 compared to the same periods last year. Although the revenues in the coating division in the second quarter of 2008 was much lower than the comparable period last year, this was mitigated by the higher interest income and licensing fee. The Company is seeing some uplift in orders for Foley catheters from Medline in the third quarter of 2008. Total revenue in the second quarter of 2008 was lower than Management's expectations but in line for the six-month period ended March 31, 2008.

Consolidated product sales decreased by \$48,988 to \$308,413 during the second quarter of 2008 and increased by \$220,580 to \$915,748 for the six-month period ended March 31, 2008 compared to the same periods last year. Covalon continues to see progressive increase in sales from Biostep™ and Biostep™ Ag bioactive collagen dressings. The Company has seen more demand for the 2x2 Biostep™ and Biostep™ Ag products. Our President and CEO continues to provide valuable business support to the sales workforce at Smith & Nephew. He continues to visit major hospitals in the United States advocating the Biostep™ and Biostep™ Ag products under the aegis of Smith & Nephew Inc., the distributor of the products. The Company is pleased with the anticipated traction on sales resulting from the business development support. Due to lower sales from the coating division, total products sales in the second quarter of 2008 were lower than Management's expectations but higher than Management's expectations for the six-month period ended March 31, 2008.

Wound Care Sales

Wound care sales increased by \$72,718 to \$291,662 during the second quarter of 2008 and by \$300,832 to \$828,325 for the six-month period ended March 31, 2008 compared to the same periods last year. The wound care sales increased due to the enhanced marketing and sales support from Smith & Nephew and Covalon's assistance in their business development program. In addition, the consumers have begun to accept the value of our products supported by the traction the Company is seeing in the volumes sold of the 2x2 Biostep™ and Biostep™ Ag products. Wound care sales in the second quarter of 2008 were slightly lower than Management's expectations; however, this is due to the timing difference of some sales in the second quarter of 2008 rolling into the third quarter of 2008. Wound care sales for the six-month period ended March 31, 2008 were in line with Management's expectations.

Coatings

Coating sales decreased by \$121,706 to \$16,751 during the second quarter of 2008 and by \$80,252 to \$87,423 for the six-month period ended March 31, 2008 compared to the same periods last year. In the April 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 coated with Covalon's antimicrobial ionic silver coating, which is distributed by Medline Industries Inc. The study compared numbers and rates of CAUTIs from data they gathered during two periods. The first was a four-month period in 2006 using a standard latex catheter. The second was a six-month period using the catheters coated with Covalon's antimicrobial silver coating. The hospital discovered ten nosocomial or hospital-acquired catheter-associated urinary tract infections during the four-month period using the standard latex catheters. During the six-months of testing using Covalon's silver-coated catheters, the hospital found "no" nosocomial catheter-associated urinary tract infections. In the U.S.A., the cost of treating a catheter associated infection is estimated between \$35,000 and \$56,000 per patient. The annual cost of caring for patients with urinary tract infections in the U.S.A. is up to \$2.6 billion. According to the CDC, CAUTIs represent almost 40% of all health-



care-acquired infections. Beginning October 1, 2008, the Centers for Medicare & Medicaid Services will cease reimbursement for the care and treatment of CAUTI acquired during a hospital stay. Consequently, in the interest of reducing costs, it would be in the best interests of the hospital and patient to prevent CAUTI by using Covalon's silver-coated Foley catheter.

The Company continues to do contract research and development applying its anti-microbial coating on a number of medical devices. Covalon recently announced that it developed an anti-microbial coating with anti-thrombogenic properties (prevents blood from clotting on the surface of the device). Covalon expects to seek a distribution partner in the vascular access market.

Cost of Goods Sold

Cost of goods sold amounted to \$147,998 in the second quarter of 2008 and \$486,406 for the six-month period ended March 31, 2008 compared to \$189,077 and \$387,844 for the same periods last year. Cost of goods sold represented 48.0% of sales in the second quarter of 2008 compared to 52.9% for the same period last year and 53.1% and 55.8% for the six-month period ended March 31, 2008 and March 31, 2007, respectively. Lower production in the coating division and higher sales in wound care in the second quarter of 2008 compared to the same periods last year resulted in the decrease in the cost of goods sold, as a percentage of sales.

