MANAGEMENT'S DISCUSSION & ANALYSIS
For the three and six month periods ended March 31, 2010

May 27, 2010

The following discussion of Covalon Technology Ltd.'s ("Covalon" or the "Company") financial condition and results of operations should be read in conjunction with our audited consolidated financial statements for the year ended September 30, 2009, and our unaudited financial statements with related notes for the three and six month period ended March 31, 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, consisting solely of non-management directors. This committee meets periodically, reviews the scope of the external audit, the adequacy of the systems of internal control and the appropriateness of financial reporting and then makes its recommendations to the Board of Directors. Based on those recommendations, the Board approves the Consolidated Financial Statements and the MD&A.

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

Non-GAAP Measures

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

Additional Information

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

Forward-looking Statements

This MD&A contains forward-looking statements which reflect the Company's current expectations regarding future events. The forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect", "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause results, performance, or

achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in the industry; others are more specific to the Company. Investors should consult the "Risks & Uncertainties" section of this MD&A as well as the Company's ongoing quarterly filings for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. Management assumes no obligation to update or alter any forward-looking statements whether as a result of new information, further events or otherwise.

This MD&A is divided into the following sections:

1. Company Overview

Nature of Our Business

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

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

- Sophisticated tissue repair products for advanced wound care dressings, trauma, and surgical applications
- Superior medical coatings with customized physical properties and infection control
- Unique "IV Clear", "SafeView" and "SurgiClear" transparent antimicrobial silicone-based dressings
- Innovations for potential over-the-counter offerings, antimicrobial consumer products and veterinary applications

Covalon licenses some of our technologies and products to some of the largest medical device companies in the world. Covalon's customers 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 major medical companies and distributors are likely to be impressed with Covalon because of our:

- Respected team of medical researchers and scientists
- Broad footprint of technologies and associated patents and applications
- The ability to rapidly customize Covalon technologies for specific usage
- The ability to achieve rapid medical product differentiation and accelerated time-to-market.
- Flexibility in negotiating licensing terms and structures
- 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

Clients value Covalon's flexible approach for delivering innovative proprietary technologies in a collaborative and rapid manner. Multiple 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, to turnkey product development and technology transfer. Companies leverage Covalon's in-depth knowledge and commercialization success to assist in establishing product specifications, testing of efficacy, microbiology and end product procedures, and file preparation for market approvals. Where appropriate, Covalon

designs a client's product to meet the requirements of the most beneficial billing codes. 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 medical company's process.

Covalon's relationships with contract manufacturing organizations (CMO) provides the Company with additional resources, flexibility and expertise in production, without the burden of substantial committed facilities. Covalon retains the manufacturing capability to make its products at a smaller commercial volume and also has the ability to sub-contract higher volumes to experienced manufacturers.

Business Model

Currently, Covalon does not sell its technologies directly to hospitals, clinics and doctors. Rather, Covalon's technologies are generally licensed to other medical companies and distributors who incorporate them into their own product offerings and then sell them to hospitals, clinics and doctors. This is referred to by the industry as an OEM sales model (original equipment manufacturer) as opposed to a direct sales model.

Our OEM sales model means that the major cost of selling Covalon's technologies is borne by its customers. These customers are typically major medical companies and distributors who employ large sales staff in geographical locations where Covalon does not have staff or offices.

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 from time-to-time exceptions both shorter and longer. On the other hand, once a company invests time and money in choosing Covalon's technology, it is likely to use it for some time to come.

Since deciding to outsource manufacturing to a partner, Covalon has made substantial progress at reducing its operating expenses and cash outflows. Covalon's new strategy is to provide its partners with short-term low-volume manufacturing support in the early stages of product launch. In the longer-term, technology transfers or third-party manufacturing will be the solution to high-volume cost-effective production. Our revenue streams are expected to evolve into royalties or other technology licensing fees.

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

Beyond our already commercialized advanced wound dressing technology, we have solutions that are combinations of natural bio-polymers, including collagen to support our customers' product strategies. Once a potential partner is satisfied with a basic wound dressing prototype from our research and development team, we begin the process of commercializing the product. Once a wound dressing is ready for use in the field, Covalon will have it manufactured and sold to its partner or will license the underlying technology to a distributor or medical product company.

