

Covalon Technologies Ltd.

Management's Discussion and Analysis of Financial
Condition and Results of Operations

September 30, 2010

MANAGEMENT'S DISCUSSION & ANALYSIS

For the year ended September 30, 2010

January 28, 2011

The following discussion of Covalon Technologies Ltd.'s ("Covalon" or the "Company") financial condition and results of operations should be read in conjunction with our audited consolidated financial statements for the year ended September 30, 2010. We have prepared these financial statements according to Canadian generally accepted accounting principles ("GAAP").

Management's Responsibility for Financial Reporting

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

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

Non-GAAP Measures

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

Additional Information

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

Forward-looking Statements

This MD&A contains forward-looking statements, which reflect the Company's current expectations regarding future events. The forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect", "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in the industry; others are more specific to the Company. Investors should consult the "Risks & Uncertainties" section of this MD&A as well as the Company's ongoing quarterly filings for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. Management assumes no obligation to update or alter any forward-looking statements whether as a result of new information, further events or otherwise.

Company Overview

Nature of Our Business

Covalon Technologies Ltd. is a unique public medical technologies company that researches, patents, develops and commercializes advanced medical technologies that improve patient outcomes and save lives. Our offices and laboratories are located in Mississauga, Ontario, Canada.

The medical device market in which Covalon is engaged offers tremendous opportunities. Any medical product or wound dressing in contact with the human body has the potential to facilitate an infection or cause other life-threatening complications that can place patients at risk and incur additional hospitalization days and expensive treatment regimes. These issues have forced medical companies to seek advanced technologies, such as those offered by Covalon, which typically command more advantageous reimbursement rates and offer product differentiation.

Covalon has a broad footprint of proprietary technologies, intellectual property, and patents related to:

- Infection Control & Drug Delivery:
 - Covalon is known for novel photo-stable silver ion antimicrobial technology, which is used in both wound dressings and coatings for medical devices;
 - Covalon has experience with the delivery of number of therapeutics and biologics which is applied in both wound dressings and coatings for medical devices to make them therapeutically active;
 - Innovations for potential over-the-counter offerings, antimicrobial consumer products and veterinary applications.
- Advanced Wound Care:
 - Sophisticated tissue repair products for advanced wound care dressings, trauma, and surgical applications;
 - Unique transparent film dressings with antimicrobials embedded in the silicone adhesive;
 - Stem cell technology focused on genetic regeneration of damaged tissue;
- Medical Coatings:
 - Superior medical coatings with customized physical properties, drug delivery capabilities and infection control applications;

Covalon licenses its technologies and products to some of the largest medical device companies in the world. Covalon also works with niche start-ups to create novel technology to advance their product offerings in the medical device markets. Covalon has worked with over twenty medical companies and our clients include C.R. Bard, Inc. a leader in vascular access devices; Medline Industries, Inc., a leading device and patient care distributor; Smith and Nephew Inc., a leader in wound care products; CareFusion Corporation, a leading specialty medical device manufacturer; Amsino International, Inc., a major contract manufacturer.

These and other major medical companies are likely to be impressed with Covalon because of our:

- Knowledgeable team of medical researchers, scientists and engineers;
- Broad footprint of technologies and associated patents and applications;
- Rapid customization of technologies for specific applications with accelerated time-to-market;

- Flexibility in structuring licensing and technology transfer arrangements;
- Ability to perform low-volume commercial manufacturing or have its high quality products contract-manufactured in high volumes and low cost, if so desired by the client;
- Relatively strong balance sheet.

Once a company partners with Covalon, there is a strong likelihood they will continue to work with us for other new product opportunities and contract renewals.

Clients value our collaborative approach in delivering innovative proprietary technologies. Key stakeholders in each company; from R&D, business development, and finance, to regulatory, sales and marketing work with Covalon's experts on everything from brainstorming on a potential offering, up to turnkey product development and technology transfer. Companies leverage our in-depth knowledge and commercialization success to assist in establishing product specifications, testing of efficacy, microbiology and file preparation for market approvals. Where appropriate, we design a client's product to meet the requirements of the most beneficial billing codes.

We leverage our in-house manufacturing facility to perfect commercialization processes and to manufacture client products in smaller commercial volumes. The relationships that Covalon has with contract manufacturing organizations ("CMO") provide us or our clients with additional resources, flexibility, and expertise for large-scale production, without the burden of substantial committed facilities. As an ISO 13485 quality-systems company, Covalon ensures all technology developments conform to quality guidelines and all transfers of technology are easily integrated into a partner company's processes.

Business Model

Currently, we do not sell our technologies directly to end-users such as hospitals, clinics, and physicians. Instead, medical companies and distributors license our technologies for incorporating into their own product offerings, which they sell to healthcare providers. Referred to by the industry as an OEM sales model (original equipment manufacturer), this approach assigns the major cost of selling to our customers, who are able to penetrate the market with a large sales force in geographical locations where Covalon does not have staff or offices. Our revenue streams are typically generated from services, technology licensing fees, and royalties from the sale or commercialization of products.

Most OEM sales models involve a long sales cycle – from initial discussion, product evaluation, regulatory filings, contract negotiation and then to market roll-out. This process generally takes twelve to eighteen months – although there are exceptions for both shorter and longer times for the completion of a project. On the other hand, once a company invests time and money in choosing our technology, it is likely to use it for some time to come.

We are confident that as we succeed in signing further new contracts with major medical companies and distributors, Covalon will become a self-sustaining medical research and development company that will continue to discover new and exciting technologies that improve patient outcomes and save lives.

Our Technologies

Covalon's accomplished team of scientists individually are recognized in the medical industry as experts in Customized medical device coatings; Antimicrobial and infection control technologies; Accelerated tissue healing and regenerative technologies; Advanced drug delivery technologies; and many other areas.

Covalon's staff compliment is largely comprised of scientists and engineers. Over eighty-five percent hold an advanced academic degree in chemistry, biology or physics and the Company's engineers have decades of collective experience in commercializing innovative technologies.

Together, our technology platforms, wound care products, and consulting services deliver a suite of cost-effective solutions to help our customers achieve product differentiation through improved patient outcomes and help save lives. Covalon's technologies address important healthcare issues such as infection control, medical device biocompatibility, and healthy tissue repair.

Advanced Wound Care

Covalon's expertise in wound care has led to the development of proprietary technologies comprising collagen, antimicrobial silicone adhesive dressings and advanced tissue repair technology.

Collagen:

Covalon's advanced collagen dressing technologies are essentially collagen-based substances that can hold and release a variety of materials, and/or allow materials to pass through the dressing. These dressings begin from a collagen base, which is generally biocompatible with the human body, and enable the release of beneficial materials, such as antimicrobials, into the wound site and/or enhance the removal of undesirable materials, such as wound exudates from the wound. Variations in Covalon's basic formulation will yield different rates of release, duration of release and/or size of particles removed. Covalon's unique collagen construct is ideally designed for wound healing because it provides a scaffold for cellular growth. By combining these characteristics with the many materials that can be added to the dressing, Covalon has a broad range of potential applications for this technology.

