

Covalon Technologies Ltd.

Consolidated Financial Statements

For the years ended

September 30, 2010 and 2009

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Auditors' Report

To the Shareholders of Covalon Technologies Ltd.

We have audited the consolidated balance sheets of Covalon Technologies Ltd. as at September 30, 2010 and 2009 and the consolidated statements of operations and comprehensive loss, cash flows and shareholders' equity for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) " *BDO Canada LLP* "

Chartered Accountants, Licensed Public Accountants

Toronto, Ontario
January 27, 2011

Covalon Technologies Ltd.

Consolidated Balance Sheets

September 30	2010	2009
Assets		
Current assets		
Cash and cash equivalents	\$ 5,838,578	\$ 6,036,626
Short term investments	500,000	500,000
Accounts receivable, net (Note 1)	422,729	761,354
Inventories (Note 5)	234,667	341,587
Prepaid expenses	31,523	73,516
Total Current Assets	7,027,497	7,713,083
Capital assets (Note 6)	808,201	989,169
Other assets (Note 7)	697,056	655,254
Deferred developments costs (Note 8)	1,787,038	3,509,652
Total Assets	\$ 10,319,792	\$ 12,867,158

Liabilities and Shareholders' Equity

Current		
Accounts payable and accrued liabilities	\$ 1,164,433	\$ 766,364
Deferred revenue (Note 9)	645,533	517,616
Total Current Liabilities	1,809,966	1,283,980
Deferred revenue (Note 9)	939,515	641,957
Total Liabilities	2,749,481	1,925,937
Shareholders' Equity		
Share capital (Note 10 (b))	29,455,316	29,173,085
Contributed surplus	1,771,496	362,625
Options (Note 10 (c))	1,219,963	2,347,028
Deficit	(24,876,464)	(20,941,517)
Total Shareholders' Equity	7,570,311	10,941,221
Total Liabilities and Shareholders' Equity	\$ 10,319,792	\$ 12,867,158

On behalf of the Board

(signed) "Martin C. Bernholtz" _____ Director

(signed) "Brian Pedlar" _____ Director

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

Covalon Technologies Ltd.

Consolidated Statements of Operations and Comprehensive Loss

For the years ended September 30,	2010	2009
Revenue		
Product and Services		
Advanced wound care	\$ 1,378,094	\$ 804,352
Specialized medical device coatings	1,323,747	845,547
Licensing fee	529,226	442,627
Total revenue	<u>3,231,067</u>	<u>2,092,526</u>
Cost of Sales	<u>1,854,582</u>	<u>1,191,841</u>
Gross Profit	<u>1,376,485</u>	<u>900,685</u>
Operating Expenses		
Operations	495,426	1,442,707
Research and development activities	734,952	977,792
Recovery of refundable investment tax credit (Note 4)	(430,161)	-
Marketing	376,726	558,021
Amortization and depreciation	445,759	394,044
General and administrative	1,797,606	2,625,384
	<u>3,420,308</u>	<u>5,997,948</u>
Loss before undernoted	<u>(2,043,823)</u>	<u>(5,097,263)</u>
Loss on disposal of capital asset	1,910	(66,962)
Write-down of patent	-	37,507
Write-down of deferred development costs (Note 8)	1,700,350	-
Settlement Pay	242,178	-
Interest income	(53,314)	(192,999)
Net loss and comprehensive loss for the year	<u>\$ (3,934,947)</u>	<u>\$ (4,874,809)</u>
Basic and diluted loss per share (Note 10 (d))	<u>\$ (0.05)</u>	<u>\$ (0.07)</u>

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

Covalon Technologies Ltd.

