

COVALON TECHNOLOGIES LTD.

MANAGEMENT'S DISCUSSION & ANALYSIS

For the three and nine month periods ended June 30, 2010

August 19, 2010

The following discussion of Covalon Technologies Ltd.'s ("Covalon" or the "Company") financial condition and results of operations should be read in conjunction with our audited consolidated financial statements for the year ended September 30, 2009, and our unaudited financial statements with related notes for the three and nine month period ended June 30, 2010. We have prepared these financial statements according to Canadian generally accepted accounting principles ("GAAP").

Management's Responsibility for Financial Reporting

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

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

Non-GAAP Measures

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

Additional Information

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

Forward-looking Statements

This MD&A contains forward-looking statements, which reflect the Company's current expectations regarding future events. The forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect", "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These forward-looking statements involve risk and

uncertainties, including the difficulty in predicting product approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in the industry; others are more specific to the Company. Investors should consult the “Risks & Uncertainties” section of this MD&A as well as the Company’s ongoing quarterly filings for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. Management assumes no obligation to update or alter any forward-looking statements whether as a result of new information, further events or otherwise.

Company Overview

Nature of Our Business

Covalon Technologies Ltd. is a unique public medical technologies company that researches, patents, develops and commercializes advanced medical technologies that improve patient outcomes and saves lives. Our 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, drug delivery capabilities and infection control;
- Unique transparent antimicrobial silicone based dressings with antimicrobials embedded in the silicone adhesive;
- Innovations for potential over-the-counter offerings, antimicrobial consumer products and veterinary applications.

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

Covalon licenses its technologies and products to some of the largest medical device companies in the world. Covalon's clients include:

- C.R. Bard, Inc. a leader in vascular access devices;
- Medline Industries, Inc., a leading device and patient care distributor;
- Smith and Nephew Inc., a leader in wound care products;
- CareFusion Corporation, a leading specialty medical device manufacturer;
- Amsino International, Inc., a major contract manufacturer.

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

- Knowledgeable team of medical researchers, scientists and engineers;
- Broad footprint of technologies and associated patents and applications;
- Rapid customization of technologies for specific applications with accelerated time-to-market;
- Flexibility in structuring licensing and technology transfer arrangements;

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

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

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

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

Business Model

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

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

In Q4 of 2009, Covalon decided to outsource large-scale manufacturing to experienced manufacturing partners. This has allowed the Company to reduce its operating expenses and cash outflows substantially. Our new strategy provides our partners with short-term low-volume manufacturing support during the early stages of product launch. In the longer-term, high-volume cost-effective production is facilitated through technology transfers to our clients or third party manufacturers. Covalon expects its revenue streams to evolve into royalties or other technology licensing fees.

While each relationship we establish with our clients is generally unique, our OEM sales model usually involves the some or all of the following steps:

- Feasibility study;
- Product prototype;
- Development agreement for a fully validated production-ready process that is used to gain regulatory approval;
- Regulatory services on an as-needed basis to gain regulatory approval;
- Manufacturing or licensing contract to bring a product to the market;
- Out-sourcing of large-scale manufacturing to a certified Contract Manufacturing Organization.

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

Our Technologies

Covalon's accomplished team of scientists individually are recognized in the medical industry as experts in:

- Customized medical device coatings;
- Antimicrobial and infection control technologies;
- Accelerated tissue healing and regenerative technologies;
- Advanced drug delivery technologies and many other areas.

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

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

Advanced Dressings and Natural Bio-polymers

Covalon's advanced dressing technologies are essentially collagen-based substances that can hold and release a variety of materials, and/or allow materials to pass through the dressing. These dressings begin from a collagen base, which is generally biocompatible with the human body, and enable the release of beneficial materials, such as antimicrobials, into the wound site and/or enhance the removal of undesirable materials, such as wound exudates from the wound. Variations in Covalon's basic formulation will yield different rates of release, duration of release and/or size of particles removed. By combining these characteristics with the many materials

that can be added to the dressing, Covalon has a broad range of potential applications for this technology.