Covalon initially developed and received regulatory approval for a suite of advanced collagen-based wound dressings. Trademarked ColActive™ and BIOSTEP™, these dressings improve wound healing by removing wound bed enzymes that otherwise slow down the healing process. The ColActive™ Ag and BIOSTEP™ Ag products contain active silver, which is released into the wound as an antimicrobial agent to further improve the wound healing process. Both product lines are currently marketed and sold by a large wound care client.

The following product families have regulatory approval for sale:

Product	Description	Clearance	Date
ColActive™	Collagen Wound Dressing	FDA, Health Canada	2007
ColActive Ag™	Collagen with Silver	FDA, Health Canada	2007
BIOSTEP™	Collagen Wound Dressing	FDA, Health Canada, CE	2007
BIOSTEP™ Ag	Collagen with Silver	FDA, Health Canada	2007
CovaClear™ Ag	Collagen Hydrogel with Silver	FDA, Health Canada	2007

BIOSTEP™ received CE approval for the European markets, but both ColActive and Biostep product lines are currently only marketed by our partner in the United States.

We have a number of new and novel wound care technologies under development that combine biocompatible materials with a variety of therapeutics to address specific needs in the wound care market.



Silicone Adhesive Technology:

Covalon has developed the first silicone adhesive with two antimicrobial agents embedded directly in the adhesive. Based on this proprietary technology, Covalon has developed a line of transparent antimicrobial film dressings for the vascular access and wound care markets (IV Clear and SurgiClear, respectively).

IV Clear™ is a unique transparent antimicrobial cover dressing designed to cover and protect infusion therapy sites. Covalon's latest wound care innovation is engineered from a novel transparent polyurethane film which is coated with a patented blend of silicone adhesives, chlorhexidine and silver. It is gentle to the skin, and provides maximum patient comfort. Unlike most other products containing silver, silver discoloration is deterred, ensuring the dressing stays transparent for seven days.

IV Clear dressings offer significant advantages over existing products in the market. IV Clear elutes or releases the active antimicrobials directly from the adhesive continuously for at least seven days, thereby providing maximum protection against direct microbial colonization as well as creating an antimicrobial shield around an IV line entry point. The combination of silver and chlorhexidine provides a much broader spectrum of powerful killing activity than any competitive product currently on the market, and also decreases the likelihood of encouraging resistant organisms.

Covalon developed SurgiClear, based on the same technology as IV Clear to address the shortcomings of other surgical site cover dressings in the market. SurgiClear is a unique transparent antimicrobial cover dressing designed to cover and protect surgical sites. Engineered from a novel transparent polyurethane film coated with a patent-pending blend of silicone adhesives and antimicrobials, SurgiClear is gentle to the skin for maximum patient comfort. Its removal will not tear or damage fragile skin, and the novel adhesive film provides excellent tissue contact and infection management. The use of silicone materials on wounds is known to help reduce excessive scarring during the healing process. We expect this product to be adopted for use on surgical site closures such as breast surgery, caesarean sections, facial surgery, vascular surgery and orthopaedic surgery.

Genetic Regeneration of Damaged Tissue:

Covalon's intellectual property portfolio includes patents and intellectual property for stem cell engineering utilizing the EPAS1 gene and a proprietary method of introducing the EPAS1 gene into stem cells ("EPAS1"). This acquired technology is thought to enhance the efficacy of delivering stem cells to repair diseased tissue. EPAS1 is believed to be capable of stimulating the growth of new blood vessels through a process of therapeutic angiogenesis (new blood vessel formation is referred to as "angiogenesis" and/or "vasculogenesis"). The processes are integral to regenerative medicine, including wound healing, treating ischemic heart disease, peripheral vascular disease as well as other diseases related to poor blood flow to tissues and organs.

Covalon performed early mouse model experiments with EPAS1 that showed some promise for stimulating the growth of new blood vessels. The Company's previous CEO, Dr. Frank DiCosmo championed a pre-clinical research program that targeted EPAS1 on heart regeneration in Congestive Heart Failure ("CHF") patients who previously suffered a myocardial infarction ("MI") or heart attack. Dr. DiCosmo's approach was for Covalon to fully fund the research and the Company invested approximately \$1.7 million into a series of pre-clinical studies. The preliminary results of these pre-clinical porcine model experiments did not demonstrate that EPAS1-modified allogeneic (non-donor specific) stem cells improved both perfusion (volume of blood flow) and cardiac function better than either un-modified allogeneic stem cells or no stem cells.

Management believes it would require significant financial investments in further studies to advance the medical application of EPAS1 in human heart regeneration treatments and then bring the perfected technology to the commercial market. While Covalon intends to pursue other potential funding sources, commercialization partners and medical applications of the underlying intellectual property, management

has determined that it is not prudent to continue further pre-clinical research studies in the technology, without proper funding.

As at March 31, 2010, the historic costs associated with the pre-clinical experiments totalling \$1,700,350 were recorded as a deferred development cost asset on the balance sheet. Substantially all of these costs were incurred and paid for commencing in October 2007 until March 31, 2010. Given the preliminary research results received to date and the change in business model around how to create commercial value with the EPAS1 intellectual property, management recorded a non-cash impairment charge of \$1,700,350 in the income statement against the deferred development cost asset during the three month period ended March 31, 2010.

The Company continues to believe that the underlying intellectual property may have potential for a number of gene therapy applications and intends to continue to investigate other commercialization opportunities related to the underlying patents and intellectual property.

Specialized Medical Device Coatings

Covalon developed a patented coating process for medical devices that enter the body. Covalon's coating process applies a biocompatible coating that is permanently bound to medical devices through a method known as covalent bonding. Our coating technology is ideally suited to be a delivery surface for therapeutics such as drugs, antimicrobials, peptides, anti-proliferatives and biologics. The Company has focused on two areas in this market, which include; 1) devices that are designed to enter the body for a limited period of time; and 2) devices that are designed to be implanted in the body forever. Many of these life-saving devices, when left uncoated, can carry a high risk of medical device failure due to biocompatibility issues between a patient and the medical device.

Covalon's coating process applies a very thin coating on a medical device that will generally be slippery when moistened and can hold and release a variety of antimicrobial or other therapeutic agents to the surrounding tissue while in use. This ensures biocompatibility and improves the functionality and performance of the medical device implant. Our technology has already proven effective on many polymer surfaces, and is currently being tested and evaluated on other materials, including various metals.

These proprietary processes can be modified and enhanced coatings with specific characteristics that meet customer needs which may include lubricity (slippery when wet), antimicrobial activity, hemo-compatibility, bio-compatibility (to prevent tissue encrustation), or controlled release of therapeutics (drug elution).