The Company's sales activities are led by William Jackson, Covalon's Chief Business Officer, Chief Financial Officer, Co-Founder and Board Director. Covalon scientific, technology-transfer and regulatory staff are also involved in supporting sales activities. The negotiation of major licenses also involves the participation of Brian Pedlar, Covalon's newly-appointed Chief Executive Officer.

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

2. Covalon's Technologies

The Company's Chief Scientific Officer and Co-Founder is Dr. Val DiTizio. Covalon's accomplished team of scientists hold doctorates in chemistry, biology and physics, and 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

Covalon's staff compliment of 25 is largely comprised of scientists and engineers. Over eight-five percent of our staff hold an advanced academic degree and our commercialization engineers have decades of combined 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. Our technologies address important healthcare issues such as infection control, medical device biocompatibility and healthy tissue repair.

Advanced Dressings and Natural Bio-polymers

Covalon's advanced dressings are essentially collagen-based matrices that can hold and release a variety of materials, and/or allow materials to pass through the matrix. These dressings begin from a collagen base, which is generally bio-compatible with the human body, and enable the release of beneficial materials into the surrounding area and/or enhance the removal of undesirable materials from the surrounding area. Variations in Covalon's underlying formulation yield different rates of release, duration of release and/or size of particles removed. By combining these factors with the many materials that can be embedded in the matrix, Covalon has a broad range of potential applications for this technology.

The Company's initial focus was to develop, get regulatory approval for and sell a series of CMO manufactured silver ion releasing collagen-based wound dressings. This resulted in FDA-approved product lines called ColActive™ and Biostep™ that improve wound care by removing wound bed enzymes that otherwise slow down healing in wounds. The ColActive™ Ag and Biostep™ Ag products add the release of silver into the wound as an antimicrobial agent to further improve the wound healing process. Both of these product lines are marketed and sold through a distribution contract with Smith & Nephew Inc.

The following product families have regulatory approval for sale in the USA and Canada:

Product	Distribution	Launch
ColActive™ Collagen Wound Dressing	Smith & Nephew Inc.	April 2007 US
ColActive Ag™ Collagen with Silver	Smith & Nephew Inc.	April 2007 US
Biostep™	Smith & Nephew Inc.	October 2007 US
Biostep™ Ag	Smith & Nephew Inc.	October 2007 US

BioStep™ received CE approval for the European markets.

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The following list outlines several of our advanced wound dressing applications in active design phase:

- Hemostatic dressing – to stop bleeding in open wounds
- Surgical hemostatic – to control bleeding during surgery
- Antimicrobial collagen film – to prevent infection in surgical or trauma sites
- Antimicrobial ocular dressing – to prevent infection following eye surgery
- Negative pressure wound therapy tissue interface – to prevent infection in treated wounds
- IV Clear – to prevent infection at the point of entry for IV lines into the body
- SafeView – to prevent infection within the surgical filed during surgery
- SurgiClear – to prevent infection at post-operative surgical wound sites
- Drug-eluting dressing – to deliver a pain relief drug at wound site

Specialized Medical Device Coatings

Covalon has developed a patented coating process for medical devices. This process results in a very thin coating on a medical device that will generally be slippery when moistened and can hold and release a variety of therapeutics. That is to say, the device can elute a variety of antimicrobial or other therapeutic agents while in use. Our technology is already proven effective on many polymeric surfaces and is currently being tested and evaluated on other materials.

Through our manufacturing partners, Covalon currently coats Foley Catheters with a silver-based antimicrobial agent for Medline Industries. The product is approved for sale in the USA through Medline Industries and is marketed as the Silvertouch Foley Catheter. The effectiveness of this technology is illustrated through the following study.

In the April 2008 issue of the Society of Urological Nurses and Associates, a study by St. Vincent Rehabilitation Hospital in Sherwood Arkansas, compared infection rates using uncoated Foley catheters and Foley catheters treated with Covalon's ionic silver coating. The study compared numbers and rates of catheter-associated urinary tract infections (CAUTI) from data

they gathered during two periods. The first was a four-month period in 2006 using uncoated Foley catheters. The second was a six-month period using Foley catheters with Covalon's silver coating. The facility discovered ten hospital-acquired CAUTIs during the four-month period using the uncoated catheters. During the six-months of testing using Covalon's silver-coated catheters, the hospital found "no" hospital-acquired CAUTIs.