Gross Profit

Gross profit margin increased from 47.1% in the second quarter of 2007 to 52.0% in the second quarter of 2008 and from 44.2% to 46.9% for the six-month periods ended March 31, 2008 and March 31, 2008. The increase in gross profit was primarily attributable to the higher sales volume in wound care for the three and six-month periods ended March 31, 2008 compared to the same periods last year.

Interest Income

Interest income increased by \$187,360 to \$235,097 during the second quarter of 2008 and by \$348,636 to \$447,540 for the six-month period ended March 31, 2008 compared to the same periods last year. The increase is due to higher cash balance during the comparable periods. (\$14,495,407 – March 31, 2008, \$6,458,215 – March 31, 2007). All investments are made in accordance with the Company's audit committee investment guidelines.

License Revenues

License revenues increased by \$54,742 to \$111,115 during the second quarter of 2008 and by \$164,497 to \$222,231 for the six-month period ended March 31, 2008 compared to the same periods last year. This increase is due to the recognition of the US\$2 million milestone payment the Company received from Smith & Nephew Inc. The milestone payment is being recognized over a 5 year period. It is Management's intention to pursue similar deals similar to that of the Smith & Nephew agreement.

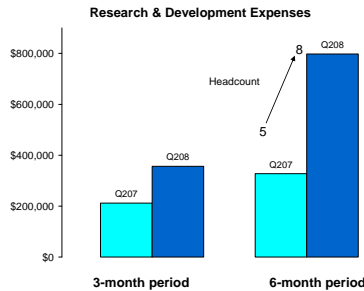
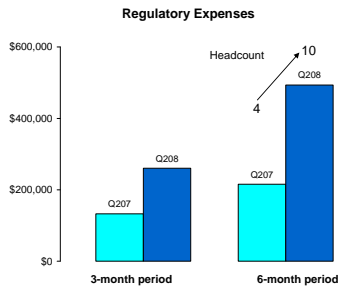
Expenses

Covalon's administrative and overhead expenses increased by \$684,413 to \$1,464,203 during the second quarter of 2008 and by \$1,360,005 to \$2,732,694 compared to the same periods last year. Although administrative and overhead expenses in the second quarter of 2008 are higher than the first quarter of 2008, they are consistent with Management's expectation due to the continued investment in regulatory and research and development infrastructure. Total headcount was 24 and 15 for the periods ended March 31, 2008 and March 31, 2007, respectively.



The expenses for the three and six month periods ended March 31 for 2008 and 2007 are summarized below.

<i>(in Canadian \$)</i>	Three months ended March 31,		Six months ended March 31,	
Administrative and overhead	2008	2007	2008	2007
Amortization	\$ 66,908	\$ 54,946	\$ 133,915	\$ 117,784
Bank Charges and interest	1,134	704	1,976	2,257
Director fees	122,262	97,910	201,409	119,276
Foreign currency (gain) loss	(7,582)	1,626	133	1,817
Management fees	164,225	88,730	300,011	166,230
Marketing	46,848	35,463	88,820	128,652
Office and administrative	302,266	126,123	498,450	225,456
Patent maintenance	275	400	275	600
Professional fees	122,592	9,133	164,772	23,279
Property maintenance	2,025	2,144	4,332	3,584
Regulatory	260,368	132,488	493,641	215,541
Research & Development	356,396	211,801	797,527	327,257
Training	7,039	-	10,416	9,606
Travel	19,447	18,322	37,017	31,350
Total	\$ 1,464,203	\$ 779,790	\$ 2,732,694	\$ 1,372,689





Director Fees

The Director fees increased by \$24,352 to \$122,262 during the second quarter of 2008 and by \$82,133 to \$201,409 for the six-month period ended March 31, 2008 compared to the same periods last year. This increase is due primarily to increases in stock compensation to the Directors resulting from the valuation of vested options.