Consolidated Statements of Cash Flows

For the years ended September 30,	2010	2009
Cash flows from operating activities		
Net loss for the year	\$ (3,934,947)	\$ (4,874,809)
Add (deduct) items not involving cash:		
Amortization of capital assets	204,647	223,394
Amortization of patent and technology rights	56,244	53,937
Amortization of deferred development costs	184,868	116,713
Write-down of patents	-	37,507
Write-down of deferred development costs (Note 8)	1,700,350	-
Loss (gain) on disposal of capital assets	1,910	(66,962)
Stock compensation expense	407,700	779,558
Foreign exchange loss on cash held	9,945	5,948
Cash provided by operating activities before change in non-cash working capital balances	(1,369,283)	(3,724,714)
Change in non-cash working capital (Note 16)	1,311,082	(943,496)
	(58,201)	(4,668,210)
Cash flows from investing activities		
Purchase of capital assets	(25,589)	(686,212)
Proceeds on disposal of capital assets	-	385,347
Expenditure on deferred development costs	(162,604)	(1,050,329)
Purchase of other assets	(98,046)	(54,275)
Redemption of short-term investments	-	8,582,699
	(286,239)	7,177,230
Cash flows from financing activities		
Net proceeds on issuance of share capital (Note 10(b))	156,337	-
Foreign exchange loss on cash held	(9,945)	(5,948)
Net Change in cash and cash equivalents during the year	(198,048)	2,503,072
Cash and cash equivalents, beginning of year	6,036,626	3,533,554
Cash and cash equivalents, end of year	\$ 5,838,578	\$ 6,036,626
Represented by		
Cash	\$ 947,331	\$ 79,140
Cash equivalents	4,891,247	5,957,486
	\$ 5,838,578	\$ 6,036,626

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

Covalon Technologies Ltd.
Consolidated Statements of Shareholders' Equity

For the years ended September 30, 2010 and 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 trust	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 loss					(4,874,809)	(4,874,809)
Balance, September 30, 2009	74,303,915	29,173,085	362,625	2,347,028	(20,941,517)	10,941,221
Issue of common shares for cash pursuant to the exercise of stock options	587,793	282,231		(125,894)		156,337
Stock based compensation				407,700		407,700
Expired options			1,408,871	(1,408,871)		-
Net loss and comprehensive loss					(3,934,947)	(3,934,947)
Balance, September 30, 2010	74,891,708	\$ 29,455,316	\$ 1,771,496	\$ 1,219,963	\$ (24,876,464)	\$ 7,570,311

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

Covalon Technologies Ltd. Summary of Significant Accounting Policies

September 30, 2010 and 2009

Nature of Business

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 disclosed two product segments which are advanced wound care and specialized medical device coatings.

Going Concern

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 \$24.9 million. The Company's ability to continue as a going concern will depend on management's ability to successfully execute its business plan and achieve profitable operations.

Basis of Consolidation

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.

Use of 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.

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.

Covalon Technologies Ltd. Summary of Significant Accounting Policies

September 30, 2010 and 2009

Revenue Recognition

Revenue is recognized on an accrual basis as follows:

- 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.

In all cases, revenue is recognized only when the amounts are fixed and determinable and when the Company can be reasonably assured of collection.

Cash and Cash Equivalents

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.

Inventories

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 CICA Section 3031.

Capital Assets

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:

Furniture and fixtures	- 20% diminishing balance basis
Lab equipment	- 20% diminishing balance basis
Leasehold improvements	- straight-line basis over 5 years

Other Assets

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.

Deferred Development Costs /Research Development

Development costs which meet generally accepted criteria are deferred and amortized from the beginning of commercial production and sales. Deferred development costs for each technology platform are amortized when the product regulatory approval to sell related products is received, on a straight-line basis over the years remaining on the patent.

Annually, the Company reviews the recoverability of deferred development costs through evaluation of the expected future cash inflows from commercialization of the associated products to determine if there is an impairment in the carrying value

Covalon Technologies Ltd. Summary of Significant Accounting Policies

September 30, 2010 and 2009

Investment Tax Credits Investment tax credits arising from qualifying research and experimental development costs are recorded 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 Foreign currency accounts are translated into Canadian dollars as follows:

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 \$44,716 (2009 - \$110,420)

Financial Instruments 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.

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

Short term investments consists of Ontario Savings Bonds (step up interest rates of 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.

Covalon Technologies Ltd. Summary of Significant Accounting Policies

September 30, 2010 and 2009

Financial Instruments (cont'd) All of the Company's cash is maintained by one of the major financial institutions.

Stock-based Compensation Direct awards of stock are based on the price of common stock measured at fair value at the date of grant and the corresponding expense is recognized in the statement of operations.

The Company uses the fair value based method of accounting for all its stock-based compensation. Accordingly, the fair value method of accounting is applied for stock options granted to directors, officers, employees and consultants whereby the weighted average fair value of options granted is recognized in the financial statements over the vesting period. When the awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to options. The forfeiture rate for stock based compensation is estimated at the date of grant and revised as necessary until the award has vested.

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 years. Diluted loss per common share is computed using the weighted average number of common and potential common shares outstanding during the year. Potential common shares consist of the incremental common shares issuable upon the exercise of stock options and warrants under the treasury stock method.