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

The following list outlines several examples of coating opportunities Covalon evaluates on a regular basis:

- 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
- Infusion set needles – to prevent infections
- Pain management catheter – to deliver pain management drugs
- Surgical wound drain – to prevent infections
- Intra-Ocular delivery device – to create a slippery surface
- Orthopedic devices – to extend the coatings technology to metals

Covalon is continuously evaluating new opportunities for applying its advanced coating technology to new materials, existing products on the market and new products being introduced.

Antimicrobials for Infection Control

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

The combination of antimicrobials allows Covalon to offer customization around customer set specifications. Infection control problems vary across the environment where medical devices, consumer products or wound dressings come into contact with the human body (or animals, in the case of the veterinary market) and there is no one set solution for all problems. Some of the key issues addressed by combining antimicrobials are:

- Antimicrobial activation
- Speed at which it works
- Effectiveness
- Duration of effectiveness
- The kind of microbes being targeted

For example, Covalon antimicrobials 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

Covalon is continually examining new applications for its antimicrobial technology in conjunction with partners who want to enhance existing products or introduce new solutions into their respective markets.

Genetic Regeneration of Damaged Organs and 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 allogeniec 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 the company 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 totaling $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 has recorded a $1,700,350 non-cash charge in the income statement and written off the deferred development cost asset.

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.

Patent Portfolio

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

- *Method of Making Antimicrobial Polymeric Surfaces*
  - patent in USA, EU, Australia, other jurisdictions patent pending
- *Drug Delivery via Therapeutic Hydrogels*
  - patent in USA, Canada, EU and Australia
- *Antimicrobial Photo-stable Coating Composition*
  - USA and International patent applications filed.
- *Non-Adhesive Elastic Gelatin Matrices*
  - USA, EU, Eurasia, Canada and other jurisdictions patent applications filed
- *EPAS1 Gene Transfer to Improve Cell Therapy*
  - USA, EU, Canada, and International patent applications filed
- *Hypoxia inducing factors and uses thereof for inducing Angiogenesis and improving muscular functions*
  - USA, EU and Canada patent applications filed

3. Analysis of Operating and Financial Results

Significant Events for the three and six months ended March 31, 2010

Significant events during the first quarter ended December 31, 2009 include:

- On October 20, 2009 Covalon announced the signing of a License Agreement as well as a Services and Supply Agreement with Bard Access Systems, 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.

Significant events during the second quarter ended March 31, 2009 include:

- 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. Mr. Pedlar was appointed to take over as Chairman of Covalon's Audit Committee.

Significant events since March 31, 2009 include:

- 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.

Financial Highlights for the three and six months ended March 31, 2010

Covalon management is focused on reducing operating losses and becoming cash flow positive on a sustainable basis. Since deciding to outsource manufacturing to a partner, Covalon has made substantial progress at reducing its operating expenses and cash outflows, but was still cash flow negative and incurred an operating loss and net loss for the three month period ended March 31, 2010. Financial highlights for the quarter compared to the same period in the prior fiscal year were:

- Quarterly revenue was $828,525, up 14% and year-to-date revenue increased 49% to $1,623,195;
- Quarterly operating expenses were $685,401, a decline of $1,079,541 or 61% or over the second quarter of 2009;
- Year-to-date operating expenses were $1,467,273, or 55% lower than the first six months of the prior fiscal year. This represents a savings of $1,778,899 of reduced operating expenses;
- Quarterly loss from operations was $282,805, a decrease of 80% or $1,117,937 from the three month period ended March 31, 2010. Year-to-date loss from operations was $621,260 compared to $2,760,342 for the same period in 2009;
- 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. There was no similar non-cash charge in the previous year;

- Loss per share was $0.028 in the second quarter of 2010 compared to $0.018 in the second quarter of 2009. The loss per share for the six months was $0.034 per share this year compared to a loss per share of $0.037 in the same period of the previous year.