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

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

Product	Launch
ColActive™ Collagen Wound Dressing	April 2007 US
ColActive Ag™ Collagen with Silver	April 2007 US
BIOSTEP™	October 2007 US
BIOSTEP™ Ag	October 2007 US

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

Covalon's additional wound care applications combine biocompatible materials with a variety of therapeutics to address specific needs in the wound care market. The list below outlines several of Covalon's technologies 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 and allow treatment access following eye surgery
- Negative pressure wound therapy tissue interface – to assist in rapid closure of difficult to heal wounds
- IV Clear – to prevent infection at the point of entry for IV lines into the body
- SafeView – to prevent infection within the surgical site during surgery
- SurgiClear – to prevent infection at post-operative surgical wound sites
- Drug-eluting dressing – to deliver a pain relief drug at the wound site

Specialized Medical Device Coatings

Covalon developed a patented coating process for medical device implants, one of the fastest growing segments of the medical device industry. The Company has focused on two areas in this market, which include; 1) devices that are designed to enter the body for a limited period of time; and 2) devices that are designed to be implanted in the body forever. Many of these life-

saving devices, when left uncoated, can carry a high risk of medical device failure due to biocompatibility issues between a patient and the medical device.

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

These proprietary processes and enhanced coatings with specific characteristics may include:

- Lubricity (slippery when wet)
- Antimicrobial activity
- Hemocompatibility
- Biocompatibility (to prevent tissue encrustation)
- Controlled release of therapeutics (drug elution)
- Thin or thick coatings

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

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

Antimicrobials for Infection Control

Covalon is known for novel photo-stable silver ion antimicrobial technology, which is used in both wound dressings and coatings for medical devices. Our expertise is now being used to develop other unique antimicrobial solutions that target a number of infection control issues. Covalon maintains a fully equipped research and development lab with top research scientists that work at characterizing different combinations of antimicrobial agents that are extensively performance tested in its in-house microbiology lab.

These new antimicrobial combinations allow us to offer customization around customer set specifications. Infection control problems vary for medical devices, consumer products or wound dressings that come into contact with the human body (or animals, in the case of the veterinary

market). There is no one set solution for all problems. Some of the key issues addressed by combining antimicrobials are:

- Speed at which it works
- Effectiveness
- Duration of effectiveness
- Species of microbes being targeted

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

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

Covalon is assessing new applications for its antimicrobial technology 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 allogeneic stem cells or no stem cells.

Management believes it would require significant financial investments in further studies to advance the medical application of EPAS1 in human heart regeneration treatments and then

bring the perfected technology to the commercial market. While Covalon intends to pursue other potential funding sources, commercialization partners and medical applications of the underlying intellectual property, management has determined that it is not prudent to continue further pre-clinical research studies in the technology, without proper funding.

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

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

Patent Portfolio

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

- *Method of Making Antimicrobial Polymeric Surfaces*
 - patent in USA, EU, Australia, other jurisdictions patent pending
- *Drug Delivery via Therapeutic Hydrogels*
 - patent in USA, Canada, EU and Australia
- *Antimicrobial Photo-Stable Coating Composition*
 - USA and International patent applications filed.
- *Non-Adhesive Elastic Gelatine Matrices*
 - USA, EU, Eurasia, Canada and other jurisdictions patent applications filed
- *EPAS1 Gene Transfer to Improve Cell Therapy*
 - USA, EU, Canada, and International patent applications filed
- *Hypoxia Inducing Factors and Uses Thereof for Inducing Angiogenesis and Improving Muscular Functions*
 - USA, EU and Canada patent applications filed
- *Self Reinforced Membrane*
 - USA patent application filed
- *Antimicrobial Silicone Wound Dressings*
 - USA patent application filed

Analysis of Operating and Financial Results

Significant Events for the three months and nine months ended June 30, 2010

Significant events during the first half of fiscal 2010 included:

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

Significant events during the third quarter ended June 30, 2010 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. The parties have reached an agreement whereby Dr. DiCosmo will receive payment equivalent to one year's compensation payable over twelve months commencing June 15, 2010.

- On June 15, 2010, Covalon announced a multi-year expanded agreement with an affiliate of C. R. Bard, Inc. that allows the use of Covalon's proprietary coating technology in an additional area of Bard's products. This agreement entailed an upfront payment of \$500,000 and future royalty payments.
- On June 22, 2010, Covalon announced a multi-year agreement with one of the largest manufacturers and distributors of health care supplies and services in the U.S. The agreement allows the client to use Covalon's proprietary coating technology specifically on one of its products in return for an upfront payment of US\$500,000 and future royalty payments.
- On June 29, 2010, Covalon announced that it had received funding of approximately \$150,000 from the National Research Council of Canada Industrial Research Assistance Program (NRC-IRAP) for the commercialization of an antimicrobial coating for orthopaedic devices made of metal.