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. In the year ended September 30, 2010, \$1,700,350 relating to deferred development costs was written off in impairment charges (2009 – \$37,507 relating to patents).

Changes in Accounting Policies In January 2009, the CICA issued EIC 173, *Credit and the Fair Value of Financial Assets and Liabilities*, that requires entities to take both counterparty credit risk and their own credit risk into account when measuring the fair value of financial assets and liabilities, including derivatives. EIC 173 came into effect for interim and annual periods beginning on or after January 1, 2009. Upon adoption, there was no impact on the Company's consolidated financial statements.

In May 2009, the CICA amended Section 3862, *Financial Instruments – Disclosure*, to improve disclosure requirements on fair value measurement for financial instruments and liquidity risk. The amendments are effective for the Company's September 30, 2010 annual financial statements and are included in note 1 on these statements.

Covalon Technologies Ltd.

Notes to Consolidated Financial Statements

September 30, 2010 and 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 and short-term investments do 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 \$5.4 million invested with two issuers; however, this risk is mitigated as the issuers are a major Canadian bank and the Province of Ontario.

The Company, in the normal course of business, is exposed to credit risk from its global customers in the medical device industry. The accounts and other receivable are subject to normal industry risks in each geographic region in which the Company operates. The Company attempts to manage these risks by dealing with creditworthy customers; however, due to the limited number of potential customers in each market this is not always possible. As at September 30, 2010, three customers accounted for 91% (September 2009 – three customers for 83%) of the accounts receivable balance. These customers, who are distributors and strategic partners of the Company, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers. The Company has recorded an allowance for bad debts in the amount of \$117,000 (2009 – nil).

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

	2010	2009
Current	\$ 267,933	\$ 215,679
31-60 days past due	57,188	91,121
Over 60 days past due (net of \$117,000) allowance for doubtful accounts, Sep 2009 - \$Nil)	97,608	454,554
	<u>\$ 422,729</u>	<u>\$ 761,354</u>

Liquidity risk

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

Interest rate risk

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

Currency risk

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

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2010 and 2009

1. FINANCIAL RISK MANAGEMENT (continued)

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

	<u>2010</u>	<u>2009</u>
Accounts receivable, net	\$ 355,860	\$ 734,659
Accounts payable	331,462	127,018
Cash	902,511	58,112
Exchange rate (\$USD / \$CAD)	1.0290	1.0707

An increase of 5% and 10% in the US dollar exchange rate would result in a decrease of the net loss by approximately \$64,000 and \$129,000 respectively.

Fair Value

The Company categorizes its financial assets and liabilities measured at the fair value into one of three different levels depending on the observation of the inputs used in the measurement. As at September 30, 2010 the Company's financial instruments are cash and cash equivalents and short-term investments for an amount of \$6,338,578 (2009 - \$6,536,626) which are considered to be Level 1 investments. There were no transfers between levels during the year.

The three levels are defined as follows:

- Level 1: Fair value is based on unadjusted quoted prices for identical assets or liabilities in active markets.
- Level 2: Fair value is based on inputs other than quoted prices included within Level 1 that are not observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3: Fair value is based on valuation techniques that require one or more significant unobservable inputs.

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. There is commodity risk for all 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, options, 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 capital at September 30, 2010 is \$7,570,311 (2009 - \$10,941,221)

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.

There were no changes to the definition or the management of capital during the year.

Covalon Technologies Ltd. Notes to Consolidated Financial Statements

September 30, 2010 and 2009

2. MANAGEMENT OF CAPITAL (continued)

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

In January 2009, the CICA issued Handbook Section 1582, *Business Combinations*, Section 1601, *Consolidated Financial Statements*, and Section 1602, *Non-controlling Interests*, which together replace Section 1600, Consolidated Financial Statements. Section 1582 establishes standards for the accounting for business combinations. It is equivalent to the business combinations accounting standard under IFRS. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in financial statements subsequent to a business combination. The sections apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011 with earlier application permitted.

Amendments have been issued to CICA Section 1625 and CICA Section 3251 to remove guidance no longer applicable and to make these standards consistent with Sections 1582, 1601, 1602 and 1625.

