

# Covalon Technologies Ltd.

Consolidated Financial Statements

For the period ended June 30, 2010

(Unaudited)

Contents

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**MANAGEMENT'S COMMENTS ON  
UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

Under National Instrument 51-102, Part 4, subsection 4.3(3) (a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited interim consolidated financial statements of Covalon Technologies Ltd. (the "Company") have been prepared by and are the responsibility of the Company's management. The unaudited interim consolidated financial statements are prepared in accordance with accounting principles generally accepted in Canada and reflect management's best estimates and judgment based on information currently available. The Company's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

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# Covalon Technologies Ltd.

## Consolidated Balance Sheets

As at June 30, 2010 and September 30, 2009  
(Unaudited)

	June 30, 2010	Audited September 30, 2009
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 6,431,954	\$ 6,036,626
Short term investments	500,000	500,000
Accounts receivable	871,729	761,354
Refundable investment tax credits (Note 4)	180,672	-
Inventories (Note 5)	127,415	341,587
Prepaid expenses	52,599	73,516
<b>Total Current Assets</b>	<b>8,164,369</b>	<b>7,713,083</b>
<b>Capital assets</b> (Note 6)	<b>860,655</b>	<b>989,169</b>
<b>Other assets</b> (Note 7)	<b>679,255</b>	<b>655,254</b>
<b>Deferred developments costs</b> (Note 8)	<b>1,833,255</b>	<b>3,509,652</b>
<b>Total Assets</b>	<b>\$ 11,537,534</b>	<b>\$ 12,867,158</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	\$ 1,518,330	\$ 766,364
Deferred revenue (Note 9)	675,981	517,616
<b>Total Current Liabilities</b>	<b>2,194,311</b>	<b>1,283,980</b>
Deferred revenue (Note 9)	1,100,898	641,957
<b>Total Liabilities</b>	<b>3,295,209</b>	<b>1,925,937</b>
<b>Shareholders' Equity</b>		
Share capital (Note 10 (b))	29,381,330	29,173,085
Contributed surplus	1,564,372	362,625
Options (Note 10 (c))	1,421,655	2,347,028
Deficit	(24,125,032)	(20,941,517)
<b>Total Shareholders' Equity</b>	<b>8,242,325</b>	<b>10,941,221</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 11,537,534</b>	<b>\$ 12,867,158</b>

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

# Covalon Technologies Ltd.

## Interim Consolidated Statements of Operations and Comprehensive Loss

For the three and nine months ended June 30, 2010 and June 30, 2009

(Unaudited)

	Three months ended June 30,		Nine months ended June 30,	
	2010	2009	2010	2009
<b>Revenue</b>				
Product and Services				
Advanced collagen dressings	\$ 549,466	\$ 225,027	\$ 1,126,361	\$ 485,465
Specialized medical device coatings	306,398	66,153	1,131,384	671,176
Licensing fee	146,530	110,657	367,844	331,971
Total revenue	<b>1,002,394</b>	401,837	<b>2,625,589</b>	1,488,612
<b>Cost of Goods Sold</b>				
Product cost of goods sold (Note 16)	<b>573,103</b>	289,109	<b>1,350,285</b>	890,054
<b>Gross Profit</b>	<b>429,291</b>	112,728	<b>1,275,304</b>	598,558
<b>Operating Expense</b>				
Operations	124,807	389,051	398,306	1,240,863
Research and development activities	272,292	217,032	652,973	811,675
Recovery of refundable investment tax credit (Note 4)	(180,672)	-	(430,161)	-
Marketing	119,132	104,727	299,175	499,450
General and administrative	411,038	522,411	1,293,577	1,927,402
	<b>746,597</b>	1,233,221	<b>2,213,870</b>	4,479,390
<b>Loss before undernoted</b>	<b>317,306</b>	1,120,493	<b>938,566</b>	3,880,832
Amortization of capital assets	49,133	55,608	152,192	164,927
Amortization of patents and technology rights	14,042	21,493	42,141	40,559
Amortization of deferred development costs	46,217	29,173	138,651	87,539
Loss on disposal of capital asset	-	-	9,290	-
Write-down of patent	-	-	-	38,857
Write-down of deferred development costs (Note 8)	-	-	1,700,350	-
Settlement Pay	242,178	-	242,178	-
Interest income	(21,653)	(25,539)	(39,853)	(182,364)
<b>Net loss and comprehensive loss for the period</b>	<b>\$ 647,223</b>	\$ 1,201,228	<b>\$ 3,183,515</b>	\$ 4,030,350
<b>Basic and diluted loss per share (Note 10 (d))</b>	<b>\$ (0.009)</b>	\$ (0.016)	<b>\$ (0.043)</b>	\$ (0.055)