(Canadian $)	Three month period ended March 31, 2010	2009	Six month period ended March 31, 2010	2009
Revenue				
Product Sales				
Advanced collagen dressings	**$ 332,501**	$ 207,772	**$ 576,895**	$ 259,941
Specialized medical device coatings	**385,367**	409,676	**824,986**	605,520
Total Product Sales	**717,868**	617,448	**1,401,881**	865,461
Licensing fee	**110,657**	110,657	**221,314**	221,314
Total Revenue	**828,525**	728,105	**1,623,195**	1,086,775
Cost of goods sold				
Product cost of goods sold (Note 15)	**425,929**	363,905	**777,182**	600,945
Gross Profit	**402,596**	364,200	**846,013**	485,830
Operating expense before undernoted items	**685,401**	1,764,942	**1,467,273**	3,246,172
Loss before undernoted	**(282,805)**	(1,400,742)	**(621,260)**	(2,760,342)
Amortization of capital assets	**48,961**	56,675	**103,059**	109,318
Amortization of patents and technology rights	**13,926**	9,529	**28,099**	19,064
Amortization of deferred development costs	**46,217**	29,183	**92,434**	58,366
Write-down of patent	**-**	38,857	**-**	38,857
Loss on disposal of capital asset	**9,290**	-	**9,290**	-
Loss on write-down of deferred development cost	**1,700,350**	-	**1,700,350**	-
Interest income	**(8,615)**	(53,328)	**(18,200)**	(156,825)
Net Loss	**$ (2,092,934)**	$ (1,481,658)	**$ (2,536,292)**	$ (2,829,122)
Loss per share	**$ (0.028)**	$ (0.018)	**$ (0.034)**	$ (0.037)

Product Sales and Gross Profit

Overall Product sales increased by 16% in the three months ended March 31, 2010 compared to the period ending March 31, 2009 and 5% over the first quarter of fiscal 2010. The product sales mix changed from the comparative period as follows;

- 46% of Product sales in the second quarter of 2010 are derived from advanced collagen dressings compared with 34% in the same period of the previous year
- 54% of Product sales in the current period were derived from specialized medical device coatings compared to 66% in the second quarter of 2009.

Gross margin as a percent of Product revenue for Q2 was 56%, compared to 59% in the comparative period. Gross margin as a percent of Product revenue for the first six months was 60%, compared to 56% in the comparative period. Gross margin is highly influenced by product mix between advanced dressings and specialized 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 focusing on cost reductions, improved product mix and the commercialization of new, higher-value dressings.

Starting October 1, 2009, the Company has identified two reportable product segments, Advanced Dressings and Specialized Medical Device Coatings. Product segments have been identified based on the underlying technology of the product. As a result, there is no comparative information for the previous fiscal year's reported periods.

In the second quarter of 2010, product sales from advanced collagen dressings increased by $124,729 over the same period in 2009. This increase is due to higher volume of orders received under contract. Gross profit related to advanced dressings for Q2 was $240,398 or 54% of advanced dressings revenue. There is no comparative information available.

Revenues from year-to-date product sales of specialized medical device coatings were $824,986, an increase of $219,466 from the same period last year. Gross profit related to sales of specialized medical device coatings for the period was $434,555 or 53% of the total specialized medical device coatings revenue. There is no comparative information available. 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 remain unchanged over the three month period ended March 31, 2010 and 2009 and relate to the historic contract from one customer.

Interest Income

Interest income decreased to $8,615 from $53,328 during the second quarter of 2010. The decrease is primarily a result of the reduction in cash and cash equivalents and decreases in interest rates. All investments are made in accordance with the Company's audit committee investment guidelines of investing Covalon's capital in low-risk interest-bearing instruments.

Operating expense

Operating expenses	Three months ended March 31, 2010	2009	Six months ended March 31, 2010	2009
Operations				
Wages and benefits	$ 101,980	$ 342,612	$ 236,380	$ 683,642
Consulting fees	3,720	26,557	7,190	60,677
Other	15,395	66,672	29,929	107,493
Total Operations	$ 121,095	$ 435,841	$ 273,499	$ 851,812
Research and development activities				
Wages and benefits	$ 168,840	$ 254,725	$ 333,194	$ 490,297
Consulting and Outside Testing	6,148	5,912	6,691	44,130
Recovery of redundable investment tax credit	(249,489)	-	(249,489)	-
Other	24,087	30,549	40,796	60,216
Total Research and Development	$ (50,414)	$ 291,186	$ 131,192	$ 594,643
Marketing				
Wages and Benefits	$ 63,000	$ 144,755	$ 115,168	$ 284,253
Travel	18,716	25,562	39,669	43,018
Investor Relations	16,493	44,723	19,675	48,835
Other	1,999	11,798	5,531	18,617
Total Marketing	$ 100,208	$ 226,838	$ 180,043	$ 394,723
General and administrative				
Wages and Benefits	$ 138,647	$ 225,089	$ 265,454	$ 482,522
Director's Compensation	79,582	114,629	119,444	204,930
Advisor expense	58,020	-	138,927	-
Professional Fees	136,030	373,989	141,780	454,701
Facility	41,850	46,444	84,435	88,792
Other	60,383	50,926	132,499	174,048
Total General and Administrative Cost	$ 514,512	$ 811,077	$ 882,539	$ 1,404,994
Total Expense	$ 685,401	$ 1,764,942	$ 1,467,273	$ 3,246,172

