

Covalon Technologies Ltd.

Consolidated Financial Statements

For the period ended December 31, 2009

(Unaudited)

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NOTICE OF NO REVIEW BY AUDITOR

In accordance with National Instrument 51-102 released by the Canadian Securities Administrators, the Company discloses that its auditors have not reviewed these unaudited financial statements for the three month period ended December 31, 2009.

Covalon Technologies Ltd.

Consolidated Balance Sheets

As at December 31, 2009 and September 30, 2009
(Unaudited)

	December 31, 2009	Audited September 30, 2009
Assets		
Current assets		
Cash and cash equivalents	\$ 5,428,742	\$ 6,036,626
Short term investments	500,000	500,000
Accounts receivable	951,099	761,354
Inventories (Note 4)	291,152	341,587
Prepaid expenses	89,037	73,516
Total Current Assets	7,260,030	7,713,083
Capital assets (Note 5)	940,436	989,169
Other assets (Note 6)	668,649	655,254
Deferred developments costs (Note 7)	3,516,858	3,509,652
Total Assets	\$ 12,385,973	\$ 12,867,158
Liabilities and Shareholders' Equity		
Current		
Accounts payable and accrued liabilities	\$ 610,434	\$ 766,364
Deferred revenue (Note 8)	517,577	517,616
Total Current Liabilities	1,128,011	1,283,980
Deferred revenue (Note 8)	531,339	641,957
Total Liabilities	1,659,350	1,925,937
Shareholders' Equity		
Share Capital (Note 9 (b))	29,381,330	29,173,085
Contributed Surplus	619,367	362,625
Options (Note 9 (c))	2,110,801	2,347,028
Deficit	(21,384,875)	(20,941,517)
Total Shareholders' Equity	10,726,623	10,941,221
Total Liabilities and Shareholders' Equity	\$ 12,385,973	\$ 12,867,158

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

Covalon Technologies Ltd.

Interim Consolidated Statements of Operations and Comprehensive Loss

For the three months ended December 31, 2009 and 2008

(Unaudited)

	2009	2008
Revenue		
Product Sales		
Advanced collagen dressings	\$ 244,394	\$ 52,170
Specialized medical device coatings	439,619	195,843
Licensing fee	110,657	110,657
Total revenue	<u>794,670</u>	<u>358,670</u>
Cost of Goods Sold		
Product cost of goods sold (Note 15)	<u>351,253</u>	237,040
Gross Profit	443,417	121,630
Operating Expense		
Operations	152,404	415,971
Research and development activities	181,606	303,457
Marketing	79,835	167,885
General and administrative	368,027	593,917
	<u>781,872</u>	<u>1,481,230</u>
Loss before undernoted	338,455	1,359,600
Amortization of capital assets	54,098	52,643
Amortization of patents and technology rights	14,173	9,535
Amortization of deferred development costs	46,217	29,183
Interest income	(9,585)	(103,497)
Loss and comprehensive loss for the year	<u>\$ 443,358</u>	<u>\$ 1,347,464</u>
Basic and fully diluted loss per share (Note 9 (d))	<u>\$ (0.006)</u>	<u>\$ (0.018)</u>

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

Covalon Technologies Ltd.

Interim Consolidated Statements of Cash Flows

For the three months ended December 31, 2009 and 2008

(Unaudited)