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

# Covalon Technologies Ltd.

## Interim Consolidated Statements of Cash Flows

For the three and nine months ended June 30, 2010 and 2009  
(Unaudited)

	Three months ended		Nine months ended	
	June 30,		June 30,	
	2010	2009	2010	2009
<b>Cash flows from operating activities</b>				
Loss and comprehensive loss for the period	\$ (647,223)	\$ (1,201,228)	\$ (3,183,515)	\$ (4,030,350)
Add (deduct) items not involving cash:				
Amortization of capital assets	49,133	55,608	152,192	164,927
Amortization of patent and technology rights	14,042	21,493	42,141	40,559
Amortization of deferred development costs	46,217	29,173	138,651	87,539
Write-down of patents	-	-	-	38,857
Write-down of deferred development costs (Note 8)	-	-	1,700,350	-
Loss on disposal of capital asset	-	-	9,290	-
Stock compensation expense	86,567	150,663	368,282	586,559
Foreign exchange loss (gain) on cash held	(5,702)	33,191	(2,567)	49,672
Cash provided by operating activities before change in non-cash working capital balances	(456,966)	(911,100)	(775,176)	(3,062,237)
Change in non-cash working capital (Note 15)	1,932,038	(20,727)	1,313,313	(293,762)
	<b>1,475,072</b>	<b>(931,827)</b>	<b>538,137</b>	<b>(3,355,999)</b>
<b>Cash flows from investing activities</b>				
Purchase of capital assets	-	(171,440)	(32,968)	(652,261)
Expenditure on deferred development costs	-	(88,509)	(162,602)	(734,802)
Purchase of other assets	(19,443)	(25,484)	(66,143)	(56,467)
	<b>(19,443)</b>	<b>(285,433)</b>	<b>(261,713)</b>	<b>(1,443,530)</b>
<b>Cash flows from financing activities</b>				
Net proceeds on issuance of share capital of share capital (Note 10(b))	-	-	116,337	21,375
Foreign exchange gain (loss) on cash held	5,702	(33,191)	2,567	(49,672)
<b>Net Change in cash and cash equivalents during the period</b>	<b>1,461,331</b>	<b>(1,250,451)</b>	<b>395,328</b>	<b>(4,827,826)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>4,970,623</b>	<b>9,038,878</b>	<b>6,036,626</b>	<b>12,616,253</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 6,431,954</b>	<b>\$ 7,788,427</b>	<b>\$ 6,431,954</b>	<b>\$ 7,788,427</b>
Represented by				
Cash	\$ 1,550,405	\$ 631,958	\$ 1,550,405	\$ 631,958
Cash equivalents	4,881,549	7,156,469	4,881,549	7,156,469
	<b>\$ 6,431,954</b>	<b>\$ 7,788,427</b>	<b>\$ 6,431,954</b>	<b>\$ 7,788,427</b>