Since deciding to outsource manufacturing to a partner, Covalon has made substantial progress at reducing its operating expenses and cash outflows. Management focused on structural cost reductions in the first six months ended March 31, 2010 in an effort to reduce operating expenses and improve cash flow, driven mainly by a change in strategy regarding manufacturing. These reductions now total in excess of $1.5 million on an annualized basis. Following on the improved results of Q4 2009 and Q1 2010, the Q2 2010 financial statements show the continued positive impact of the reductions along with increased revenues.

Compared to Q2 of 2009, operating expenses fell by 61% or $1,079,541, is attributable to the following;

- A reduction of Wages and benefits of approximately $495,000 due to a reduction of approximately 20 staff;
- A reduction in outside consultant and professional fees of approximately $295,000, offset by a non-cash increase in Advisor fees $58,020 which represents the vesting expense related to options granted during fiscal 2009; and
- A recovery of refundable income tax credits in the amount of $249,489.

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.

4. Related Party Transactions

a. During the six month period ended March 31, 2010, the Company paid fees to related parties as follows:

(i) Management fees totaling $221,473 (2009 – $339,676) to two corporations controlled by officers and directors, included in management fees are stock option benefits that have been valued at $21,473 (2009 – $144,676).

(ii) Directors fees include cash compensation of $23,500 (2009 - $78,000) paid to certain of the independent directors and stock option benefits that have been valued at $94,944 (2009 – $119,607).

b. The management fees are paid pursuant to two separate management agreements, expiring August 31, 2010. The commitments for the 2010 fiscal year are $400,000.

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

5. Critical Accounting Estimates

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

Deferred Development Costs

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

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

Stock Based Compensation

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

The Company uses the fair value based method of accounting for all its stock-based compensation. Accordingly, the fair value method of accounting is applied for stock options

granted to directors, officers, employees and consultants whereby the weighted average fair value of options granted is recognized in the financial statements over the vesting period. When the awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to options.

Impairment of Long-Lived 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.

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. In the three month period ended March 31 2009, the Company recognized an impairment loss of $38,857 related to liposome patents not related to the EPAS1 project.

6. 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 Second Quarter	2010 First Quarter	2009 Fourth Quarter	2009 Third Quarter	2009 Second Quarter	2009 First Quarter	2008 Fourth Quarter	2008 Third Quarter
Revenue (1)	$837,140	$804,255	$614,549	$427,376	$781,433	$462,167	$419,721	$467,739
Operating Loss	$283,000	$338,000	$754,000	$1,121,000	$1,400,000	$(1,359,000)	$(1,532,000)	$(539,000)
Net loss	$2,029,934	$443,358	$844,459	$1,201,228	$1,481,658	$1,347,464	$1,608,315	$498,949
Net loss per share	$(0.03)	$(0.01)	$(0.01)	$(0.02)	$(0.02)	$(0.02)	$(0.02)	$(0.01)
Cash and Cash Equivalents	$4,970,623	$5,428,742	$6,036,626	$7,788,427	$9,038,878	$10,817,508	$3,533,544	$13,886,375
Net Working Capital	$5,760,550	$6,132,019	$6,429,103	$7,141,868	$8,482,245	$10,060,370	$12,007,901	$13,652,270
Current Ratio	5.9	6.4	6.0	6.1	6.7	7.6	11.1	17.7

(1) Includes Product Revenue, Licensing Revenue and Interest Income for comparative purpose to prior quarters.