	2009	2008
Cash flows from operating activities		
Loss and comprehensive loss for the period	\$ (443,358)	\$ (1,347,464)
Add (deduct) items not involving cash:		
Amortization of capital assets	54,098	52,643
Amortization of patent and technology rights	14,173	9,535
Amortization of deferred development costs	46,217	29,183
Stock compensation expense	112,423	245,249
Foreign exchange loss	771	10,224
Cash provided by operating activities before change in non-cash working capital balances	<u>(215,676)</u>	<u>(1,000,630)</u>
Change in non-cash working capital (Note 14)	<u>(421,419)</u>	<u>38,129</u>
	<u>(637,095)</u>	<u>(962,501)</u>
Cash flows from investing activities		
Purchase of capital assets	(5,365)	(304,064)
Expenditure on deferred development costs	(53,423)	(512,348)
Purchase of other assets	<u>(27,568)</u>	<u>(30,983)</u>
	<u>(86,356)</u>	<u>(847,395)</u>
Cash flows from financing activities		
Net proceeds on issuance of share capital	<u>116,338</u>	<u>21,375</u>
Foreign exchange loss on cash held	<u>(771)</u>	<u>(10,224)</u>
Net Change in cash and cash equivalents during the period	(607,884)	(1,798,745)
Cash and cash equivalents, beginning of period	<u>6,036,626</u>	<u>12,616,253</u>
Cash and cash equivalents, end of period	\$ 5,428,742	\$ 10,817,508
Represented by		
Cash	\$ 103,432	\$ 40,766
Cash equivalents	<u>5,325,310</u>	<u>10,776,742</u>
	<u>\$ 5,428,742</u>	<u>\$ 10,817,508</u>

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

Covalon Technologies Ltd.
Interim Consolidated Statements of Shareholders' Equity
(Unaudited)

For the three months ended December 31, 2009 and year ended September 30, 2009

	Share Capital		Contributed Surplus	Options	Deficit	Total
	Number of Shares	Amount				
Balance, September 30, 2008	74,303,915	\$ 29,151,710	\$ 329,004	\$ 1,601,091	\$ (16,066,708)	\$ 15,015,097
Issue of common shares to Perfusion Therapeutics Inc. Issued in escrow	75,000 (75,000)	21,375				21,375
Stock based compensation				779,558		779,558
Expired options			33,621	(33,621)		-
Net loss and comprehensive income					(4,874,809)	(4,874,809)
Balance, September 30, 2009	74,303,915	29,173,085	362,625	2,347,028	(20,941,517)	10,941,221
Issue of common shares for cash pursuant to the exercise of stock options	387,793	208,245		(91,908)		116,337
Stock based compensation				132,095		132,095
Forfeited Options				(19,672)		(19,672)
Expired options			256,742	(256,742)		-
Net loss and comprehensive income					(443,358)	(443,358)
Balance, December 31, 2009	74,691,708	\$ 29,381,330	\$ 619,367	\$ 2,110,801	\$ (21,384,875)	\$ 10,726,623

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

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

December 31, 2009 and September 30, 2009

Nature of Business	<p>The Company is incorporated under the laws of Ontario and is engaged in the business of developing, licensing and selling medical technologies. The Company has now received regulatory approval on numerous products and is currently generating revenue. The Company has adopted a business model that contracts the manufacturing and distribution of its commercialized products through partners. The Company generates its revenues through development contracts, licensing agreements and distribution contracts and sales. Commencing October 1, 2009, the Company has identified two reportable segments which are advanced collagen dressings and specialized medical device coatings.</p>
Going Concern	<p>Covalon is considered to be a going concern and as such, no provisions are made for the valuation of assets or the cost to discharge liabilities, other than in the normal course of operations. The Company has an accumulated deficit of \$21.4 million. The Company's ability to continue as a going concern will depend on management's ability to successfully execute its business plan and achieve profitable operations.</p>
Basis of Consolidation	<p>These consolidated financial statements include the accounts of the Company and its wholly owned subsidiary and have been prepared using the purchase method of consolidation. The assets and liabilities of the acquired companies are initially recorded at cost. The results of operations of the acquired companies are included from the dates of acquisition. All significant intercompany transactions and balances have been eliminated on consolidation.</p>
Use of Estimates	<p>The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from management's best estimate as additional information becomes available in the future.</p> <p>Significant estimates made by management include useful lives of long-lived assets, expected future cash flows used in evaluating long-lived assets for impairment and recoverability and annual volatility used in estimating the fair values of stock-based compensation. Management reviews its estimates periodically and any adjustment is reported in the year in which it becomes known.</p>