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

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

For the nine months ended June 30, 2010 and year ended September 30, 2009

	Share Capital		Contributed Surplus	Options	Deficit	Total
	Number of Shares	Amount				
<b>Balance, September 30, 2008</b>	74,303,915	\$ 29,151,710	\$ 329,004	\$ 1,601,091	\$ (16,066,708)	\$ 15,015,097
Issue of common shares to Perfusion Therapeutics Inc. Issued in trust	75,000 (75,000)	21,375				21,375
Stock based compensation				779,558		779,558
Expired options			33,621	(33,621)		-
Net loss and comprehensive loss					(4,874,809)	(4,874,809)
<b>Balance, September 30, 2009</b>	74,303,915	29,173,085	362,625	2,347,028	(20,941,517)	10,941,221
Issue of common shares for cash pursuant to the exercise of stock options	387,793	208,245		(91,908)		116,337
Stock based compensation				368,282		368,282
Expired options			1,201,747	(1,201,747)		-
Net loss and comprehensive loss					(3,183,515)	(3,183,515)
<b>Balance, June 30, 2010</b>	74,691,708	\$ 29,381,330	\$ 1,564,372	\$ 1,421,655	\$ (24,125,032)	\$ 8,242,325

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

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## Covalon Technologies Ltd. Summary of Significant Accounting Policies

**June 30, 2010 and September 30, 2009**

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Nature of Business	<p>The Company is incorporated under the laws of Ontario and is engaged in the business of developing, licensing and selling medical technologies. The Company has now received regulatory approval on numerous products and is currently generating revenue. The Company has adopted a business model that contracts the manufacturing and distribution of its commercialized products through partners. The Company generates its revenues through development contracts, licensing agreements and distribution contracts and sales. Commencing October 1, 2009, the Company has identified two reportable segments which are advanced dressings and specialized medical device coatings.</p>
Going Concern	<p>Covalon is considered to be a going concern and as such, no provisions are made for the valuation of assets or the cost to discharge liabilities, other than in the normal course of operations. The Company has an accumulated deficit of \$24.1 million. The Company's ability to continue as a going concern will depend on management's ability to successfully execute its business plan and achieve profitable operations.</p>
Basis of Consolidation	<p>These consolidated financial statements include the accounts of the Company and its wholly owned subsidiary and have been prepared using the purchase method of consolidation. The assets and liabilities of the acquired companies are initially recorded at cost. The results of operations of the acquired companies are included from the dates of acquisition. All significant intercompany transactions and balances have been eliminated on consolidation.</p>
Use of Estimates	<p>The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from management's best estimate as additional information becomes available in the future.</p> <p>Significant estimates made by management include useful lives of long-lived assets, expected future cash flows used in evaluating long-lived assets for impairment and recoverability and annual volatility used in estimating the fair values of stock-based compensation. Management reviews its estimates periodically and any adjustment is reported in the year in which it becomes known.</p>

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**Covalon Technologies Ltd.**  
**Summary of Significant Accounting Policies**

**June 30, 2010 and September 30, 2009**

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

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## Covalon Technologies Ltd. Summary of Significant Accounting Policies

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June 30, 2010 and September 30, 2009

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Investment Tax Credits	Investment tax credits arising from qualifying research and experimental development costs are recorded in the period in which these tax credits are considered reasonably assured to be recovered.
Future Income Tax	The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in operations in the year in which the change occurs.
Foreign Currency Translation	<p>Foreign currency accounts are translated into Canadian dollars as follows:</p> <p>At the transaction date, each asset, liability, revenue and expense is translated into Canadian dollars by an estimate of the exchange rate in effect at that date. At the reporting date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate currently in effect. The resulting foreign exchange gains and losses are included in income in the current period. Included in General and Administrative costs are foreign exchange gains/(losses) of \$22,487 (2009 – (\$49,672)).</p>
Financial Instruments	<p>The Company's cash and cash equivalents are classified as held for trading and measured at fair value. Short-term investments are classified as held for trading and measured at fair value. Subsequent changes in fair value are recorded to net income or loss. Accounts receivable are classified as loans and receivables and are initially measured at fair value; subsequently measured at their amortized cost using the effective interest rate method. Accounts payable and accrued liabilities are classified as other liabilities and are initially measured at fair value, subsequently measured at their amortized cost using the effective interest rate method. The fair values of the financial assets and liabilities that are included in the balance sheet approximate their fair value due to their short term nature.</p> <p>Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments. The Company is exposed to currency risk arising from fluctuations in foreign exchange rates and the degree of volatility in those rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.</p> <p>Short term investments consists of Ontario Savings Bonds (step up interest rates of .75%, 1.5%, 2.5%, 3.5% and 4.5% in each respective year, redeemable every 6 months and maturing on June 21, 2014) and the carrying value approximates fair market value.</p>