Our quarterly revenue is inherently unpredictable and fluctuates from quarter to quarter depending on the composition of contractual arrangements entered into in each quarter and the level of funded coating and development services undertaken in any period. Average revenues in the first two quarters of the 2010 fiscal year were approximately $821,000 and average quarterly revenues for the past two fiscal years were approximately $595,000.

Operating loss in the second quarter of the 2010 fiscal year was approximately $283,000 compared to the first quarter of approximately $338,000. The average operating loss in the first two quarters of 2010 was $310,500 and the average quarterly operating loss for the past two fiscal years was approximately $915,750. Management intends to continue to manage expenses tightly while focusing on generating increasing revenues though new product introductions and adding new customers in an effort to continue to improve results.

The Current Ratio is a model for measuring the liquidity of the Company by calculating the ratio between all current assets and all current liabilities. It is an indicator of the Company's ability to pay short-term obligations. Current assets includes cash and cash equivalents, short term investments, accounts receivable, refundable investment tax credits, inventories and prepaid expenses. Current liabilities include accounts payable and accrued liabilities and deferred revenue. Net Working Capital is calculated as current assets minus current liabilities. At March 31, 2010, the Company has 5.9 times the current assets needed to pay its current liabilities.

7. Liquidity & Capital Resources

	As at	
(Canadian $)	March 31, 2010	September 30, 2009
Cash and cash equivalents	**$ 4,970,623**	$ 6,036,626
Short-term investments	**$ 500,000**	$ 500,000
Total assets	**$ 10,399,619**	$ 12,867,158
Deferred revenue	**$ 898,443**	$ 1,159,573

Highlights

On March 31, 2010 cash, cash equivalents and short-term investments amounted to $5,470,623. The Company follows a policy of investing its surplus cash resources in high quality, liquid, short-term notes. Cash equivalents as of March 31, 2010 and September 30, 2009 had less than one year to maturity and are cashable without penalty. As at March 31, 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.

As at March 31, 2010, we continued to incur operating cash flow losses. However, over the six month period ended March 31, 2010, the level of operating cash loss has been drastically reduced due to significant operating expense reductions and improved revenues and cash collections. For the quarter-ended March 31, 2010, we incurred a net loss in cash and cash equivalents of $458,119. Were this level of cash shortfall to continue, the Company would have sufficient cash for approximately 12 quarters or 3 years.

Total assets at March 31, 2010 were $10,399,619 compared to $12,867,158 at September 30, 2009. The decline was largely attributable to the $1,700,000 non-cash charge related to EPAS1 deferred development costs. Cash and Cash equivalents comprised almost 48% of total assets at March 31, 2010. Of the remaining assets, the Company's accounts receivable and inventory are fairly liquid with collection periods and turnover ratios in the 60 to 180 day range. The balance of our assets is comprised of capital assets and the Company's intangible assets. These have low liquidity but represent much of the intellectual property assets that are used to generate Covalon's revenue streams.

Deferred revenue decreased by $261,130 to $898,443 at March 31, 2010 from the fiscal year ended September 30, 2009. The reduction in deferred revenue relates to the amortization of

the initial funds received from Smith & Nephew Inc. upon signing its exclusive distribution contract with Covalon and the recognition of technology transfer fee.

Commitments

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

The minimum annual lease payments for the next 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	387,793		208,245
Balance, March 31, 2010	74,691,708	$	29,381,330

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 March 31, 2010, 150,000 shares valued at $213,875 have been released from trust. No shares were released during the six month period ended March 31, 2010.The remaining balance of 950,000 shares is still being held in trust.

During the six month period ended March 31, 2010, 387,793 options to purchase common shares with a value of $91,908 were exercised for cash consideration of $116,337.

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	1,800,000		398,950	$ 0.53
Vested			443,592	$ 1.96
Expired	(19,582)		(33,621)	
Forfeited	(197,920)		(62,984)	
Balance, September 30, 2009	5,270,673		2,347,028	$ 0.91
Granted	955,000		110,010	$ 0.31
Vested			221,716	$ 1.00
Exercised	(387,793)		(91,908)	
Expired	(2,117,462)		(816,100)	
Forfeited	(120,841)		(50,011)	
Balance, March 31, 2010	3,599,577		1,720,735	$ 0.84

Total value of options granted to employees during the six month period ended March 31, 2010 was $23,990 of which $8,031 was recorded as vesting expense.