Covalon has a number of commercialized coating successes that are currently marketed by our clients under private labelled brand names. As well, existing and new clients are continuously evaluating new coating opportunities for existing products that can benefit from our advanced coating technology, including new materials, existing products on the market or new products under development, as exemplified in the list below:

- Urinary Catheter and IV lines – to prevent infections
- Venous access catheter – to prevent blood clots and infections on the device
- Implantable infusion devices – to prevent blood clots and infections on the device
- Pain management catheter – to deliver pain management drugs
- Surgical wound drain – to prevent infections
- Orthopaedic devices – to extend the coatings technology to metals
- Breast implants and tissue expanders – to prevent infections

Infection Control & Drug Delivery

The targeted delivery of therapeutics from the surfaces of medical devices is an emerging segment of the medical device industry known as combination devices. The FDA has even set up a new category for this segment to accommodate the increasing demand for such devices. Covalon's initial focus has been on antimicrobial and device combinations. Covalon is known for novel photo-stable silver ion antimicrobial technology, which is used in both wound dressings and coatings of medical devices. Our expertise is now being used to develop other unique antimicrobial solutions that target a number of infection control issues. Covalon maintains a fully equipped research and development lab with top research scientists that work at characterizing different combinations of antimicrobial agents that are extensively performance tested in its in-house microbiology lab.

These new antimicrobial combinations allow us to offer customization around customer set specifications. Infection control problems vary for medical devices, consumer products or wound dressings that come into contact with the human body (or animals, in the case of the veterinary market). There is no one set solution for all problems. Some of the key issues addressed by combining antimicrobials are speed at which it works, effectiveness and the duration of its effectiveness, and the species of microbes being targeted.

Covalon's antimicrobial technologies can be used for applications in the following areas:

- Medical device coatings
- Wound care products
- Polymer mixes for extrusion and molds
- Skin Sanitizers
- Surface Sanitizers
- Cosmetics
- Consumer products
- Veterinary applications

Over the past number of years Covalon has developed expertise in the controlled delivery of antimicrobials that can be applied to other therapeutics. The Company continues to develop promising customer driven combinations of drugs and medical devices. Covalon assesses new applications for its drug delivery technology and know-how with partners who want to enhance existing products or introduce new solutions into their respective markets.

Patent Portfolio

Covalon's intellectual property strategy actively pursues new patents on our discoveries as they are made. Covalon currently has patents approved or pending in various jurisdictions around the world. A summary of these patents is included below:

- *Method of Making Antimicrobial Polymeric Surfaces* (patent in USA, EU, Australia, other jurisdictions patent pending)
- *System and Method For Coating Medical Devices* (USA and International patent applications filed)
- *Drug Delivery via Therapeutic Hydrogels* (patent in USA, Canada, EU and Australia)

- *Antimicrobial Photo-Stable Coating Composition* (USA and International patent applications filed)
- *Non-Adhesive Elastic Gelatine Matrices* (USA, EU, Eurasia, Canada and other jurisdictions patent applications filed)
- *EPAS1 Gene Transfer to Improve Cell Therapy* (USA, EU, Canada, and International patent applications filed)
- *Hypoxia Inducing Factors and Uses Thereof for Inducing Angiogenesis and Improving Muscular Functions* (USA, EU and Canada patent applications filed)
- *Self-Reinforced Membrane* (USA patent application filed)
- *Antimicrobial Silicone Wound Dressings* (USA patent application filed)

Analysis of Operating and Financial Results

Significant Events for the Year Ended September 30, 2010

Significant events during fiscal 2010 included:

- On October 20, 2009 Covalon announced the signing of a License Agreement as well as a Services and Supply Agreement with a division of C. R. Bard, Inc. that provides Bard with a license to use certain of Covalon's technologies on a number of its products; and Covalon to provide various services to Bard including assistance in technology transfer (commercialization) and product supply.
- On October 22, 2009, Covalon announced a manufacturing agreement with Amsino International Inc., a business unit of Amsino Medical Group, a leading global manufacturer of single use medical devices. The successful completion of this manufacturing agreement confirmed the commitment of the two companies to the global strategic marketing alliance previously announced on April 24, 2009. The manufacturing agreement provided that (i) Amsino will establish a high-volume manufacturing facility for customers who need to have their medical devices coated with Covalon's CovaCoat™ technology; (ii) Amsino will purchase from Covalon a custom-designed, new-generation CovaCoat™ machine; and (iii) Covalon and Amsino will share revenues from joint marketing activities directed at medical device companies.
- On October 23, 2009, the Company announced the appointment of William Jackson as its Chief Financial Officer and his appointment as a member of the Board of Directors. Mr. Jackson succeeded Peter Hobbes, the former CFO who resigned from the Company.
- On October 26, 2009, Covalon announced a development agreement with CareFusion Corporation, the new specialty products company recently spun off by Cardinal Health. The development agreement provides that Cardinal will pay Covalon for use of certain of its technology platform and development expertise to develop and design a process that meets CareFusion's specifications.
- On January 15, 2010, the Company announced that Dr. Murray Miller and Mr. Brian Pedlar were appointed to the Board of Directors. Dr. Murray Miller is the managing director of Trillium Imaging Inc., which operates medical imaging centres in Mississauga and Toronto. He has served as Chief Radiologist at Trillium Health Centre - West Toronto, and has been a consultant to the medical industry, including medical device manufacturers and medical imaging vendors. Mr. Brian Pedlar is President of Pedlar Ventures Limited, a private venture investment and consulting firm based in Oakville, Ontario. He has served in senior executive positions with public companies including Merge Healthcare, Cedara Software Corp. and IMAX Corporation. Mr. Pedlar is a

Chartered Accountant. Dr. Miller and Mr. Pedlar replace outgoing Directors, Mr. Brad Williams, and Mr. David McFaul. Mr. Martin Bernholtz, who for the past four years served as a Covalon director and Chairman of the Audit Committee, was appointed Chairman of the Board, a position previously held by Mr. Williams.

- On April 5, 2010, Covalon announced the appointment of Mr. Brian Pedlar, a current director of the Company, as Chief Executive Officer of the Company. Mr. Pedlar replaced Dr. Frank DiCosmo, who terminated his services arrangement with the Company over a disputed bonus payment. The parties have reached an agreement whereby Dr. DiCosmo will receive payment equivalent to one year's compensation payable over twelve months commencing June 15, 2010.
- On June 15, 2010, Covalon announced a multi-year expanded agreement with an affiliate of C. R. Bard, Inc. that allows the use of Covalon's proprietary coating technology in an additional area of Bard's products. This agreement entailed an upfront payment of US\$500,000 and future royalty payments.
- On June 22, 2010, Covalon announced a multi-year agreement with one of the largest manufacturers and distributors of health care supplies and services in the U.S. The agreement allows the client to use Covalon's proprietary coating technology specifically on one of its products in return for an upfront payment of US\$500,000 and future royalty payments.
- On June 29, 2010, Covalon announced that it had received funding of approximately \$150,000 from the National Research Council of Canada Industrial Research Assistance Program (NRC-IRAP) for the commercialization of an antimicrobial coating for orthopaedic devices made of metal.
- On September 3, 2010, Covalon announced it had finalized an employment agreement with Brian Pedlar, Covalon's recently-appointed CEO.