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**Covalon Technologies Ltd.**  
**Summary of Significant Accounting Policies**

**June 30, 2010 and September 30, 2009**

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Financial Instruments (cont'd)	All of the Company's cash is maintained by one of the major financial institutions.
Stock Based Compensation	<p>Direct awards of stock are based on the price of common stock measured at fair value at the date of grant and the corresponding expense is recognized in the statement of operations.</p> <p>The Company uses the fair value based method of accounting for all its stock-based compensation. Accordingly, the fair value method of accounting is applied for stock options granted to directors, officers, employees and consultants whereby the weighted average fair value of options granted is recognized in the financial statements over the vesting period. When the awards are exercised, share capital is credited by the sum of the consideration paid together with the related portion previously credited to options.</p>
Loss per Common Share	Loss per common share has been computed by dividing the loss applicable to common shareholders by the weighted average number of shares of common stock outstanding during the respective periods. Diluted loss per common share is computed using the weighted average number of common and potential common shares outstanding during the period. Potential common shares consist of the incremental common shares issuable upon the exercise of stock options and warrants under the treasury stock method.
Impairment of Long-Lived Assets	An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes the assets' carrying value to exceed the reasonably estimated 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 the nine month period ended June 30, 2010, impairment charges of \$1,700,350 (2009 – \$38,857) were recorded.

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# Covalon Technologies Ltd.

## Notes to Unaudited Consolidated Financial Statements

June 30, 2010 and September 30, 2009

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### 1. FINANCIAL RISK MANAGEMENT

#### Risk factors

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

#### Credit risk

The Company's cash and cash equivalents does not subject the Company to significant credit risk. The Company has investment savings accounts and provincial bonds, as per its practice of protecting its capital rather than maximizing investment yield, of \$4.9 million invested with two issuers; however, this risk is mitigated as the issuers are a major Canadian bank and the Province of Ontario.

The Company, in the normal course of business, is exposed to credit risk from its global customers in the medical device industry. The accounts and other receivable are subject to normal industry risks in each geographic region in which the Company operates. The Company attempts to manage these risks by dealing with creditworthy customers; however, due to the limited number of potential customers in each market this is not always possible. As at June 30, 2010, four customers accounted for 93% (September 2009 – three customers for 83%) of the accounts receivable balance. These customers, who are distributors and partners of the Company, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers. The Company has not had a history of bad debts and as such management has not recorded a significant allowance.

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

	June 2010	September 2009
Current	<b>\$418,050</b>	\$215,679
31-60 days past due	<b>57,525</b>	91,121
Over 60 days past due	<b>396,154</b>	454,554
	<b>\$871,729</b>	\$761,354

#### Liquidity risk

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

#### Interest rate risk

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

#### Currency risk

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

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**Covalon Technologies Ltd.**  
**Notes to Unaudited Consolidated Financial Statements**  
**June 30, 2010 and September 30, 2009**

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**1. FINANCIAL RISK MANAGEMENT** (continued)

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

	<u>June</u> <u>2010</u>	<u>September</u> <u>2009</u>
Accounts receivable	\$ 826,843	\$ 734,659
Accounts payable	377,591	127,018
Cash	1,478,235	58,112
Exchange rate (\$USD / \$CAD)	1.0646	1.0707

**Commodity risk**

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

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**2. MANAGEMENT OF CAPITAL**

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

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

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

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**3. FUTURE ACCOUNTING PRONOUNCEMENTS**

***International financial reporting standards (IFRS)***

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

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

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## Covalon Technologies Ltd.