Total value of options granted to related parties during the six month period ended March 31, 2010 was $222,728 of which $101,979 was recorded as vesting expense.

A total of 387,793 stock options with a value of $91,908 were exercised for common shares with a cash consideration value of $116,337 during the three month period ended December 31, 2009. There were no stock options exercised in the three month period ended March 31, 2010.

During the six month period ended March 31, 2010, a total of 2,117,462 options valued at $816,100 expired and 120,841 options with expiry dates of October 15, 2013, March 31, 2013 and March 4, 2014 and related vesting expense of $50,011 were forfeited.

As at March 31, 2010, 2,029,959 (March 2009 – 3,427,740) options with a weighted average exercise price of $1.03 were available for exercise.

8. Sources and Uses of Cash

	Three month period ended March 31,		Six month period ended March 31,	
	2010	2009	**2010**	2009
Cash Provided By (Used In)				
Operating Activities				
Cash used in operating activities before change in non-cash working capital	**$ (102,534)**	$ (1,150,509)	**$ (318,210)**	$ (2,151,099)
Change in non-cash working capital	**(197,307)**	(311,162)	**(618,725)**	(273,031)
	$ (299,841)	$ (1,461,671)	**$ (936,935)**	$ (2,424,130)
Investing Activities				
Purchase of capital assets, net	**$ (27,603)**	$ (176,757)	**$ (32,968)**	$ (480,821)
Expenditure on deferred development cost	**(109,179)**	(133,945)	**(162,602)**	(646,293)
Purchase of other assets	**(19,132)**	-	**(46,700)**	(30,983)
	$ (155,914)	$ (310,702)	**$ (242,270)**	$ (1,158,097)
Financing Activities				
Net proceeds on issuance of share capital	**$ -**	$ -	**$ 116,337**	$ 21,375
Foreign exchange gain (loss) on cash held	**$ (2,364)**	$ (6,257)	**$ (3,135)**	$ (16,523)
Increase (decrease) in cash and cash equivalents	**$ (458,119)**	$ (1,778,630)	**$ (1,066,003)**	$ (3,577,375)

Operating Activities

Cash used in operating activities during the second quarter of 2010 before change in non-cash working capital was $102,534 compared to $1,150,509 in the same period of the previous year.

Accounts receivable have decreased to $935,440 at March 31, 2010 from $951,099 at December 31, 2009.

Inventories have decreased from the first quarter of 2010 due mostly to increased sales resulting in increased inventory turnover.

Accounts payable and accrued liabilities increased to $698,195 at March 31, 2010 from $610,434 at December 31, 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 $116,337 representing the exercise of 387,793 options during the six month period ended March 31, 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 .75%, 1.5%, 2.5%, 3.5% and 4.5% in each respective year, redeemable every 6 months and maturing on June 21, 2014) and the carrying value approximates fair market value.

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

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

9. Subsequent Event

There were no subsequent events.

10. Risk and Uncertainties

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

Medical Device and Biotechnology companies in the early revenue stage are subject to a number of risks and uncertainties that are inherent to the development of any new technology. General business risks include, among other things, uncertainty in product development and related clinical trials, the regulatory environment including delays or denial of approval to market products, the impact of technological change and competing technologies, the ability to protect and enforce its patent portfolio and intellectual property assets, the availability of capital to finance continued and new product development, the ability to secure strategic collaborators and its reliance on these collaborators for the development, regulatory approval, testing, manufacturing, commercialization and/or distribution of its products and the risk of product liability claims. In addition, market prices for securities of biotechnology companies are generally

volatile, and may or may not move in a manner consistent with the progress being made by such company.

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

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

Covalon cannot predict if profitability will ever be achieved and, if it is, whether or not it will be sustainable on a quarterly or an annual basis. Even if Covalon is not able to successfully further commercialize its products, Covalon believes that it has sufficient capital to fund its business and operations through at least 2010. However, Covalon may need to raise additional capital in the future. Additional financing may not be available, and even if available, may not be on acceptable terms.

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

There can be no assurance that:

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

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

Covalon's intellectual property includes trade secrets and know-how that may not be protected by patents. There can be no assurance that Covalon will be able to protect its trade secrets. To help protect its rights, Covalon requires employees, consultants, advisors and collaborators to enter into confidentiality agreements. These agreements may not adequately protect Covalon's

trade secrets, know-how or other proprietary information in the event of any unauthorized use or disclosure.