Marketing

Marketing increased by \$11,385 to \$46,848 during the second quarter of 2008 and decreased by \$39,832 to \$88,820 for the six-month period ended March 31, 2008 compared to the same periods last year. During the three-month period ended March 31, 2008, significantly more travel was spent visiting potential partnerships that are in the vascular coating and ocular shield industry.

Management Fees

The Management fees increased by \$75,495 to \$164,225 during the second quarter of 2008 and by \$133,781 to \$300,011 for the six-month period ended March 31, 2008 compared to the same periods last year. The increase is due primarily to the value of stock options vesting during the period.

Office and Administration

Office and administration costs increased by \$176,143 to \$302,266 during the second quarter of 2008 and by \$272,994 to \$498,450 for the six-month period ended March 31, 2008 compared to the same periods last year. A majority of this increase reflects the addition of a new Chief Financial Officer and related stock compensation expenses.

Regulatory Expense

Regulatory expenses increased by \$127,880 to \$260,368 during the second quarter of 2008 and by \$278,100 to \$493,641 for the six-month period ended March 31, 2008 compared to the same periods last year. Professional staff has increased 150% from four at March 31, 2007 to ten at March 31, 2008. The addition of Tech Transfer and Quality resources greatly enhanced the sophistication of the Regulatory Division.

Research and Development

Research and Development expenses increased by \$144,595 to \$356,396 during the second quarter of 2008 and by \$470,270 to \$797,527 for the six-month period ended March 31, 2008 compared to the same periods last year. The number of scientists has increased by 60% from five at March 31, 2007 to eight at March 31, 2008. The increase allows the Company to support the increase level of research and development activities related to collagen matrices, coatings and EPAS1 technologies. The Company has spent \$155,964 for the three month period ended March 31, 2008 and \$357,361 for the six-month period ended March 31, 2008 on EPAS1 activities. This investment in EPAS1 is in line with Management's expectations. Overall, the level of spending for the three-month period in Research and Development is consistent with Management's expectations.

Net Income (Loss)

Net loss totaled \$957,576 or \$0.01 per share for the three-month period ended March 31, 2008 compared to \$1,633,581 or \$0.01 per share for the six-month period ended March 31, 2008. Higher expenses during the three and six month periods ended March 31, 2008 in director fees, management fees, office and administration, regulatory and research and development compared to the same periods last year were mitigated by higher total revenues in the three and



six-month period ended March 31, 2008. Net loss for the three and six-month period ended March 31, 2008 was better than Management's expectations.

Summary of Quarterly Results

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

<i>(in Canadian \$)</i>	2008 Second Quarter	2008 First Quarter	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter	2007 First Quarter	2006 Fourth Quarter	2006 Third Quarter
Revenue (1)	654,625	\$930,893	\$372,768	\$560,241	\$461,511	\$390,295	\$383,829	\$403,063
Net loss	(957,576)	\$(676,007)	\$(1,425,046)	\$(742,604)	\$(507,356)	\$(401,371)	\$(684,668)	\$(518,097)
Net loss per share	(0.01)	\$(0.01)	\$(0.02)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.02)	\$(0.01)

(1) Includes Other Revenues

The Company's ongoing quarterly losses relate primarily to the continuing buildup of the regulatory and research and development departments. However, the Company is seeing steady sales activity in the wound care sales resulting from the partnership agreement with Smith & Nephew Inc.

Other Performance Indicators

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

	2008 Second Quarter	2008 First Quarter	2007 Fourth Quarter	2007 Third Quarter	2007 Second Quarter	2007 First Quarter	2006 Fourth Quarter	2008 First Quarter
Current Ratio	7.0	6.9	6.4	3.0	2.5	9.2	10.7	11.5
Net Working Capital	\$13,274,549	\$13,832,958	\$14,322,821	\$5,341,353	\$4,346,329	\$4,815,698	\$5,113,130	\$5,508,379

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

The Company's cash balance of \$14,495,407 at March 31, 2008 has enabled the Company to maintain its strong liquidity ratios while allowing us to continue investing in research, product and business development.