### Notes to Unaudited Consolidated Financial Statements

June 30, 2010 and September 30, 2009

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#### 4. REFUNDABLE INVESTMENT TAX CREDITS

The Company is eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% refundable in cash to the Company. The refundable tax credits received by the Company are subject to review by Canada Revenue Agency and the Ontario Ministry of Finance. The Company has received confirmation from the Canada Revenue Agency and the Ontario Ministry of Finance that OITC's for the fiscal year ended 2008 in the amount of \$180,672 will be refunded to the Company. During the three months ended June 30, 2010, the Company received payments totaling \$249,489 for the fiscal years ended 2005, 2006 and 2007.

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#### 5. INVENTORIES

Inventories consist of the following:

	June 30, 2010	Audited September 30, 2009
Raw materials	\$ 111,358	\$ 210,142
Finished Goods	16,057	131,445
	<u>\$ 127,415</u>	<u>\$ 341,587</u>

Cost of goods sold includes \$1,106,345 in inventoried materials in 2010 (June 2009 - \$607,104).

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#### 6. CAPITAL ASSETS

	June 30, 2010		Audited September 30, 2009	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 423,591	\$ 178,056	\$ 425,051	\$ 136,863
Lab equipment	1,264,892	649,772	1,240,791	544,989
Leasehold improvements	71,416	71,416	71,416	66,237
	<u>1,759,899</u>	<u>899,244</u>	1,737,258	748,089
Cost less accumulated amortization		<u>\$ 860,655</u>		<u>\$ 989,169</u>

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**Covalon Technologies Ltd.**

**Notes to Unaudited Consolidated Financial Statements**

**June 30, 2010 and September 30, 2009**

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**7. OTHER ASSETS**

	<b>June 30, 2010</b>	Audited September 30, 2009
Patents and technology rights	<b>\$ 952,089</b>	\$ 929,328
Less: Accumulated amortization	<b>272,834</b>	236,567
	<b>679,255</b>	692,761
Less: Write down (net of \$Nil accumulated amortization; Sep 2009 - \$5,874)	-	37,507
	<b>\$ 679,255</b>	\$ 655,254

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**8. DEFERRED DEVELOPMENT COSTS**

	<b>June 30, 2010</b>	Audited September 30, 2009
Cost	<b>\$ 4,134,415</b>	\$ 3,971,813
Less: accumulated amortization	<b>600,810</b>	462,161
	<b>3,533,605</b>	3,509,652
Less: Write-down (net of \$Nil accumulated amortization; September 2009 - \$Nil)	<b>1,700,350</b>	-
	<b>\$ 1,833,255</b>	\$ 3,509,652

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

The related patents in the amount of \$236,791 net have not been written down because the Company continues to believe that the patents still have value.

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**Covalon Technologies Ltd.**

**Notes to Unaudited Consolidated Financial Statements**

**June 30, 2010 and September 30, 2009**

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**9. DEFERRED REVENUE**

In fiscal 2007, the Company received an initial exclusivity payment of Cdn. \$2,321,200. The Company has recorded the exclusivity payment as deferred revenue and is recording this licensing fee revenue monthly over the five year term of the agreement. Related costs have been offset against deferred revenue.

During the year ended September 30, 2009, the Company recorded an up front technology transfer services fee as deferred revenue of Cdn. \$74,949. During the period ended June 30, 2010, \$44,500 was recognized as revenue. The Company received upfront payments totaling Cdn. \$1,029,650 during the three month period ending June 30, 2010.