Financial Highlights for the three months and nine months ended June 30, 2010

Covalon management continues to make substantial progress in its focus on reducing operating losses and becoming cash flow positive on a sustainable basis. At the end of the prior year, Covalon changed its strategy to outsource large-scale manufacturing to third parties. Since the change in management, we now focus on licensing our technologies to partners earlier in the product development cycle. As a result, Covalon has increased revenues and reduced its operating expenses and cash outflows. Financial highlights for the quarter compared to the same period in the prior fiscal year were:

- Quarterly revenue reached \$1,002,394, up 150% and year-to-date revenue increased 76% to \$2,625,589;
- Quarterly operating expenses before amortization were \$746,597, a significant reduction of \$486,624 or 39% over the third quarter of 2009;
- Year-to-date operating expenses before amortization were significantly lower by 51% or \$2,213,870 compared to \$4,479,390 for the first nine months of the prior fiscal year;
- Quarterly loss from operations before amortization improved to \$317,306, representing a decrease of 72% or \$803,187 from the three month period ended June 30, 2009. Year-to-date loss from operations before amortization was also improved at \$938,566 compared to \$3,880,832 for the corresponding period in 2009;
- Loss per share was \$0.009 in the third quarter of 2010 compared to \$0.016 in the corresponding period of 2009. Loss per share for the nine month periods of 2010 and 2009 were \$0.043 and \$ 0.055 respectively;
- The Company's cash position improved in Q3 2010 by \$1,461,331 compared to a decrease in cash reserves of \$1,250,451 for the corresponding period in fiscal 2009. The Company was cash flow positive from operations for both the three and nine months ended June 30, 2010, largely due to cash provided by accounts payable and increases in deferred revenue from upfront payments related to the two agreements previously mentioned.

Consolidated Statement of Operations and Comprehensive Loss

(Canadian \$)	Three month period ended		Nine month period ended	
	June 30, 2010	2009	June 30, 2010	2009
Revenue				
Product Sales				
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
Total Product Sales	855,864	291,180	2,257,745	1,156,641
Licensing fee	146,530	110,657	367,844	331,971
Total Revenue	1,002,394	401,837	2,625,589	1,488,612
Cost of goods sold				
Product cost of goods sold	573,103	289,109	1,350,285	890,054
Gross Profit	429,291	112,728	1,275,304	598,558
Operating expense before undernoted items	746,597	1,233,221	2,213,870	4,479,390
Loss before undernoted	(317,306)	(1,120,493)	(938,566)	(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
Loss on write-down of deferred development cost	-	-	1,700,350	-
Settlement Pay	242,178	-	242,178	-
Interest income	(21,653)	(25,539)	(39,853)	(182,364)
Net Loss	\$ (647,223)	\$ (1,201,228)	\$ (3,183,515)	\$ (4,030,350)
Loss per share	\$ (0.009)	\$ (0.016)	\$ (0.043)	\$ (0.055)

Product and Service Revenue and Gross Profit

For the three months ended June 30, 2010, the Company achieved record revenues that exceeded \$1 million. However, quarter-to-quarter revenues continue to be unpredictable. Consolidated revenue from products and services increased by 194% in the three months ended June 30, 2010 compared to the comparative period of 2009. The products and services revenue mix changed from the comparative period as follows:

- 64% of revenue in the third quarter of 2010 is derived from advanced collagen dressings compared with 77% in the same period of the previous year;
- 36% of products and services revenue in the current period are derived from specialized medical device coatings compared to 23% in the third quarter of 2009;

Gross margin as a percentage of total revenue for the three months ended June 30, 2010 was 42.8%, compared to 28.1% in the comparative period of 2009. Gross margin as a percent of total revenue for the first nine months of 2010 was 48.6%, compared to 40.2% 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 rationalizing resources and focusing on business opportunities with greater profit potential.