In December 2009, the CICA issued EIC 175, *Multiple Deliverable Revenue Arrangements*, which replaced EIC 142, *Revenue Arrangements with Multiple Deliverables*. The amendments were made to: a) provide updated guidance on whether multiple deliverables exist, how the deliverables should be separated and the consideration allocated; b) require, in situations where a vendor does not have vendor-specific objective evidence or third-party evidence of selling price, that the entity allocate revenue in an arrangement using estimated selling prices of deliverables; c) eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method; and d) require expanded qualitative and quantitative disclosures regarding significant judgments made in applying this guidance.

The accounting changes summarized in EIC 175 are effective for fiscal years beginning on or after January 1, 2011 with early adoption permitted. Adoption may either be on a prospective basis or by retrospective application, if the abstract is adopted early, in a reporting period that is not the first reporting period in the entity's fiscal year, it must be applied retroactively from the beginning of the Company's fiscal period of adoption. The Company did not early adopt this change.

Section 1506, *Accounting Changes* allows for voluntary changes in accounting policy only when they result in the financial statements providing reliable and more relevant information. In addition, Section 1506: requires changes in accounting policy to be applied retrospectively unless doing so is impracticable; requires prior period errors to be corrected retrospectively; and calls for enhanced disclosures about the effects of changes in accounting policies, estimates and errors on the financial statements.

The Company is currently assessing the future impact of these amendments on its consolidated financial statements and has not yet determined the timing and the method of their adoption.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2010 and 2009

3. FUTURE ACCOUNTING PRONOUNCEMENTS (continued)

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.

The Company is currently evaluating various accounting policy choices under IFRS and cannot quantify the impact of IFRS on its financial statements at this time.

4. REFUNDABLE INVESTMENT TAX CREDITS

The Company is eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% refundable in cash to the Company. The refundable tax credits received by the Company are subject to review by Canada Revenue Agency and the Ontario Ministry of Finance. During the year ended September 30, 2010, the Company received payments totaling \$430,161 for the fiscal years ended 2005, 2006, 2007 and 2008.

5. INVENTORIES

Inventories consist of the following:

	2010		2009
Raw materials	\$ 135,237	\$	210,142
Finished Goods	99,430		131,445
	\$ 234,667	\$	341,587

Product expenses include \$1,455,350 in inventoried materials in 2010 (2009 - \$894,414).

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2010 and 2009

6. CAPITAL ASSETS

	2010		2009	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 423,591	\$ 193,647	\$ 425,051	\$ 136,863
Lab equipment	1,264,892	686,635	1,240,791	544,989
Leasehold improvements	71,416	71,416	71,416	66,237
	1,759,899	951,698	1,737,258	748,089
Cost less accumulated amortization		\$ 808,201		\$ 989,169

7. OTHER ASSETS

	2010	2009
Patents and technology rights	\$ 983,994	\$ 929,328
Less: Accumulated amortization	286,938	236,567
	697,056	692,761
Less: Write down (net of \$Nil accumulated amortization; Sep 2009 - \$5,874)	-	37,507
	\$ 697,056	\$ 655,254

8. DEFERRED DEVELOPMENT COSTS

	2010	2009
Cost	\$ 4,134,415	\$ 3,971,813
Less: accumulated amortization	647,027	462,161
	3,487,388	3,509,652
Less: Write-down (net of \$Nil accumulated amortization; September 2009 - \$Nil)	1,700,350	-
	\$ 1,787,038	\$ 3,509,652

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

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8. DEFERRED DEVELOPMENT COSTS (continued)

During the second quarter of the current fiscal year, the Company received preliminary results on its pre-clinical cardiovascular cell therapy study program (EPAS1) that were not in line with its expectations. Management and the Board of Directors have determined that the Company is not able to invest the significant financial resources required to commercialize the product from the current research. Accordingly, in the second quarter of the current fiscal year, the Company recorded an impairment charge of \$1,700,350 against the related deferred development asset.

The related patents in the amount of \$238,493 net have not been written down because the Company continues to believe that the patents still have value.

9. DEFERRED REVENUE

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

During the year ended September 30, 2009, the Company recorded an up front technology transfer services fee as deferred revenue of Cdn. \$74,949. During the year ended September 30, 2010, the entire amount was recognized as revenue.

The Company received upfront licensing fees totaling Cdn. \$1,029,650 during the year ending September 30, 2010.