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

December 31, 2009 and September 30, 2009

Revenue Recognition	<p>Revenue is recognized on an accrual basis as follows:</p> <ul style="list-style-type: none">a) Revenue arising from product sales is recognized once the product has been shipped to the customer.b) Revenue arising from licensing fees and royalties is initially recorded as deferred revenue and recognized over the period of the relevant agreements.c) Revenue arising from development contracts is recognized once specific milestones are achieved.d) Revenue arising from interest is recognized as earned. <p>In all cases, revenue is recognized only when the amounts are fixed and determinable and when the Company can be reasonably assured of collection.</p>						
Cash and Cash Equivalents	<p>Cash and cash equivalents are defined as highly liquid investments and consist of cash and short-term interest bearing instruments that are cashable at any time without penalty.</p>						
Inventories	<p>Raw materials and supplies are stated at the lower of average cost and net realizable value. Work in process and finished goods are stated at the lower of average cost and net realizable value in accordance with Section 3031.</p>						
Capital Assets	<p>Capital assets are recorded at cost less related investment tax credits. Amortization is based on the estimated useful life of the asset and is calculated as follows:</p> <table><tr><td>Furniture and fixtures</td><td>- 20% diminishing balance basis</td></tr><tr><td>Lab equipment</td><td>- 20% diminishing balance basis</td></tr><tr><td>Leasehold improvements</td><td>- straight-line basis over 5 years</td></tr></table>	Furniture and fixtures	- 20% diminishing balance basis	Lab equipment	- 20% diminishing balance basis	Leasehold improvements	- straight-line basis over 5 years
Furniture and fixtures	- 20% diminishing balance basis						
Lab equipment	- 20% diminishing balance basis						
Leasehold improvements	- straight-line basis over 5 years						
Other Assets	<p>Other assets include expenditures related to obtaining patents and technology rights associated with the patents and are stated at cost less accumulated amortization. Amortization is being provided on a straight-line basis over the remaining life of the patent being 20 years less the number of years since application for the patent.</p>						
Deferred Development Costs / Research Development	<p>Development costs which meet generally accepted criteria, are deferred and amortized from the beginning of commercial production and sales. Deferred development costs for each technology platform are amortized when the product regulatory approval to sell related products is received, on a straight-line basis over the years remaining on the patent.</p> <p>Annually, the Company reviews the recoverability of deferred development costs through evaluation of the expected future cash inflows from commercialization of the associated products to determine if there is an impairment in the carrying value.</p>						

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

December 31, 2009 and September 30, 2009

Investment Tax Credits	Investment tax credits arising from qualifying research and experimental development costs are recorded as a reduction of deferred development costs or capital asset purchases in the period in which these tax credits are considered reasonably assured to be recovered.
Future Income Tax	The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in operations in the year in which the change occurs.
Foreign Currency Translation	<p>Foreign currency accounts are translated into Canadian dollars as follows:</p> <p>At the transaction date, each asset, liability, revenue and expense is translated into Canadian dollars by an estimate of the exchange rate in effect at that date. At the reporting date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate currently in effect. The resulting foreign exchange gains and losses are included in income in the current period. Included in General and Administrative costs are foreign exchange losses of \$14,952 (2008 - \$10,224)</p>
Financial Instruments	<p>The Company's cash and cash equivalents are classified as held for trading and measured at fair value. Short-term investments are classified as held for trading and measured at fair value. Subsequent changes in fair value are recorded to net income or loss. Accounts receivable are classified as loans and receivables and are initially measured at fair value; subsequently measured at their amortized cost using the effective interest rate method. Accounts payable and accrued liabilities are classified as other liabilities and are initially measured at fair value, subsequently measured at their amortized cost using the effective interest rate method. The fair values of the financial assets and liabilities that are included in the balance sheet approximate their fair value due to their short term nature.</p> <p>Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments. The Company is exposed to currency risk arising from fluctuations in foreign exchange rates and the degree of volatility in those rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.</p> <p>Short term investments consists of Ontario Savings Bonds (step up interest rates of .75%, 1.5%, 2.5%, 3.5% and 4.5% in each respective year, redeemable every 6 months and maturing on June 21, 2014) and the carrying value approximates fair market value.</p>