Financial Highlights for the Year Ended September 30, 2010

Covalon management continues to make substantial progress in its focus on reducing operating losses and becoming cash flow positive on a sustainable basis. Since the change in management, we now focus on licensing our technologies to partners earlier in the product development cycle. As a result, Covalon has increased revenues and reduced its operating expenses and cash outflows. Financial highlights compared to the same period in the prior fiscal year were:

- Yearly cash outflow from operations improved significantly to \$58,201 compared to cash out flow of \$4,668,210 for the prior year – an improvement of \$4,610,009.
- Year-to-date revenue grew 54.4% to reach \$3,231,067, compared to \$2,092,526 in revenues for 2009;
- Year-to-date operating expenses before amortization, were reduced significantly by \$2,629,355 or 46.9% to reach \$2,974,549, compared to \$5,603,904 in the prior year;
- During fiscal 2010, the Company recorded a non-cash charge of \$1,700,350 for deferred development costs related to the pre-clinical research studies based on the Company's EPAS1 intellectual property.
- Year-to-date loss from operations before amortization, defined as loss before undernoted in our consolidated financial statements for the year ended September 30, 2010 less amortization, was substantially reduced by \$3,105,155 to \$1,598,064, compared to \$4,703,219 for the corresponding period in 2009.
- Loss per share for the year ended 2010 and 2009 were \$0.05 and \$ 0.07 respectively;

- Yearly cash outflow before redemption of short-term investments decreased significantly by \$5,881,579 to \$198,048 compared to \$6,079,627 for the prior year.

Consolidated Statement of Operations and Comprehensive Loss

(Canadian \$)	Three month period ended		Year ended	
	September 30, 2010	2009	September 30, 2010	2009
Revenue				
Product Sales				
Advanced wound care	\$ 251,733	\$ 318,627	\$ 1,378,094	\$ 804,352
Specialized medical device coatings	192,363	174,631	1,323,747	845,547
Total Product Sales	444,096	493,258	2,701,841	1,649,899
Licensing fee	161,382	110,656	529,226	442,627
Total Revenue	605,478	603,914	3,231,067	2,092,526
Cost of Sales	504,297	301,787	1,854,582	1,191,841
Gross Profit	101,181	302,127	1,376,485	900,685
Operating expense before undernoted items	873,454	1,225,534	3,420,308	5,997,948
Loss before undernoted	(772,273)	(923,407)	(2,043,823)	(5,097,263)
Loss on disposal of capital asset	(7,380)	(66,962)	1,910	(66,962)
Write-down of patent	-	(1,351)	-	37,507
Loss on write-down of deferred development cost	-	-	1,700,350	-
Settlement Pay	-	-	242,178	-
Interest income	(13,461)	(10,635)	(53,314)	(192,999)
Net Loss	\$ (751,432)	\$ (844,459)	\$ (3,934,947)	\$ (4,874,809)
Loss per share	\$ (0.01)	\$ (0.01)	\$ (0.05)	\$ (0.07)

Product and Service Revenue and Gross Profit

Cumulative operating revenues for the 2010 fiscal year have surpassed those in the same period of the prior year. However, quarter-to-quarter revenues continue to be unpredictable. Even though the revenue mix between advanced wound care and specialized medical device coatings remained relatively constant year to year, quarterly revenue mix can change substantially from period to period. The products and services revenue mix changed from the comparative period as follows:

- 60% of revenue in the fourth quarter of 2010 was derived from advanced wound care compared with 71% in the same period of the previous year;
- 40% of products and services revenue in the current period were derived from specialized medical device coatings compared to 29% in the fourth quarter of 2009;

Gross margin as a percentage of total revenue for the year ended September 30, 2010 was 42.6%, compared to 43.0% in the comparative period of 2009. Gross margin is highly influenced by product mix between advanced wound care and specialized medical device coatings; the mix of silver-based and non-silver based collagen dressings sold in the periods; and the amount of funded coating services included in

revenue and costs. Management continues to focus on improving gross margins by rationalizing resources and focusing on business opportunities with greater profit potential.

On October 1, 2009, the Company began to disclose two product segments, namely, Advanced Wound Care and Specialized Medical Device Coatings. These segments have been disclosed based on the underlying technology of the product. As a result, there is no comparative information from the reported periods for the previous fiscal year.

For the year ended September 30, 2010, product and services revenue from advanced wound care increased by \$570,717 or 45.8% over the comparative period of 2009. Gross Profit related to advanced wound care for the year ended September 30, 2010 was \$788,614 or 43.4% of revenue. There is no comparative information in respect to gross profit available for 2009.

Products and services revenue for the year ended September 30, 2010 from specialized medical device coatings increased by \$567,824 or 67.2% over the same period in 2009. This increase is due to higher volume of orders received under contract and an increase in revenue from development services. Gross profit related to our specialized medical device coatings for the year ended September 30, 2010 was \$587,871 or 41.6% of specialized medical device coating revenue. There is no comparative information in respect to gross profit available for 2009. One of the major factors affecting gross margin is the value of coating services related to development contracts. Specialized medical device coatings revenue comprises product fees and the fees charged for services associated with coating products.

Licensing Fees

Licensing fees increased due to the signing of two new licensing agreements during the year, where licensing fees of approximately US\$1,000,000 were collected by the Company, but are recognized in revenue over the term of the licensing agreements.

Interest Income

Interest income on investments during the year decreased \$139,685 primarily as a result of the reduction in interest rates and redemption of investments. All investments are made in accordance with the Company's audit committee investment guidelines of investing cash of the Company in low-risk interest-bearing instruments.



Operating expenses

(Canadian \$)	Three months ended September 30,		Year ended September 30,	
Operating expenses	2010	2009	2010	2009
<u>Operations</u>				
Wages and benefits	\$ 74,448	\$ 177,030	\$ 412,132	\$ 1,188,579
Consulting fees	6,022	6,054	16,497	104,327
Other	16,650	18,760	66,797	149,801
Total Operations	<u>\$ 97,120</u>	<u>\$ 201,844</u>	<u>\$ 495,426</u>	<u>\$ 1,442,707</u>
<u>Research and development activities</u>				
Wages and benefits	\$ 169,477	\$ 151,516	\$ 673,445	\$ 837,942
Consulting and Outside Testing	(111,078)	2,612	(8,297)	52,419
Recovery of refundable investment tax credit	-	-	(430,161)	-
Other	23,580	11,990	69,804	87,431
Total Research and Development	<u>\$ 81,979</u>	<u>\$ 166,118</u>	<u>\$ 304,791</u>	<u>\$ 977,792</u>
<u>Marketing</u>				
Wages and Benefits	\$ 59,029	\$ 43,025	\$ 243,494	\$ 390,979
Travel	8,116	10,944	70,599	64,750
Investor Relations	7,345	1,837	35,124	77,143
Other	3,061	2,765	27,509	25,149
Total Marketing	<u>\$ 77,551</u>	<u>\$ 58,571</u>	<u>\$ 376,726</u>	<u>\$ 558,021</u>
<u>General and administrative</u>				
Wages and Benefits	\$ 154,958	\$ 192,032	\$ 517,385	\$ 892,751
Director's Compensation	15,441	46,141	210,331	304,543
Advisor expense	496	183,363	180,799	205,943
Professional Fees	71,024	114,018	391,651	661,378
Facility	42,708	42,693	166,336	174,934
Foreign exchange loss	67,204	60,748	44,717	110,420
Other	152,198	59,269	286,387	275,415
Total General and Administrative	<u>\$ 504,029</u>	<u>\$ 698,264</u>	<u>\$ 1,797,606</u>	<u>\$ 2,625,384</u>
	<u>\$ 760,679</u>	<u>\$ 1,124,797</u>	<u>\$ 2,974,549</u>	<u>\$ 5,603,904</u>
Amortization and depreciation	\$ 112,775	\$ 100,737	\$ 445,759	\$ 394,044
Total Operating Expenses	<u>\$ 873,454</u>	<u>\$ 1,225,534</u>	<u>\$ 3,420,308</u>	<u>\$ 5,997,948</u>