5. Liquidity & Capital Resources

Financial Position

<i>(Canadian \$)</i>	March 31, 2008	As at September 31, 2007
Total assets	\$ 18,728,820	\$ 20,244,461
Deferred revenue	\$ 1,755,673	\$ 1,977,904



Total Assets

Total assets at March 31, 2008 were \$18,728,820 compared to \$20,244,461 at September 30, 2007. The decrease of \$1,515,641 is comprised of decreases in cash and cash equivalents and short term investments of \$1,674,593, inventory of \$29,547, prepaids of \$59,344, capital assets of \$52,795, and deferred development costs of \$58,367. Increases relate to accounts receivable of \$266,647 and other assets of \$92,358. The Company drew down on its cash balance to fund its operations. Accounts receivable was a timing issue and the Company is current with all of its accounts.

Deferred Revenue

Deferred revenue decreased by \$222,231 to \$1,755,673 at March 31, 2008 compared to the same period last year. The reduction in deferred revenue relates to the amortizing element of this account.

Liquidity

On March 31, 2008, cash and cash equivalents and short term investments amounted to \$14,495,407. The Company follows a policy of investing its surplus cash resources in high quality, liquid, short-term notes. Cash equivalents as of March 31, 2008 and September 30, 2007 had less than three months maturity. Short-term investments have a maturity on December 1, 2008 which is less than one year and the investment is readily cashable in a short period of time for use in our operations. As at March 31, 2008 there were no restrictions on the flow of these funds nor have any of these funds been committed in any way. The Company believes that it has the capital resources and liquidity necessary to meet its commitments, support its operations and finance its current growth strategies.

Commitments

The Company has entered into an operating lease for its premises at 405 Britannia Road East, Mississauga commencing December 1, 2004 and expiring November 30, 2009. The annual rental payments for the first two years are \$68,627 payable monthly and \$91,855 payable monthly for the remaining portion of the lease.

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

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

2009	\$	100,624
2010		21,541
2011		5,724
2012		5,724
2013		<u>5,724</u>
	\$	<u>139,337</u>

The Company intends to continue to use its capital resources to fund research and development activities, including EPAS1. The amount of capital resources to be allocated to these activities will depend upon the scale of programs undertaken and a number of factors, such as the terms of our partnering agreement, input from outside experts and regulatory authorities on clinical programs. The Company has agreed to fund the development of EPAS1 through various



milestones and has committed \$628,000 for the twelve month period ending September 30, 2008.

Shares Outstanding

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

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

	Number of Common Shares	Number of Warrants	Stated Capital	Warrants
Balance, September 30, 2006	56,322,784	14,792,328	\$ 15,828,922	\$ 927,479
Options exercised	501,194		265,920	
Warrants granted		1,095,728	(2,338,229)	2,338,229
Warrants exercised	15,888,056	(15,888,056)	14,907,819	(3,265,708)
Balance, September 30, 2007	72,712,034	-	28,664,432	-
Issued to Perfusion Therapeutics Inc.	25,000		82,500	
Options exercised	163,181		110,726	
Balance, March 31, 2008	72,900,215	-	28,857,658	-

At March 31, 2008, 6,884,830 (2007 – 9,179,772) shares are held in escrow.

In fiscal 2007, 501,194 options to purchase common shares with a value of \$71,287 were exercised for cash consideration of \$194,633. 200,000 options to purchase common shares expired, resulting in a corresponding increase to contributed surplus of \$12,400.

In fiscal 2007, 1095,728 broker warrants were exchanged for Series III warrants.

In fiscal 2007, 15,888,056 Series III warrants to purchase 15,888,056 common shares, with a value of \$3,265,708 were exercised for cash consideration of \$11,642,111.

During fiscal 2007, the Company issued a total of 16,389,250 common shares.

During the period, the Company issued a total of 188,181 common shares.