For the years ended September 30,	2010	2009
Balance, beginning of period	\$ 1,159,573	\$ 1,527,251
Add:		
Up front payments	1,029,650	74,949
Less:		
Technology transfer fee recognized	(74,949)	-
Amortization of license and supply agreements	(529,226)	(442,627)
Balance, end of period	1,585,048	1,159,573
Amount to be recognized within one year	(645,533)	(517,616)
Long term balance	\$ 939,515	\$ 641,957

Covalon Technologies Ltd. Notes to Consolidated Financial Statements

September 30, 2010 and 2009

10. SHARE CAPITAL

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

b) **Issued** – Common shares

In fiscal 2006, Covalon acquired technology from Perfusion Therapeutics Inc. for 1,100,000 fully paid non-assessable common shares of Covalon Technologies Ltd., issued in escrow to be released on various success milestones. At September 30, 2010, 150,000 (2009 – 150,000) shares valued at \$213,875 (2009 - \$213,875) have been released from trust. The remaining balance of 950,000 shares are still being held in trust.

In fiscal 2010, 587,793 (2009 – nil) options to purchase common shares with a value of \$125,894 were exercised for cash consideration of \$156,337.

At September 30, 2010, 1,123,101 (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:

	Number of Shares	Value	Weighted Average 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 related parties	1,055,000	198,712	\$ 0.29
Granted to employees	2,380,000	64,611	\$ 0.20
Vested to related parties		48,445	\$ 2.05
Vested to consultants		180,799	\$ 0.50
Vested to employees		26,257	\$ 1.62
Exercised	(587,793)	(125,894)	
Expired	(3,019,948)	(1,408,871)	
Forfeited	(162,932)	(111,124)	
Balance, September 30, 2010	4,935,000	\$ 1,219,963	\$ 0.45

Covalon Technologies Ltd.
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10. SHARE CAPITAL (continued)

Range of Exercise Prices	Number of Options Outstanding	Weighted Average Exercise Price \$	Weighted Average Remaining Contractual Life (years)
\$0.20 - \$0.50	4,435,000	0.28	4.47
\$0.56 - \$0.75	200,000	0.75	1.54
\$1.54 - \$2.79	300,000	2.79	2.50
	<u>4,935,000</u>	<u>0.45</u>	<u>4.20</u>

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.

During the year ended September 30, 2010, 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 – 2.12%, dividend rate NIL, average volatility – 128% and an average term of 4.75 years. The estimated forfeiture rate was revised during the year from 0% to 6%. This change has been accounted for as a change in estimate and thus a reduction of approximately \$64,000 to stock compensation expense was recorded in the year.

Total value of 2,380,000 options granted to employees during the year ended September 30, 2010 was \$411,362 of which \$64,611 was recorded as vesting expense.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

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10. SHARE CAPITAL (continued)

Total value of 1,055,000 options granted to related parties during the year ended September 30, 2010 was \$256,708 of which \$198,712 was recorded as vesting expense.

587,793 stock options with a value of \$125,894 were exercised for common shares a cash consideration of \$156,337 during the year ended September 30, 2010.

During the year ended September 30, 2010, 3,019,948 options valued at \$1,408,871 expired and 162,932 options with expiry dates of October 15, 2013, March 31, 2013 and March 4, 2014 and related vesting expense of \$111,124 were forfeited.

As at September 30, 2010, 1,941,209 (Sep 2009 – 3,550,640) options with a weighted average exercise price of \$0.71 (2009 - \$0.93) were available for exercise.

(d) Loss per Share

Loss per share is calculated using the weighted average number of common shares outstanding during the year ended September 30, 2010, which is 74,607,942 (2009 – 74,303,915) shares. As the Company experienced losses for the years ended September 30, 2010 and 2009, 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 are as follows:

Anti-dilutive potential securities	2010	2009
Common shares potentially assumable:		
- under stock options	4,935,000	5,270,673

11. RELATED PARTY TRANSACTIONS

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

(i) Management fees totaling \$377,346 (2009 – \$595,307) to two corporations controlled by officers and directors, included in management fees is a net reversal of stock option benefits of \$17,750 resulting from the forfeiture of 33,336 options (2009 – \$200,307).

(ii) Directors fees include cash compensation of \$23,500 (2009 - \$136,000) paid to certain of the independent directors and stock option benefits that have vested during the year amounted to \$186,831 (2009 – \$168,543).

b. The management fees are paid pursuant to a single management agreement, expiring August 31, 2011. The commitment for the 2011 fiscal year is \$175,000.