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

December 31, 2009 and September 30, 2009

Financial Instruments (cont'd)	All of the Company's cash is maintained by one of the major financial institutions.
Stock Based Compensation	<p>Direct awards of stock are based on the price of common stock measured at fair value at the date of grant and the corresponding expense is recognized in the statement of operations.</p> <p>The Company uses the fair value based method of accounting for all its stock-based compensation. Accordingly, the fair value method of accounting is applied for stock options granted to directors, officers, employees and consultants whereby the weighted average fair value of options granted is recognized in the financial statements over the vesting period. When the awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to options.</p>
Loss per Common Share	Loss per common share has been computed by dividing the loss applicable to common shareholders by the weighted average number of shares of common stock outstanding during the respective periods. Diluted loss per common share is computed using the weighted average number of common and potential common shares outstanding during the period. Potential common shares consist of the incremental common shares issuable upon the exercise of stock options and warrants under the treasury stock method.
Impairment of Long-Lived Assets	An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes the assets' carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the asset and its carrying value. There were no impairments during the three month period ended December 31, 2009, (2008 – Nil).

Covalon Technologies Ltd.

Notes to Unaudited Consolidated Financial Statements

December 31, 2009 and September 30, 2009

1. FINANCIAL RISK MANAGEMENT

Risk factors

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

Credit risk

The Company's cash and cash equivalents does not subject the Company to significant credit risk. The Company has guaranteed investment certificates and provincial bonds, as per its practice of protecting its capital rather than maximizing investment yield, of \$6 million invested with two issuers; however, this risk is mitigated as the issuers are a major Canadian bank and the Province of Ontario.

The Company, in the normal course of business, is exposed to credit risk from its global customers in the medical device industry. The accounts and other receivable are subject to normal industry risks in each geographic region in which the Company operates. The Company attempts to manage these risks by dealing with creditworthy customers; however, due to the limited number of potential customers in each market this is not always possible. As at December 31, 2009, four customers accounted for 95% (September 2009 – three customers for 83%) of the accounts receivable balance. These customers, who are distributors and partners of the Company, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers. The Company has not had a history of bad debts and as such management has not recorded a significant allowance.

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

	December 2009	September 2009
Current	\$546,683	\$215,679
31-60 days past due	62,782	91,121
Over 60 days past due	341,634	454,554
	\$951,099	\$761,354

Liquidity risk

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

Interest rate risk

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

Currency risk

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

Covalon Technologies Ltd.
Notes to Unaudited Consolidated Financial Statements
December 31, 2009 and September 30, 2009

1. FINANCIAL RISK MANAGEMENT (continued)

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

	December	September
	2009	2009
Accounts receivable	\$ 913,333	\$ 734,659
Accounts payable	172,080	127,018
Cash	35,259	58,112

Commodity risk

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

2. MANAGEMENT OF CAPITAL

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

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

The Company is not subject to any externally imposed capital requirements and the Company's overall strategy with respect to management of capital remains unchanged from the year ending September 30, 2009.

3. FUTURE ACCOUNTING PRONOUNCEMENTS

International financial reporting standards (IFRS)

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

Covalon Technologies Ltd.

Notes to Unaudited Consolidated Financial Statements

December 31, 2009 and September 30, 2009

4. INVENTORIES

Inventories consist of the following:

September 30	December 31, 2009	Audited September 30, 2009
Raw materials	\$ 274,552	\$ 210,142
Finished Goods	16,600	131,445
	\$ 291,152	\$ 341,587

Cost of goods sold includes \$255,578 in inventoried materials in 2009 (December 2008 - \$155,715).

5. CAPITAL ASSETS

	December 31, 2009		Audited September 30, 2009	
	Accumulated		Accumulated	
	Cost	Amortization	Cost	Amortization
Furniture and fixtures	\$ 426,539	\$ 150,975	\$ 425,051	\$ 136,863
Lab equipment	1,244,668	579,796	1,240,791	544,989
Leasehold improvements	71,416	71,416	71,416	66,237
	1,742,623	802,187	1,737,258	748,089
Cost less accumulated amortization		\$ 940,436		\$ 989,169

6. OTHER ASSETS

	December 31, 2009	Audited September 30, 2009
Patents and technology rights	\$ 913,515	\$ 929,328
Less: Accumulated amortization	244,866	236,567
	668,649	692,761
Less: Write down (net of \$Nil accumulated amortization; Sep 2009 - \$5,874)	-	37,507
	\$ 668,649	\$ 655,254

Covalon Technologies Ltd.