The Company issued 1,100,000 shares in escrow in December 2007 relating to the acquisition of technology from Perfusion Therapeutics Inc. to be released on various successful milestones. To date, 25,000 shares valued at \$82,500 have been released from escrow.



In the period, 163,181 options to purchase common shares with a value of \$32,085 were exercised for cash consideration of \$78,641.

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Stock Option Plan

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

	Number of Shares	Value	Exercise Price
Balance, September 30, 2006	3,103,082	\$ 418,739	
Options reinstated to consultant	112,500	23,693	\$ 0.33
Granted to related parties	975,000	473,336	\$ 1.53
Granted to employees	100,000	40,494	\$ 0.75
Vested to related parties		53,050	\$ 0.50
Exercised	(501,194)	(71,287)	
Expired	(200,000)	(12,400)	
Balance, September 30, 2007	3,589,388	\$ 925,625	
Granted to related parties	375,000	108,998	\$ 2.79
Granted to employees	360,000	135,676	\$ 2.93
Vested to related parties		149,809	\$ 1.01
Vested to employees		10,881	\$ 1.22
Exercised	(163,181)	(32,085)	
Balance March 31, 2008	4,161,207	\$ 1,298,904	

In fiscal 2007, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: risk-free rate of interest – 4.5%, dividend rate NIL, volatility – 66% and a term of 3 and 5 years respectively.

Total value of options granted to related parties during fiscal 2007 was \$728,475, of which \$473,336 vested, total value of options granted to employees during fiscal 2007 was \$57,300 of which \$40,494 vested. Stock Options granted to related parties during fiscal 2007 expire on March 27, 2010 (675,000), July 10, 2010 (150,000), July 10, 2012 (150,000), Stock options granted to employees during fiscal 2007 expire on March 20, 2010.

501,194 stock options with a value of \$71,287 were exercised for common shares for cash consideration of \$194,633.

200,000 stock options granted to related parties with an exercise price of \$0.30 expired in February 2007.



During the period, 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 – 3.75%, dividend rate NIL, volatility – 66% and a term of 5 years.

Total value of options granted to related parties during the period was \$600,000 of which \$108,998 vested, total value of options granted to employees during the period was \$609,900 of which \$135,676 vested. Stock options granted to related parties during the period expire on March 31, 2013. Stock options granted to employees during the period expire on September 30, 2012 (100,000) and on March 31, 2013 (260,000).

During the period, 163,181 stock options with a value of \$32,085 were exercised for common shares for cash consideration of \$78,641.

As at March 31, 2008, 2,879,587(2007 – 2,468,707) options were available for exercise.

Sources and Uses of Cash

	Three month period ended March 31,		Six month period ended March 31,	
	2008	2007	2008	2007
Cash Provided By (Used in)				
Operating Activities				
Cash flow from operating activities before change in non-cash working capital	\$ (602,179)	\$ (386,981)	\$ (1,094,171)	\$ (725,323)
Change in non-cash working capital	(491,616)	2,297,430	(626,321)	2,147,973
	\$ (1,093,795)	\$ 1,910,449	\$ (1,720,492)	\$ 1,422,650
Investing Activities				
Purchase of capital assets, net	\$ 3,775	\$ 33,533	\$ (8,389)	\$ 6,948
Purchase of patents and technology rights	166,360	(98,893)	169,404	(131,208)
Short term investments	(10,732)	-	(24,223)	-
	\$ 159,403	\$ (65,360)	\$ 136,792	\$ (124,260)
Financing Activities				
Issuance of share capital, net	\$ 43,144	\$ 50,000	\$ 78,644	\$ 150,000
Foreign exchange gain (loss) on cash held	\$ 7,582	\$ (1,626)	\$ (133)	\$ (1,817)
Increase (decrease) in cash and cash equivalents	\$ (883,666)	\$ 1,893,463	\$ (1,505,189)	\$ 1,446,573

Operating Activities

Cash flow used in operations increased by \$215,198 during the second quarter of 2008 and by \$368,848 for the six-month period ended March 31, 2008. The net increase in the three and six-month periods ending March 31, 2008 compared to the same period last year is mainly due to the higher losses for the comparable periods last year, exclusive of the effect of the changes in non-cash working capital items.