Since deciding to outsource manufacturing to a partner, Covalon has made substantial progress at reducing its operating expenses and cash outflows. Management has achieved revenue growth while being focused on structural cost reductions in an effort to reduce operating expenses and improve cash flow.

Compared to fiscal 2009, operating expenses before amortization fell by 47% or \$2,629,355 for fiscal 2010, and is attributable to the following:

- An overall reduction of wages and benefits and directors compensation of approximately \$1,400,000;
- A decrease in outside consultant and professional fees of approximately \$430,000
- A recovery of refundable investment tax credits of \$430,161, which is not likely to recur in 2011.

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

Related Party Transactions

During the year ending September 30, 2010, the Company paid fees to related parties as follows:

- (i) Management fees totalling \$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 directors and stock option benefits that have vested during the year amounted to \$186,831 (2009 – \$168,543). The directors waived cash compensation for the fiscal year ending September 30, 2010.

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

Critical Accounting Estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from Management's best estimate as additional information becomes available in the future. Management believes that the estimates and assumptions upon which the Company relies are reasonable based upon information available at the time these estimates and assumptions are made. Estimates and assumptions may be revised as new information is acquired, and are subject to change. Areas of significant estimates include deferred development costs, stock based compensation and impairment of long lived assets.

Deferred Development Costs

Development costs that 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.

During Q2 of this fiscal year, the Company recorded a non-cash charge of \$1,700,350 for deferred development costs related to the pre-clinical research studies based on the Company's EPAS1 intellectual property.

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.

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.

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.

Summary of Quarterly Results and Financial Position

The quarterly financial information presented below represents eight quarters of operating results and financial position:

in Canadian \$)	2010 Fourth Quarter	2010 Third Quarter	2010 Second Quarter	2010 First Quarter	2009 Fourth Quarter	2009 Third Quarter	2009 Second Quarter	2009 First Quarter
Revenue (1)	\$ 618,939	\$ 1,024,047	\$ 837,140	\$ 804,255	\$ 614,549	\$ 427,376	\$ 781,433	\$ 462,167
Operating loss before amortization	\$ 659,498	\$ 317,306	\$ 282,805	\$ 338,455	\$ 822,670	\$ 1,120,493	\$ 1,400,742	\$ 1,359,000
Net loss	\$ 751,432	\$ 647,223	\$ 2,029,034	\$ 443,358	\$ 844,459	\$ 1,201,228	\$ 1,481,658	\$ 1,347,464
Net loss per share	\$ (0.01)	\$ (0.01)	\$ (0.03)	\$ (0.01)	\$ (0.01)	\$ (0.02)	\$ (0.02)	\$ (0.02)
Cash and cash equivalents	\$ 5,838,578	\$ 6,431,954	\$ 4,970,623	\$ 5,428,742	\$ 6,036,626	\$ 7,788,427	\$ 9,038,878	\$ 10,817,508
Net working capital	\$ 5,217,531	\$ 5,970,058	\$ 5,760,650	\$ 6,132,019	\$ 6,429,103	\$ 7,141,868	\$ 8,482,245	\$ 10,060,370
Current Ratio	3.9	3.7	5.9	6.4	6	6.1	6.7	7.6

(1) includes Product Revenue, Licensing Revenue and interest income for comparative purposes to prior quarters

Our quarterly revenue is inherently unpredictable due to our business model and fluctuates from quarter to quarter depending on the composition of contractual arrangements entered into in each quarter and the timing of completed coating and development services milestone in any period. The year-over-year revenue trend continues to be positive, however, revenues in Q4 decreased from the prior quarter mainly due to service milestone timing issues. Average revenues for each quarter of the 2010 fiscal year were approximately \$821,000, compared to average quarterly revenues of approximately \$595,000 for the previous two fiscal years.

Highlights of fourth quarter operating results are:

- Quarterly revenue for the three months ended September 30, 2010 was \$618,939, a slight increase over revenues of \$614,549 recorded for the same period in 2009;
- Quarterly operating expenses before amortization decreased by 32.4% or \$364,118 from \$1,124,797 in the fourth quarter of the prior fiscal year to \$760,679 in the fourth quarter of the current fiscal year;

- Quarterly loss from operations before amortization improved by 19.8% to \$659,498 from \$822,670 in the fourth quarter of 2009
- Loss per share was \$0.01 in the fourth quarter of 2010 and 2009 respectively;
- Quarterly cash outflow also decreased by \$658,427 or 52.6% to \$593,374 from \$1,251,801 in the prior year.

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 our ability to pay short-term obligations. Current assets includes cash and cash equivalents, short-term investments, accounts receivable, refundable investment tax credits, inventories and prepaid expenses. Current liabilities include accounts payable and accrued liabilities, and deferred revenue. Net Working Capital is calculated as current assets minus current liabilities. At September 30, 2010, the Company has 3.9 times the current assets needed to pay its current liabilities.

Liquidity & Capital Resources

(Canadian \$)	As at September 30,	
	2010	2009
Cash and cash equivalents	\$ 5,838,578	\$ 6,036,626
Short-term investments	\$ 500,000	\$ 500,000
Total assets	\$ 10,319,792	\$ 12,867,158
Deferred revenue	\$ 1,585,048	\$ 1,159,573

Highlights

Cash flows as a result of entering into customer contracts will continue to be unpredictable quarter-to-quarter, due to the timing of receipt of up front payments under new contracts and the timing of receipt of ongoing royalty payments. Over the year ended September 30, 2010, we had a net cash outflow of \$198,048 compared to net cash outflow of \$6,079,627 before redemption of short-term investments for the same period in the prior year.