Notes to Unaudited Consolidated Financial Statements

December 31, 2009 and September 30, 2009

7. DEFERRED DEVELOPMENT COSTS

	December 31, 2009		Audited
		September 30, 2009	
Cost	\$ 4,025,236	\$ 3,971,813	
Less: accumulated amortization	<u>508,378</u>	<u>462,161</u>	
	\$ 3,516,858	\$ 3,509,652	

8. DEFERRED REVENUE

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

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

	December 31, 2009		Audited
		September 30, 2009	
Balance, beginning of year	\$ 1,159,573	\$ 1,527,251	
Add:			
Up front payment for technology transfer services	-	74,949	
Less:			
Amortization of license and supply agreements	<u>110,657</u>	<u>442,627</u>	
Balance, end of period	1,048,916	1,159,573	
Amount to be recognized within one year	<u>517,577</u>	<u>517,616</u>	
Long term balance	\$ 531,339	\$ 641,957	

Covalon Technologies Ltd.
Notes to Unaudited Consolidated Financial Statements

December 31, 2009 and September 30, 2009

9. SHARE CAPITAL

a) Authorized – Unlimited number of Common Shares

b) Issued – Common shares

In fiscal 2006, Covalon acquired technology from Perfusion Therapeutics Inc. for 1,100,000 fully paid non-assessable common shares of Covalon Technologies Ltd., issued in escrow to be released on various success milestones. At December 31, 2009, 150,000 (September 2009 – 150,000) shares valued at \$213,875 (September 2009 - \$213,875) have been released from trust. The remaining balance of 950,000 shares are still being held in trust.

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

During the period ended December 31, 2009, 387,793 options to purchase common shares with a value of \$91,908 were exercised for cash consideration of \$116,337.

At December 31, 2009, 2,246,202 (September 2009 – 3,369,302) shares are held in escrow.

c) Stock Option Plan

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

Covalon Technologies Ltd.
Notes to Unaudited Consolidated Financial Statements

December 31, 2009 and September 30, 2009

9. SHARE CAPITAL (continued)

	Number of Shares	Value	Exercise Price
Balance, September 30, 2008	3,688,175	\$ 1,601,091	\$ 1.14
Granted to related parties	250,000	72,807	\$ 0.71
Granted to consultants	1,300,000	237,985	\$ 0.45
Granted to employees	250,000	88,158	\$ 0.75
Vested to related parties		310,311	\$ 1.91
Vested to employees		133,281	\$ 2.17
Expired	(19,582)	(33,621)	
Forfeited	(197,920)	(62,984)	
Balance, September 30, 2009	5,270,673	2,347,028	\$ 0.91
Granted to employees	100,000	1,999	\$ 0.29
Vested to related parties		34,124	\$ 1.46
Vested to consultants		80,907	\$ 0.50
Vested to employees		15,065	\$ 0.96
Exercised	(387,793)	(91,908)	
Expired	(1,031,182)	(256,742)	
Forfeited	(66,668)	(19,672)	
Balance, December 31, 2009	3,885,030	\$ 2,110,801	\$ 1.04

Range of Exercise Prices	Number of Options Outstanding	Weighted Average Exercise Price \$	Weighted Average Remaining Contractual Life (years)
\$0.23 - \$0.50	1,677,948	0.39	2.31
\$0.56 - \$0.75	747,082	0.72	1.02
\$1.22 - \$1.53	975,000	1.53	1.35
\$1.54 - \$2.79	485,000	2.79	3.25
	3,885,030	\$ 1.04	1.75

Covalon Technologies Ltd.
Notes to Unaudited Consolidated Financial Statements

December 31, 2009 and September 30, 2009

9. SHARE CAPITAL (continued)

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

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

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

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

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

During the three month period ended December 31, 2009, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 2.42%, dividend rate NIL, volatility – 123% and a term of 5 years.

Total value of options granted to employees during the three month period ended December 31, 2009 was \$23,990 of which \$1,999 was recorded as vesting expense.