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

In the third quarter of 2010, products and services revenue from advanced collagen dressings increased by \$324,439 or 144% over the same period in 2009. This increase is due to higher volume of orders received under contract. Gross profit related to our advanced collagen dressings for the three months ended June 30, 2010 was \$279,686 or 42.3% of advanced collagen dressings revenue. For the nine-months ended June 30, 2010, product and services revenue from advanced collagen dressings increased by \$640,896 or 132.0% over the comparative period of 2009. There is no comparative information in respect to gross profit available for 2009.

In the third quarter of 2010, products and services revenue from specialized medical device coatings increased by \$240,245 or 363.2% over the same period in 2009. This increase is due to higher volume of orders received under contract and an increase in revenue from development services. Gross profit related to our specialized medical device coatings for the three months ended June 30, 2010 was \$149,605 or 43.9% of specialized medical device coating revenue. There is no comparative information in respect to gross profit available for 2009.

For the nine months ended June 30, 2010, products and services revenue of specialized medical device coatings were \$1,131,384, an increase of \$460,208 or 68.6% from the same period last year. Gross profit related to sales of specialized medical device coatings for the nine-months of 2010 was \$584,160 or 50.1% of the total specialized medical device coatings revenue. There is no comparative information in respect to gross profit available for 2009. One of the major factors affecting gross margin is the value of coating services related to development contracts. Specialized medical device coatings revenue comprises product fees and the fees charged for services associated with coating products.

Licensing Fees

Licensing fees increased by 32.4% over the three month period ended June 30, 2010 compared to the three months ended June 30, 2009. The increase is attributed to two new licensing agreements signed during the three months ended June 30, 2010.

Interest Income

Interest income for the three months ended June 30, 2010 includes approximately \$15,000 related to the Ontario Innovative Tax credits for the years 2005, 2006 and 2007. Interest on investments during this quarter decreased primarily as a result of the reduction 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 expenses

Operating expenses	Three months ended June 30,		Nine months ended June 30,	
	2010	2009	2010	2009
Operations				
Wages and benefits	\$ 101,304	\$ 327,907	\$ 337,684	\$ 1,011,549
Consulting fees	3,285	37,596	10,475	98,273
Other	20,218	23,548	50,147	131,041
Total Operations	\$ 124,807	\$ 389,051	\$ 398,306	\$ 1,240,863
Research and development activities				
Wages and benefits	\$ 170,774	\$ 196,129	\$ 503,968	\$ 686,426
Consulting and Outside Testing	96,090	5,677	102,781	49,807
Recovery of refundable investment tax credit	(180,672)	-	(430,161)	-
Other	5,428	15,226	46,224	75,442
Total Research and Development	\$ 91,620	\$ 217,032	\$ 222,812	\$ 811,675
Marketing				
Wages and Benefits	\$ 69,297	\$ 63,701	\$ 184,465	\$ 347,954
Travel	22,814	10,788	62,483	53,806
Investor Relations	8,104	26,471	27,779	75,306
Other	18,917	3,767	24,448	22,384
Total Marketing	\$ 119,132	\$ 104,727	\$ 299,175	\$ 499,450
General and administrative				
Wages and Benefits	\$ 96,973	\$ 235,709	\$ 362,427	\$ 723,302
Director's Compensation	75,446	58,543	194,890	258,402
Advisor expense	41,376	-	180,303	-
Professional Fees	178,847	92,659	320,627	547,360
Facility	39,193	43,449	123,628	132,241
Foreign exchange (gain) loss	(70,023)	33,191	(22,487)	49,672
Other	49,226	58,860	134,189	216,425
Total General and Administrative Cost	\$ 411,038	\$ 522,411	\$ 1,293,577	\$ 1,927,402
Total Expense	\$ 746,597	\$ 1,233,221	\$ 2,213,870	\$ 4,479,390

Since deciding to outsource manufacturing to a partner, Covalon has made substantial progress at reducing its operating expenses and cash outflows. Management has achieved revenue growth while being focused on structural cost reductions in the first nine months ended June 30, 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 fourth quarter of 2009 and first six months of 2010, the financial statements of the third quarter of 2010 continue to show the positive impact of the reductions along with increased revenues.

Compared to the third quarter of 2009, operating expenses before amortization fell by 39.5% or \$486,624 for the third quarter of 2010, and is attributable to the following:

- A reduction of wages and benefits of approximately \$385,000 due to a reduction of approximately 18 staff;
- A recovery of refundable income tax credits in the amount of \$180,672;
- Foreign exchange gains of approximately \$103,000;
- An increase in outside consultant and professional fees of approximately \$142,000;
- A non-cash increase in Advisor fees of \$41,376, which represents the vesting expense, related to options granted during fiscal 2009.