On September 30, 2010 cash, cash equivalents, and short-term investments amounted to \$6,338,578. Covalon follows a policy of investing its surplus cash resources in high quality, liquid, short-term deposits. Cash equivalents as of September 30, 2010 had less than three months to maturity and are cashable without penalty. As at September 30, 2010, there were no restrictions on the flow of these funds nor have any of these funds been committed in any way. Management believes that the Company has the capital resources and liquidity necessary to meet its current commitments, support its operations, and finance its current growth strategies.

Total assets at September 30, 2010 were \$10,319,792 compared to \$12,867,158 at September 30, 2009. The decline is mainly attributable to the \$1,700,000 non-cash charge related to EPAS1 deferred development costs. Cash and cash equivalents comprised almost 57% of total assets at September 30, 2010. Of the remaining assets, the Company's accounts receivable and inventory are liquid, with collection periods and turnover ratios in the 60 to 180 day range. The balance of our assets is comprised of capital assets and the Company's intangible assets. These have low liquidity but represent much of the intellectual property assets that are used to generate Covalon's revenue streams.

Deferred revenue increased by \$425,475 to \$1,585,048 at September 30, 2010 from the fiscal year ended September 30, 2009. The increase in deferred revenue is due to upfront fees received from two customers offset by amortization expense recorded during the period.

Commitments

Covalon has signed an offer to lease for its premises at 405 Britannia Road East, Mississauga commencing December 1, 2009 and expiring on November 30, 2014. The annual rental payment for the first year was \$80,719 and increases annually over the term of the lease. The Company has also entered into an operating lease for some of its office equipment. The equipment is leased at \$477 per month under a lease expiring in 2013.

The minimum annual lease payments for the next 4 fiscal years are:

2011 Fiscal Year	\$86,443
2012 Fiscal Year	\$90,988
2013 Fiscal Year	\$95,965
2014 Fiscal Year	\$91,627

Shares Outstanding

	Number of Common Shares	Stated Capital
Balance, September 30, 2008	74,303,915	\$ 29,151,710
Issued for technology rights	75,000	21,375
Issued in trust	(75,000)	-
Balance, September 30, 2009	74,303,915	29,173,085
Exercise of stock options	587,793	282,231
Balance, September 30, 2010	74,891,708	\$ 29,455,316

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 trust to be released on various success milestones. At September 30, 2010, 150,000 shares valued at \$213,875 have been released from trust. No shares were released during the year ended September 30, 2010. The remaining balance of 950,000 shares is still being held in trust.

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

Stock Option Plan

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

	Number of Shares	Value	Weighted Average Exercise Price
Balance, September 30, 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

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.

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.

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

During the year ended September 30, 2010, a total of 3,019,948 options valued at \$1,408,871 expired and 162,392 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.

Sources and Uses of Cash

	Three month period ended September 30,		Year ended September 30,	
	2010	2009	2010	2009
Cash Provided By (Used In)				
Operating Activities				
Cash used in operating activities before				
Change in non-cash working capital	\$ (594,107)	\$ (662,477)	\$ (1,369,283)	\$ (3,724,714)
Change in non-cash working capital	(2,231)	(649,734)	1,311,082	(943,496)
	\$ (596,338)	\$ (1,312,211)	\$ (58,201)	\$ (4,668,210)
Investing Activities				
Purchase of capital assets	\$ 7,379	\$ (33,951)	\$ (25,589)	\$ (686,212)
Proceeds on disposal of capital assets	-	385,347	-	\$ 385,347
Expenditure on deferred development cost	-	(315,527)	(162,604)	(1,050,329)
Purchase of other assets	(31,903)	(19,183)	(98,046)	(54,275)
Redemption of short-term investments	-	-	-	8,582,699
	\$ (24,524)	\$ 16,686	\$ (286,239)	\$ 7,177,230
Financing Activities				
Net proceeds on issuance of share capital	\$ 40,000	\$ -	\$ 156,337	\$ -
Foreign exchange gain (loss) on cash held	\$ (12,512)	\$ 43,724	\$ (9,945)	\$ (5,948)
Increase (decrease) in cash and cash equivalents	\$ (593,374)	\$ (1,251,801)	\$ (198,048)	\$ 2,503,072

Operating Activities

Cash used in operating activities for the year was \$58,201 compared to \$4,668,210 in 2009. Cash used in operating activities during the fourth quarter of 2010 before change in non-cash working capital was \$594,107 compared to \$662,477 in the same period of the previous year. Accounts receivable, net, decreased to \$422,729 at September 30, 2010 from \$761,354 at September 30, 2009. Inventories decreased to \$234,667 from \$341,587 at September 30, 2009 due mostly to increased sales and improved inventory turnover. Accounts payable and accrued liabilities increased to \$1,164,433 at September 30, 2010 from \$766,364 at September 30, 2009.

Investing Activities

Expenditures on deferred development costs related to costs associated with the pre-clinical research study based on the EPAS1 intellectual property, which were incurred prior to the non-cash charge related to the EPAS1 project.

Financing Activities

The Company received cash in the amount of \$156,337 representing the exercise of 587,793 options during the year ended September 30, 2010.

Off-Balance Sheet Arrangements

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

Financial Instruments

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

Short term investments consists of Ontario Savings Bonds (step up interest rates of 1.5%, 2.5%, 3.5% and 4.5% in each respective year, redeemable every 6 months and maturing on June 21, 2014) and the carrying value approximates fair market value.

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

The Company has not entered into any futures or forward contracts, or other derivative instruments as at the date of this MD&A.

Subsequent Event

There were no subsequent events.

Risks and Uncertainties

An investment in the securities of the Company is speculative due to the proposed nature of the Company's business and the fact that Covalon Technologies Ltd. has not yet achieved an annual profit. Consequently, an investment in the Company is subject to certain risks and investors should not invest in securities of the Company unless they can afford to lose their entire investment. In addition to the factors disclosed elsewhere in this MD&A, investors should consider the following risk factors in assessing the investment merits of such securities.

Medical Device and Biotechnology companies in the early revenue stage are subject to a number of risks and uncertainties that are inherent to the development of any new technology. General business risks include, among other things, uncertainty in product development and related clinical trials, the regulatory environment including delays or denial of approval to market products, the impact of technological change and competing technologies, the ability to protect and enforce its patent portfolio and intellectual property assets, the availability of capital to finance continued and new product development, the ability to secure strategic collaborators and its reliance on these collaborators for the development, regulatory approval, testing, manufacturing, commercialization and/or distribution of its products and the risk of product liability claims. In addition, market prices for securities of biotechnology companies are generally volatile, and may or may not move in a manner consistent with the progress being made by such company.

Without limiting the foregoing, the following risks are discussed in more detail:

Covalon has a history of net losses and may not achieve or maintain profitability.

Covalon has not yet achieved profitability and there is no guarantee that Covalon will be able to achieve profitability in the future. Covalon has never paid a dividend on its common shares and does not expect to do so in the foreseeable future. Covalon's business and prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in new and rapidly evolving markets such as healthcare.