387,793 stock options with a value of \$91,908 were exercised for common shares a cash consideration of \$116,337 during the three month period ended December 31, 2009.

During the three month period ended December 31, 2009, 1,031,182 options valued at \$256,724 expired and 66,668 options with an expiry date of October 15, 2013 and related vesting expense of \$19,672 were forfeited.

As at December 31, 2009, 2,699,577 (December 2008 – 3,254,415) options with a weighted average exercise price of \$1.14 were available for exercise.

Covalon Technologies Ltd.
Notes to Unaudited Consolidated Financial Statements

December 31, 2009 and September 30, 2009

9. SHARE CAPITAL (continued)

(d) Loss per Share

Loss per share is calculated using the weighted average number of common shares outstanding during the three month period ended December 31, 2009, which is 74,337,636 (2008 – 73,228,915) shares. As the Company experienced losses for the periods ended December 31, 2009 and 2008, all potential common shares outstanding from dilutive securities are considered anti-dilutive and are excluded from the calculation of loss per share for those years.

Details of anti-dilutive potential securities outstanding not included in diluted EPS calculations at December 31, 2009 and 2008 are as follows:

Anti-dilutive potential securities	2009	2008
Common shares potentially assumable:		
- under stock options	<u>3,885,030</u>	4,121,925

10. RELATED PARTY TRANSACTIONS

a. During the three month period, the Company paid fees to related parties as follows:

- (i) Management fees totaling \$117,762 (2008 – \$192,346) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at \$17,762 (2008 – \$96,010).
 - (ii) Directors fees include cash compensation of \$23,500 (2008 - \$35,848) paid to certain of the independent directors and stock option benefits that have been valued at \$16,362 (2008 – \$54,453).
- b. The management fees are paid pursuant to two separate management agreements, expiring August 31, 2010. The commitments for the 2010 fiscal year are \$400,000.

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

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11. COMMITMENTS

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

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

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

2011	\$	86,443
2012		90,988
2013		95,965
2014		91,627
	\$	<u>365,023</u>

12. CONTINGENCIES

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

13. SUPPLEMENTAL CASH FLOW INFORMATION

For the three months ending December 31, 2009 2008

Non-Cash Financing and Investing

Issuance of shares for technology rights \$ - \$ 21,375

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14. CHANGE IN NON-CASH OPERATING WORKING CAPITAL ITEMS

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

For the three months ended December 31,	2009	2008
Accounts receivable	\$ (189,745)	\$ (54,952)
Inventory	50,435	(104,170)
Prepaid expenses	(15,521)	(31,963)
Accounts payable and accrued liabilities	(155,931)	339,871
Deferred revenue	(110,657)	(110,657)
	<u>\$ (421,419)</u>	<u>\$ 38,129</u>

15. SEGMENTED INFORMATION

Starting October 1, 2009, the Company has identified two reportable product segments, Advanced Collagen Dressings and Specialized Medical Device Coatings. Product segments have been identified based on the underlying technology of the product. Assets and other operating expenses are not allocated by reportable segment for internal reporting purposes and therefore have not been presented.

Information on product segments is as follows:

For the three months ended December 31, 2009

	Advanced Collagen Dressings \$	Specialized Medical Device Coatings \$	Total \$
Sales	244,394	439,619	684,013
Licensing Fee	110,657	-	110,657
	<u>355,051</u>	<u>439,619</u>	<u>794,670</u>
Cost of goods sold	<u>183,991</u>	<u>167,262</u>	<u>351,253</u>
Segment earnings before the following	171,060	272,357	443,417
Operations			152,404
Research and development activities			181,606
Marketing			79,835
General and administrative			368,027
Amortization of capital assets			54,098
Amortization of patents and technology rights			14,173
Amortization of deferred development costs			46,217
Interest income			(9,585)
Net loss for the period			<u>(443,358)</u>

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15. SEGMENTED INFORMATION (continued)

During 2009, management did not regularly review segmented information as there was no discrete information available for product segments.

All of the Company's sales are generated in US Dollars from customers in the United States. All of the Company's assets are located in Canada.

16. COMPARATIVE FIGURES

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