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

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12. COMMITMENTS

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

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

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

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

13. CONTINGENCIES

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

14. INCOME TAXES

(a) Reconciliation between statutory rate and actual rate

	<u>2010</u>	<u>2009</u>
Income tax recovery computed at statutory combined basis rate of 32% (2009 - 33%)	\$ (1,259,200)	\$ (1,608,700)
Permanent differences	132,600	262,300
Expiring losses	270,100	290,500
Change in future tax rates	228,400	683,200
Prior year adjustment for R & D claim	(314,100)	29,600
Other	86,100	(94,000)
Valuation allowance	856,100	437,100
	<u>\$ -</u>	<u>\$ -</u>

Covalon Technologies Ltd.
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14. INCOME TAXES (continued)

(b) Future tax assets

The tax effect of the temporary differences that gives rise to future tax assets (liabilities) as of September 30, 2010 and 2009 is presented below. No benefit has been recorded in these financial statements as there is no assurance that the Company will generate taxable income to utilize these differences.

	2010	2009
Non-capital loss carry forwards	\$ 2,944,100	\$ 3,070,600
Capital loss carry forwards	120,400	127,800
Capital and other assets	287,200	221,500
Deferred development costs	1,050,500	265,200
Deferred revenue and other liabilities	442,900	289,900
Valuation allowance	(4,845,100)	(3,975,000)
	\$ -	\$ -

(c) The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2010 of approximately \$11,772,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

Year	Amount
2014	787,000
2015	1,996,000
2026	1,494,000
2028	2,132,000
2029	4,083,000
2030	1,280,000
	\$ 11,772,000

(d) The Company has capital losses carry forward for income tax purposes as at September 30, 2010 of approximately \$962,833 (2009 - \$955,503) which are available to reduce taxable capital gains in future years. These losses do not expire.

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

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

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14. INCOME TAXES (continued)

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

Under the Income Tax Act of Canada, certain expenditures are classified as SR&ED expenditures and for tax purposes are grouped into a pool, which is 100% deductible in the year incurred. This SR&ED expenditure pool can also be carried forward indefinitely and deducted in full in any subsequent year. The balance of the SR&ED expenditure pool at September 30, 2010 is \$4,776,209 (2009 - \$3,519,980).

At September 30, 2010, the Company has \$511,296 (2009 - \$513,306) of unclaimed investment tax credits available to reduce federal income taxes payable in future years. If not utilized, these investment tax credits will start expiring in 2013.

15. SUPPLEMENTAL CASH FLOW INFORMATION

<u>For the years ending September 30,</u>	<u>2010</u>	<u>2009</u>
Non-Cash Financing and Investing		
Issuance of shares for technology rights	\$ -	\$ 21,375

16. CHANGE IN NON-CASH OPERATING WORKING CAPITAL ITEMS

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

<u>For the years ended September 30,</u>	<u>2010</u>	<u>2009</u>
Accounts receivable, net	\$ 338,625	\$ (521,732)
Inventory	106,920	(63,330)
Prepaid expenses	41,993	(6,981)
Accounts payable and accrued liabilities	398,069	16,228
Deferred revenue	425,475	(367,681)
	<u>\$ 1,311,082</u>	<u>\$ (943,496)</u>

Covalon Technologies Ltd. Notes to Consolidated Financial Statements

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17. SEGMENTED INFORMATION

Starting October 1, 2009, the Company has disclosed two product segments, Advanced Wound Care 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 segment for internal reporting purposes and therefore have not been presented.

Information on product segments is as follows:

For the year ended September 30, 2010	Advanced Wound Care \$	Specialized Medical Device Coatings \$	Total \$
Product and Services	1,378,094	1,323,747	2,701,841
Licensing Fee	439,602	89,624	529,226
	<u>1,817,696</u>	<u>1,413,371</u>	<u>3,231,067</u>
Segment earnings before the following	788,614	587,871	1,376,485
Operations			495,426
Research and development activities			734,952
Recovery of refundable investment tax credit			(430,161)
Marketing			376,726
General and administrative			1,797,606
Amortization and depreciation			445,759
Loss on disposal of capital asset			1,910
Write-down of deferred development cost			1,700,350
Settlement pay			242,178
Interest income			(53,314)
Net loss for the year			<u><u>(3,934,947)</u></u>

During 2009, management did not regularly review segmented information as there was no discrete information available for product segments. Product sales and coating services in 2009 includes sales from advanced wound care of \$804,352 and specialized medical device coatings of \$845,547.

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.

18. COMPARATIVE FIGURES

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