Covalon's development programs and products subject it to the risk of product liability claims for which Covalon may not be able to obtain adequate insurance coverage.
Human therapeutic products and medical devices involve the risk of product liability claims and associated adverse publicity. Covalon's principal risks relate to the sales of its products and currently their use in clinical trials. Claims may be made by consumers, healthcare providers, third party strategic collaborators or others selling Covalon's products. There can be no assurance that Covalon will be able to obtain or maintain sufficient and affordable insurance coverage for any of these claims. Without sufficient coverage, any claim, any threat of such a claim or any product withdrawal could seriously harm Covalon's business.

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

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

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

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

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

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

These laws require, among other things:

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

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

Even if some of Covalon's products and manufacturing facilities receive regulatory approval, those products and facilities may still face subsequent regulatory difficulties.
If Covalon receives regulatory approval to sell any of its products, regulatory agencies will limit the approval to certain diseases, conditions or categories of patients who can use them. In addition, regulatory agencies subject a marketed product, its manufacturer and the manufacturer's facilities to ongoing regulatory requirements. Regulatory agencies may also require expensive post-approval studies. Any adverse effects associated with Covalon's products must also be reported to regulatory authorities. If new data are developed, previously unknown adverse experiences with a product occur, deficiencies in Covalon's manufacturing and laboratory facilities are discovered, or it fails to comply with applicable post-market regulatory requirements, a regulatory agency may impose restrictions on that product or on Covalon including the requirement to withdraw the product from the market, close the facility, suspend manufacturing, change the product's label or pay substantial fines.

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

Examples of such issues Include:

- Manufacturing may be prioritized other than as Covalon's customers desires
- Production quality measures may not be achieved
- Sales expectations are not achieved

- New products are not launched expeditiously

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

11. Accounting Policies

Accounting Policies adopted in the 2010 fiscal year

No new accounting policies were implemented the current period.

International Financial Reporting Standards (IFRS)

Background, project structure and project progress

In February 2008, the Canadian Accounting Standards Board ("AcSB") confirmed that Canadian public entities will have to adopt IFRS effective for fiscal years beginning on or after January 1, 2011. The Company will issue consolidated financial statements in accordance with IFRS as issued by the International Accounting Standards Board ("IASB") for the first quarter ended December 31, 2011, with comparative information.

Preliminary Impact Assessment

An impact assessment was completed to analyze potential significant differences between current IFRS and Canadian GAAP as they apply to the Company. 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
- Preliminary training requirements
- A preliminary IFRS Transition Plan (details outlined below)

IFRS Transition Plan

The Company is establishing an IFRS Transition Plan which will include:

- 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 is currently completing an assessment of all IFRS standards. A detailed transition plan will be developed based on this assessment to analyze all IFRS issues. We expect that most issues will be fully analyzed by the third and fourth quarters.

Potential accounting changes as a result of transition to IFRS

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. The list 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 in the table could have a significant impact on the Company's consolidated financial statements.

Presentation & 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. This will be the most significant impact to the Company. Specifically, the increased disclosure requirements will cause the Company to change current processes and implement new financial reporting processes to ensure the appropriate data is collected for disclosure purposes.

Revenue Recognition – We expect to analyze all key contracts review and documented against the requirements of IFRS. At present Management has not determined the impact, if any, on revenue recognition.

Business Combinations - We expect to apply the business combinations exemption in IFRS 1 to not apply IFRS 3 Business Combinations retrospectively to past business combinations. Accordingly, we will not restate business combinations that took place prior to the transition date or modify the carrying amounts arising on business combinations occurring before the transition date.

Share Based Payments - IFRS 2 Share-based Payment only requires recognition of equity instruments in respect of share-based payment transactions granted prior to the transition date. We expect to apply IFRS 2 to equity instruments granted after November 7th, 2002 which have not vested by the transition date.

At this time, Covalon can not quantify the impact of IFRS to its financial statements. The Company is close to 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 2010 and 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 Company is assessing the need for systems upgrades or modifications to ensure an efficient conversion to IFRS. 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, and
- 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.

12. Disclosure Controls and Procedures and Internal Controls over Financial Reporting

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

The Company continues to formalize procedures and control measures that are already in place and to introduce new ones to ensure good evaluation and control practices. As of March 31, 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.