Investing Activities

Cash used in investing activities increased from (\$65,360) in the second quarter of 2007 to \$159,403 in the second quarter of 2008 reflecting the higher purchases of patents and technology rights.



Financing Activities

The exercise of some of the employee's vested options in the second quarter of 2008 resulted in additional funding.

Off-Balance Sheet Arrangements

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

Financial Instruments

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

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

Short term investments consist of Ontario Savings Bonds (interest rate of 5.7% and maturing on December 1, 2008) and the carrying value approximates fair market value.

For the three months ended March 31, 2008, two customers accounted for 96% (three customers, September 30, 2007 – 95%) of the accounts receivable balance. These customers, who act as distributors of the Company's product, 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 entered into any futures or forward contracts or other derivative instruments as at March 31, 2008.

6. 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 present stage of Covalon's development. 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.

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 and commercialization 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. To the extent possible, the Company's Management pursues and implements strategies to reduce or mitigate the risks and uncertainties associated with its business. See "Information concerning the



Resulting Issuer – Risk Factors” outlined in Seder Capital Corp.’s Filing Statement dated December 9, 2004 and available for review on SEDAR at www.sedar.com.

7. Related Party Transactions

- a) During the period the Company paid fees to related parties as follows:
- (i) Management fees totaling \$300,011 (2007 – \$166,230) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$118,377 (2007 – \$11,230).
 - (ii) Directors fees include cash compensation of \$75,800 (2007 - \$73,866) paid to **certain of the ~~four~~** independent directors and stock option benefits that have been valued at \$125,609 (2007 – \$45,410).
- b) The management fees are paid pursuant to two separate management agreements, expiring September 30, 2008. The commitments for the 2008 fiscal year are \$330,000.

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

8. 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, research and development costs, and stock based compensation.

Deferred Development Costs/Research Development

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

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

Stock Based Compensation

Direct awards of stock are based on the price of common stock measured at fair value at each reporting date, with the change in fair value reported 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.

9. Accounting Policies

For the period ended March 31, 2008 Management is using CICA Handbook Section 3855, Financial Instruments – Recognition and Measurement, Section 3861, Financial Instruments – Disclosure and Presentation, Section 1530, Comprehensive Income, and Section 3251, Equity, as described in the December 31, 2007 Consolidated Financial Statements.

CICA Section 1400, Going Concern Amendments was issued in June 2007. This section requires Management to assess the Company's ability to continue as a going concern. Unless there is a plan to liquidate, cease trading or suspend operations, the financial statements are prepared on a going concern basis. Covalon is considered to be a going concern and as such, no provisions are made for the valuation of assets or the cost to discharge liabilities, other than in the normal course of operations. To sustain the business in the future, there must be profitable operations or support from shareholders and other financial parties.

CICA Handbook New Section 1506, based on International Reporting IAS 8—Accounting Policies, Changes in Accounting Policies together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates, and the correction of errors. The notes describe disclosure, on an interim and annual basis, of the description and the impact on financial statements of any new primary source of GAAP that has been issued by not yet instituted. It is effective for interim and annual periods beginning on or after January 1, 2007. At this time, there is no impact of this section on our financial position or on the results of our operations.

For fiscal years beginning on or after October 1, 2007, the CICA Handbook Section 1535, Capital Disclosures applies. This section specifies disclosures of information about a company's objectives, policies and processes for managing capital structure; quantitative data about what the company regards as capital; and whether the company has complied with externally imposed capital requirements, like bank covenants, and if it has not complied, the consequences of such non-compliance. Management is examining its practices regarding this Section.