	<b>June 30, 2010</b>	Audited September 30, 2009
Balance, beginning of period	\$ 1,159,573	\$ 1,527,251
Add:		
Up front payment	1,029,650	74,949
Less:		
Technology transfer fee recognized	(44,500)	-
Amortization of license and supply agreements	(367,844)	(442,627)
Balance, end of period	1,776,879	1,159,573
Amount to be recognized within one year	(675,981)	(517,616)
Long term balance	<b>\$ 1,100,898</b>	<b>\$ 641,957</b>

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**Covalon Technologies Ltd.**  
**Notes to Unaudited Consolidated Financial Statements**

**June 30, 2010 and September 30, 2009**

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**10. SHARE CAPITAL**

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

**b) Issued – Common shares**

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

During the nine month period ended June 30, 2010, 387,793 options to purchase common shares with a value of \$91,908 were exercised for cash consideration of \$116,337.

At June 30, 2010, 1,123,101 (September 2009 – 3,369,302) shares are held in escrow.

**c) Stock Option Plan**

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

**Covalon Technologies Ltd.**  
**Notes to Unaudited Consolidated Financial Statements**

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**10. SHARE CAPITAL (continued)**

	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	855,000	171,439	\$ 0.31
Granted to employees	100,000	12,064	\$ 0.29
Vested to related parties		66,412	\$ 1.87
Vested to consultants		180,303	\$ 0.50
Vested to employees		35,812	\$ 1.82
Exercised	(387,793)	(91,908)	
Expired	(2,827,039)	(1,201,747)	
Forfeited	(154,177)	(97,748)	
Balance, June 30, 2010	2,856,664	\$ 1,421,655	\$ 0.74

Range of Exercise Prices	Number of Options Outstanding	Weighted Average Exercise Price \$	Weighted Average Remaining Contractual Life (years)
\$0.23 - \$0.50	2,155,000	0.36	4.19
\$0.56 - \$0.75	300,000	0.75	1.29
\$1.54 - \$2.79	401,664	2.79	2.75
	2,856,664	0.74	3.69

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**Covalon Technologies Ltd.**  
**Notes to Unaudited Consolidated Financial Statements**

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**10. SHARE CAPITAL** (continued)

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

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

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

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

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

During the nine month period ended June 30, 2010, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 2.45%, dividend rate NIL, average volatility – 123% and a term of 5 years.

Total value of 100,000 options granted to employees during the nine month period ended June 30, 2010 was \$23,990 of which \$12,064 was recorded as vesting expense.

Total value of 855,000 options granted to related parties during the nine month period ended June 30, 2010 was \$222,728 of which \$171,439 was recorded as vesting expense.

387,793 stock options with a value of \$91,908 were exercised for common shares a cash consideration of \$116,337 during the nine month period ended June 30, 2009.

During the nine month period ended June 30, 2010, 2,827,039 options valued at \$1,201,747 expired and 154,177 options with expiry dates of October 15, 2013, March 31, 2013 and March 4, 2014 and related vesting expense of \$97,748 were forfeited.

As at June 30, 2010, 1,728,707 (June 2009 – 3,699,399) options with a weighted average exercise price of \$0.86 were available for exercise.

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**Covalon Technologies Ltd.**  
**Notes to Unaudited Consolidated Financial Statements**

**June 30, 2010 and September 30, 2009**

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**10. SHARE CAPITAL** (continued)

**(d) Loss per Share**

Loss per share is calculated using the weighted average number of common shares outstanding during the nine month period ended June 30, 2010, which is 74,572,387 (2009 – 73,316,415) shares. As the Company experienced losses for the periods ended June 30, 2010 and 2009, all potential common shares outstanding from dilutive securities are considered anti-dilutive and are excluded from the calculation of loss per share for those years.

Details of anti-dilutive potential securities outstanding not included in diluted EPS calculations at June 30, 2010 and 2009 are as follows:

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Anti-dilutive potential securities	2010	2009
Common shares potentially assumable:		
- under stock options	<u>2,856,664</u>	<u>5,355,257</u>

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**11. RELATED PARTY TRANSACTIONS**

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

- (i) Management fees totaling \$309,346 (2009 – \$473,043) currently paid to two corporations controlled by officers and directors. Included in management fees for the nine month period ending June 30, 2010 is a net reversal of stock option benefits of \$11,614 resulting from the forfeiture of 33,336 options, (stock option benefit for the nine month period ending June 30, 2009 was \$178,043).
- (ii) Directors fees include cash compensation of \$23,500 (2009 - \$110,500) paid to certain of the directors and stock option benefits that have been valued at \$171,390 (2009 – \$147,902). The directors have 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 by the related parties.