Covalon cannot predict if profitability will ever be achieved and, if it is, whether or not it will be sustainable on a quarterly or an annual basis. Even if Covalon is not able to successfully further commercialize its products, Covalon believes that it has sufficient capital to fund its business and operations through at least 2011. However, Covalon may need to raise additional capital in the future. Additional financing may not be available, and even if available, may not be on acceptable terms.

Any failure to obtain or protect intellectual property could adversely affect Covalon.

Covalon's success depends, in part, on its ability to obtain patents, or licenses to patents, maintain trade secret protection, and enforce its rights against others. Covalon has filed and is actively pursuing patent applications in Canada, the United States and other jurisdictions. Covalon may not be able to obtain patent protection for key elements of its technology.

There can be no assurance that:

- patent applications will result in the issuance of patents;
- additional proprietary products developed will be suitably protected from infringement;
- patents issued will provide adequate protection or any competitive advantages;
- patents will not be successfully challenged by any third parties; and
- patents of others will not impede Covalon's ability to commercialize its technology.

Covalon may need to obtain licenses for the development of its products. Licenses may not be available on satisfactory terms or at all. If available, these licenses may obligate Covalon to exercise diligence in bringing its technology to market and may obligate it to make minimum guarantee or milestone payments. These diligence and milestone payments may be costly and could seriously harm Covalon's business. Covalon may also be obligated to make royalty payments on the sales, if any, of products resulting from licensed technology and may be responsible for the costs of filing and prosecuting patent applications. These costs could affect Covalon's results of operations and decrease its earnings.

Covalon's intellectual property includes trade secrets and know-how that may not be protected by patents. There can be no assurance that Covalon will be able to protect its trade secrets. To help protect its rights, Covalon requires employees, consultants, advisors and collaborators to enter into confidentiality agreements. These agreements may not adequately protect Covalon's trade secrets, know-how, or other proprietary information in the event of any unauthorized use or disclosure.

Covalon's development programs and products subject it to the risk of product liability claims for which Covalon may not be able to obtain adequate insurance coverage.

Human therapeutic products and medical devices involve the risk of product liability claims and associated adverse publicity. Covalon's principal risks relate to the sales of its products and currently their use in clinical trials. Claims may be made by consumers, healthcare providers, third party strategic collaborators or others selling Covalon's products. There can be no assurance that Covalon will be able to obtain or maintain sufficient and affordable insurance coverage for any of these claims. Without sufficient coverage, any claim, any threat of such a claim or any product withdrawal could seriously harm Covalon's business.

Covalon may incur substantial costs as a result of litigation or other proceedings relating to patent and other intellectual property rights.

Covalon's future success and competitive position depends in part on its ability to obtain and maintain certain proprietary intellectual property rights used in its principal products. Any such success may be achieved in part by prosecuting claims against others who Covalon believes are infringing its rights and by defending claims of intellectual property infringement brought by its competitors and others. Covalon's involvement in intellectual property litigation could result in significant expense, adversely affecting the development of product candidates or sales of the challenged product or intellectual property and diverting the efforts of its technical and management personnel, whether or not such litigation is resolved in its favour. Some of Covalon's competitors may be able to sustain the costs of complex patent litigation more effectively than it can because they have substantially greater resources. Uncertainties resulting from the initiation and continuation of any litigation could affect Covalon's ability to continue its operations.

In the event of an adverse outcome as a defendant in any such litigation, Covalon may, among other things, be required to:

- pay substantial damages;
- cease the development, manufacture, use or sale of product candidates or products that infringe upon the intellectual property of others;
- expend significant resources to design around a patent or to develop or acquire non-infringing intellectual property;
- discontinue processes incorporating infringing technology;
- obtain licenses to the infringed intellectual property.

If third-parties file patent applications, or are issued patents claiming technology also claimed by Covalon in pending applications, Covalon may be required to participate in interference proceedings with the U.S. Patent and Trademark Office, or other proceedings outside the United States, including oppositions, to determine priority of invention or patentability, which could result in substantial cost to Covalon even if the eventual outcome were favourable.

Covalon or its clients must receive regulatory approval for each of Covalon's product candidates before they can be sold commercially in North America or internationally, which can take significant time and be very costly.

The development, manufacture and sale of medical devices and human therapeutic products in Canada, the United States and internationally is governed by a variety of statutes and regulations.

These laws require, among other things:

- approval of manufacturing facilities and practices;
- adequate and well-controlled research and testing of products in pre-clinical and clinical trials;
- review and approval of submissions containing manufacturing, pre-clinical and/or clinical data in order to obtain marketing approval based on establishing the safety and efficacy of the product for each use sought, including adherence to good manufacturing practices during production and storage;
- control of marketing activities, including advertising and labelling.

Some product candidates currently under development by Covalon will require significant development, pre-clinical and clinical testing, pre-market review and approval, and investment of significant funds prior to their commercialization. The process of completing clinical testing and obtaining such approvals (if required) is likely to take many years and require the expenditure of substantial resources, and Covalon does not know whether any clinical studies by it will be successful, that regulatory approvals will be received, or that regulatory approvals will be obtained in a timely manner. Despite the time and resources expended by Covalon, regulatory approval is never guaranteed.

Even if some of Covalon's products and manufacturing facilities receive regulatory approval, those products and facilities may still face subsequent regulatory difficulties.

If Covalon receives regulatory approval to sell any of its products, regulatory agencies will limit the approval to certain diseases, conditions, or categories of patients who can use them. In addition, regulatory agencies subject a marketed product, its manufacturer, and the manufacturer's facilities to ongoing regulatory requirements. Regulatory agencies may also require expensive post-approval studies. Any adverse effects associated with Covalon's products must also be reported to regulatory authorities. If new data are developed, previously unknown adverse experiences with a product occur, deficiencies in

Covalon's manufacturing and laboratory facilities are discovered, or it fails to comply with applicable post-market regulatory requirements, a regulatory agency may impose restrictions on that product or on Covalon including the requirement to withdraw the product from the market, close the facility, suspend manufacturing, change the product's label or pay substantial fines.

Covalon's success is partly dependent on its partners' success and the relationship with partners is governed by contracts.

Covalon is reliant on partners to execute certain key business processes. If its partners do not perform to Covalon's expectations, Covalon may be unable to enforce a change due to contractual terms. This may significantly impact Covalon's ability to generate revenues and profits.

Examples of such issues include:

- Manufacturing may be prioritized other than as Covalon's customers desires;
- Production quality measures may not be achieved;
- Sales expectations are not achieved;
- New products are not launched expeditiously.

If Covalon fails to hire and retain key management, scientific and technical personnel, it may be unable to successfully implement its business plan.

Covalon is highly dependent on its senior management and its scientific and technical personnel for their domain knowledge and technical expertise. The competition for qualified personnel in the healthcare field is intense, and Covalon relies heavily on its ability to attract and retain qualified managerial, scientific, and technical personnel. Covalon's ability to manage growth effectively will require continued implementation and improvement of its management systems and the ability to recruit and train new employees. Covalon may not be able to successfully attract and retain skilled and experienced personnel, which could harm its ability to develop product candidates and generate revenues.