For fiscal years beginning on or after October 1, 2007, the CICA Handbook Section 3862, Financial Instruments – Disclosure, and CICA Handbook Section 3863, Financial Instruments - Presentation applies. These new standards revise and enhance the disclosure requirements, and carry forward, substantially unchanged, the presentation requirements. Sections 3862 and 3863 emphasize the significance of financial instruments for the entity's financial position and performance, the nature and extent of risks arising from financial instruments, and how these risks are managed. Management has determined that the application of Sections 3862 and 3863 did not have any impact on the unaudited interim consolidated financial statements for the three and six-month period ending March 31, 2008.

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 January 1, 2009. Management is assessing the impact of this new standard on its consolidated financial statements.

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. Management is assessing the impact of this new standard on its consolidated financial statements.

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In March 2006, the Accounting Standards Board of the CICA released its new strategic plan which will abandon Canadian GAAP and affect a complete convergence to the International Financial Reporting Standards. At the end of a transitional period of approximately five years, Canadian GAAP will cease to exist as a separate, distinct basis of financial reporting for public companies. Management will closely monitor changes arising from this convergence.

10. Opportunities

The Company has now identified 22 opportunities for the coatings and collagen platforms. In the current year the Company has entered into three strategic product development arrangements and is in discussion on a number of the identified applications. The Company continues to direct development and partnering opportunities towards product applications that are focused on the surgical suite. As strategic partnerships and products are launched the Company will release details on each deal and product.

11. Subsequent Events

In May, 2008, the following material events were announced by the Company.

EPAS1 Pre-Clinical Milestone

The Company has successfully achieved an important milestone with its EPAS1 research program that is directed toward stimulating new blood vessel growth and tissue regeneration in tissues damaged by loss of or restricted blood flow. The research and development program is expected to allow Covalon to produce "universal donor" mesenchymal stem cells (MSCs) that can be used by all individuals for use in myocardial preservation following loss of blood flow due to coronary vessel occlusion by therapeutic cell transplantation. The use of a "universal donor" will allow for simplification and standardization of procedures related to stem cell therapy including cardiovascular disease and generally in regenerative medicine.

Health Canada Approval

The Company has received approval from the Therapeutic Product Directorate at Health Canada to begin marketing the Corporation's proprietary BIOSTEP™ Collagen Matrix Dressing and BIOSTEP™ Ag Collagen Matrix Dressing with Silver. BIOSTEP™ & BIOSTEP™ Ag are advanced wound care dressings of 5cmx5cm and 10cmx10cm configurations thus providing flexible surface area coverage of the wound. The products will be marketed by Smith & Nephew Inc. under terms of a product marketing agreement finalized last year. The Company intends to continue to broaden its proprietary collagen-based platform to take advantage of other medical applications in the near future.



Antimicrobial Coating Development Agreement

The Company entered into a Development Agreement for the development of its antimicrobial coating. This new Development Agreement will be on Percutaneous Urinary Catheters. Covalon and its partner have agreed upon a series of development milestones for which Covalon will be compensated. The milestones cover a 4 month time span and at the completion of the development program Covalon will provide ongoing coating services to its partner. Due to confidentiality and market considerations no details on the product and the partner will be disclosed until the product is launched. The Development Agreement is to begin immediately and Covalon has received a purchase order for the first milestone.

12. Disclosure Controls

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 March 31, 2008, the Company's Management evaluated the effectiveness of the design and operation of its disclosure controls and procedures as defined under the rules. The evaluation was performed under the supervision, and with the participation, of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on the evaluation of the Disclosure Controls, 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 Disclosure Controls 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.

13. Internal Controls over Financial Reporting

The design of internal controls over financial reporting ("ICFR") within the Company is a Management 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. While the CEO and CFO believe that the internal controls are adequate to provide the above information, a process is underway to evaluate and document all policies and procedures that could impact financial reporting. Shareholders should be aware that Covalon is a small sized company without the departmental resources associated with larger firms and consequently the on-going changes imposed by the accounting industry and securities regulators are an added burden for your Company. Notwithstanding, examination of the Company's process for segregation of duties, compliance with accounting standards and assurance that the consolidated financial statements meet all material reporting requirements is reviewed quarterly and updated within the limitations of the resources of the Company.