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**Covalon Technologies Ltd.**  
**Notes to Unaudited Consolidated Financial Statements**

**June 30, 2010 and September 30, 2009**

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**12. COMMITMENTS**

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

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

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

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

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**13. CONTINGENCIES**

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

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**14. SUPPLEMENTAL CASH FLOW INFORMATION**

For the nine months ending June 30,	<u>2010</u>	<u>2009</u>
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**Non-Cash Financing and Investing**

Issuance of shares for technology rights	\$ -	\$ 21,375
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**Covalon Technologies Ltd.**  
**Notes to Unaudited Consolidated Financial Statements**

**June 30, 2010 and September 30, 2009**

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**15. CHANGE IN NON-CASH OPERATING WORKING CAPITAL ITEMS**

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

	For the three months ended June 30,		For the nine months ended June 30,	
	<b>2010</b>	2009	<b>2010</b>	2009
Accounts receivable	\$ 63,711	\$ 288,273	\$ (110,375)	\$ (33,648)
Inventory	62,948	87,020	214,172	(92,638)
Prepaid expenses	37,991	(34,656)	20,917	(33,648)
Refundable investment tax credit	68,817	-	(180,672)	-
Accounts payable and accrued liabilities	820,135	(250,707)	751,965	198,144
Deferred revenue	878,436	(110,657)	617,306	(331,972)
	<u>\$ 1,932,038</u>	<u>\$ (20,727)</u>	<u>\$ 1,313,313</u>	<u>\$ (293,762)</u>

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**16. SEGMENTED INFORMATION**

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. Assets and other operating expenses are not allocated by reportable segment for internal reporting purposes and therefore have not been presented.

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## Covalon Technologies Ltd.

### Notes to Unaudited Consolidated Financial Statements

**June 30, 2010 and September 30, 2009**

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#### 16. SEGMENTED INFORMATION (continued)

Information on product segments is as follows:

For the three and nine months ended June 30, 2010

	Three months ended June 30, 2010			Nine months ended June 30, 2010		
	Advanced Collagen Dressings	Specialized Medical Device Coatings	Total	Advanced Dressings	Specialized Medical Device Coatings	Total
	\$	\$	\$	\$	\$	\$
Product and Services	549,466	306,398	855,864	1,126,361	1,131,384	2,257,745
Licensing Fee	112,169	34,361	146,530	333,483	34,361	367,844
	<u>661,635</u>	<u>340,759</u>	<u>1,002,394</u>	<u>1,459,844</u>	<u>1,165,745</u>	<u>2,625,589</u>
Cost of goods sold	<u>381,949</u>	<u>191,154</u>	<u>573,103</u>	<u>768,700</u>	<u>581,585</u>	<u>1,350,285</u>
Segment earnings before the following	279,686	149,605	429,291	691,144	584,160	1,275,304
Operations			124,807			398,306
Research and development activities			272,292			652,973
Recovery of refundable investment tax credit			(180,672)			(430,161)
Marketing			119,132			299,175
General and administrative			411,038			1,293,577
Amortization of capital assets			49,133			152,192
Amortization of patents and technology rights			14,042			42,141
Amortization of deferred development costs			46,217			138,651
Loss on disposal of capital asset			-			9,290
Write-down of deferred development cost			-			1,700,350
Settlement pay			242,178			242,178
Interest income			(21,653)			(39,853)
Net loss for the period			<u>(647,223)</u>			<u>(3,183,515)</u>

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

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

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**Covalon Technologies Ltd.**  
**Notes to Unaudited Consolidated Financial Statements**

**June 30, 2010 and September 30, 2009**

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**17. COMPARATIVE FIGURES**

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