Accounting Policies

Accounting Policies adopted in the 2010 fiscal year

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.

International Financial Reporting Standards (IFRS)

Background, project structure and project progress

In March 2006, the CICA released its plan to adopt International Financial Reporting Standards. After a five year transitional period, at the end of 2011, Canadian GAAP will cease to exist as a separate basis of financial reporting for public companies. The Company will issue consolidated financial statements in accordance with IFRS as issued by the International Accounting Standards Board ("IASB") for the year ended September 30, 2012, with comparative information.

Preliminary Impact Assessment

The Company has completed a diagnostic study of the conversion of its consolidated financial statements to IFRS, with the assistance of external consultants. The study identified the principal differences between the Company's records using existing Canadian GAAP and IFRS standards.

The results of this assessment identified:

- Preliminary analysis of all Canadian GAAP to IFRS differences and IFRS 1 elections and resulting prioritization of high, medium and low impact areas of focus for the Company based on potential impact;
- Preliminary resource requirements;
- A preliminary IFRS Transition Plan (details outlined below).

IFRS Transition Plan

During the year, the Company has established a formal IFRS Transition Plan. This plan includes:

- An established project structure and governance practices;
- Detailed timetable with milestones and deliverables;
- Identification and allocation of resources (combination of internal and external);
- Development and execution of a training program;
- Detailed analysis of all Canadian GAAP to IFRS differences;
- Detailed analysis and selection of all IFRS 1 elections;
- Assessment of impact on data systems, internal controls over financial reporting, and business activities, such as financing and compensation arrangements.

The Company has completed the detailed assessment of all standards that affect the transition.

The Company has scheduled the solutions development and the implementation for the second and third quarter of next year including construction of full financial statements. Specifically, the items identified are being analysed and any differences quantified.

Potential accounting changes as a result of transition to IFRS

The Company has implemented a detailed review of the potential impact of International Financial Reporting Standards, IFRS, on its accounting policies. Outlined below is a very brief summary of select IFRS that may impact the Company, their differences from Canadian Generally Accepted Accounting Principles ("GAAP") and their potential impact. Based on the impact analysis performed with the assistance of the external consultants, the Company is currently considering what IFRS 1 exemptions to elect. The list below is not comprehensive and does not include all of the differences from GAAP for the standards noted. Also, the list does not include all the standards that may require changes for the transition to IFRS. Some of the standards not presented below could have a significant impact on the Company's consolidated financial statements.

Revenue Recognition – The Company has contracts which generate revenue from licensing fees. Many of these contracts provide upfront payments and under CGAAP have been deferred over the life of the contract. Each contract must be reviewed to ensure that the accounting is appropriate under IFRS to determine whether any differences in timing or amount of revenue recognized exist. IFRS 1 does not contain any special exemptions for revenue for first-time adoption. All accounting

policies related to revenue will be assessed against the appropriate standard including IAS 18, Revenue for compliance.

Stock-based Compensation – The Company intends to use the IFRS 1 exemption to prevent full retrospective restatement of stock options under IFRS. However, retrospective restatement will still be required for any outstanding equity instruments that are unvested and liabilities that have not been settled prior to the date of transition to IFRS.

Under IFRS 2 *Share-based payments*, stock options with graded vesting must be accounted for as separate awards. In addition, forfeitures must be estimated when the stock options are issued. The Company is reviewing all stock options.

Foreign Exchange Translation - The Company sells products to customers in U.S. dollars and purchases some services and raw materials from suppliers invoiced in U.S. dollars. All labour costs are denominated and settled in Canadian dollars. An analysis is currently underway to determine if there is any impact on the functional currency under IFRS.

Property, Plant & Equipment (PP&E) – Analysis of all material PP&E accounts is required to ensure that any components with different useful lives are identified and amortized appropriately. Net book values as at the date of transition will be reviewed to ensure that any material components are identified. The Company is reviewing componentization of PP&E.

Presentation and Disclosure – IFRS requires significantly more disclosure than GAAP for certain standards. In some cases, IFRS also requires different presentation on the balance sheet and income statement.

At this time, Covalon cannot quantify the impact of IFRS to its financial statements. The Company is in the process of finalizing preliminary conclusions and accounting policy choices on the standards noted above. Those conclusions and accounting policy choices will be reported on when finalized.

The IASB has several projects slated for completion in 2011 that may significantly impact the transition to IFRS and the financial statements of the Company. The Company continues to monitor the IASB's progress on these projects and their impact on Covalon's transition to IFRS.

Impact on Information Systems and Technology

It is anticipated that the adoption of IFRS will have some impact on information systems requirements. The main drivers for systems changes include:

- Additional information required as a result of enhanced note disclosures;
- Tracking of IFRS to GAAP differences during the transition;
- Tracking sufficient level of details within the accounting records to allow management to maintain adherence with IFRS going forward.

The impact and changes to systems are on-going and will be prioritized as part of the project.

Impact on Reporting and Internal Controls

In accordance with Covalon's approach to certification of internal controls required under Canadian Securities Administrators' National Instrument 52-109, all entity-level, information technology, disclosure and business process controls will require updating and testing to reflect changes arising from Covalon's conversion to IFRS. Where material changes are identified, these changes will be mapped and tested to ensure that no material control deficiencies exist as a result of the Corporation's conversion to IFRS.

Impact on Business

The transition to IFRS may have an impact on the Company's business practices. The Company is currently considering the contractual implications of IFRS on any licensing and other arrangements.

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Effective as of December 15, 2008, the Ontario Securities Commission approved the revised *National Instruments 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings* ("NI 52-109"). The revised NI 52-109 extends the exemption for venture issuers from certifications relating to the establishment and maintenance of disclosure controls and procedures ("DC&P") and internal controls over financial reporting ("ICFR"), as defined in NI 52-109. Additional risks to the quality, reliability, transparency, and timeliness of the Company's interim and annual filings may result from the inherent limitations on management's ability to design and implement on a cost effective basis DC&P and ICFR. The Company recognizes the importance of DC&P and ICFR, and will endeavour to have sufficient controls in place to ensure financial statements are materially correct and sufficiently disclosed.

The Company continues to formalize procedures and control measures that are already in place and to introduce new ones to ensure good evaluation and control practices. As of September 30, 2010, the Company's management evaluated the effectiveness of the design and operation of its disclosure controls and procedures as defined under the rules. The evaluation was performed under the supervision, and with the participation, of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on the evaluation of the DC&P, the CEO and the CFO have concluded that, subject to the fact that an evaluation of controls can provide only reasonable, not absolute, assurance that all control issues and instances of fraud or error, if any, within the Company have been detected, the Company's DC&P are effective in providing reasonable assurance that material information relating to the Company is made known to management. Changes and new controls are evaluated and implemented as required to provide greater business control.

The design of ICFR within the Company is management's responsibility to provide reasonable assurance that the reliability of financial reporting and that the preparation of financial statements for external purposes follow Canadian generally accepted accounting principles.