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

Related Party Transactions

During the nine month period ending June 30, 2010, the Company paid fees to related parties as follows:

- (i) Management fees totalling \$309,346 (2009 – \$473,043) is 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 upon by the related parties.

Critical Accounting Estimates

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

Deferred Development Costs

Development costs that meet generally accepted criteria are deferred and amortized from the beginning of commercial production and sales. Deferred development costs for each

technology platform are amortized when the product regulatory approval to sell related products is received, on a straight-line basis over the years remaining on the patent.

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

Stock Based Compensation

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

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

Impairment of Long-Lived Assets

An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes the assets' carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the asset and its carrying value.

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

Summary of Quarterly Results and Financial Position

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

in Canadian \$)	2010 Third Quarter	2010 Second Quarter	2010 First Quarter	2009 Fourth Quarter	2009 Third Quarter	2009 Second Quarter	2009 First Quarter	2008 Fourth Quarter
Revenue (1)	\$ 1,024,047	\$ 837,140	\$ 804,255	\$ 614,549	\$ 427,376	\$ 781,433	\$ 462,167	\$ 419,721
Operating loss before amortization	\$ 318,000	\$ 283,000	\$ 338,000	\$ 754,000	\$ 1,121,000	\$ 1,400,000	\$ 1,359,000	\$ 1,532,000
Net loss	\$ 647,223	\$ 2,029,034	\$ 443,358	\$ 844,459	\$ 1,201,228	\$ 1,481,658	\$ 1,347,464	\$ 1,608,315
Net loss per share	\$ (0.01)	\$ (0.03)	\$ (0.01)	\$ (0.01)	\$ (0.02)	\$ (0.02)	\$ (0.02)	\$ (0.02)
Cash and cash equivalents	\$ 6,431,954	\$ 4,970,623	\$ 5,428,742	\$ 6,036,626	\$ 7,788,427	\$ 9,038,878	\$ 10,817,508	\$ 3,533,544
Net working capital	\$ 5,970,058	\$ 5,760,650	\$ 6,132,019	\$ 6,429,103	\$ 7,141,868	\$ 8,482,245	\$ 10,060,370	\$ 12,007,901
Current Ratio	3.7	5.9	6.4	6	6.1	6.7	7.6	11.1

(1) includes Product Revenue, Licensing Revenue and interest income for comparative purposes 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. The revenue trend for the past four quarters has been positive. For the first time we achieved quarterly revenues in excess of \$1 million. Average revenues in the first three quarters of the 2010 fiscal year were approximately \$888,000 and average quarterly revenues for the past two fiscal years were approximately \$595,000.

The trend continues to improve as the operating loss before amortization in the third quarter of 2010 before charges related to EPAS1 declined to \$253,000, compared to an average operating loss in the first two quarters of approximately \$310,000. Operating loss before amortization in the third quarter of the 2010 fiscal year was approximately \$318,000 and includes approximately \$65,000 of consulting costs related to EPAS1. The average operating loss before amortization in the first three quarters of 2010 was \$313,000 and the average quarterly operating loss before amortization for the past two fiscal years was approximately \$1,082,000. Management will continue to manage expenses tightly while focusing on generating increasing revenues through 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 our ability to pay short-term obligations. Current assets includes cash and cash equivalents, short-term investments, accounts receivable, refundable investment tax credits, inventories and prepaid expenses. Current liabilities include accounts payable and accrued liabilities, and deferred revenue. Net Working Capital is calculated as current assets minus current liabilities. At June 30, 2010, the Company has 3.7 times the current assets needed to pay its current liabilities.

Liquidity & Capital Resources

(Canadian \$)	As at	
	June 30, 2010	September 30, 2009
Cash and cash equivalents	\$ 6,431,954	\$ 6,036,626
Short-term investments	\$ 500,000	\$ 500,000
Total assets	\$ 11,537,534	\$ 12,867,158
Deferred revenue	\$ 1,776,879	\$ 1,159,573

Highlights

Cash flows as a result of entering into customer contracts will continue to be unpredictable quarter-to-quarter, due to the timing of receipt of up front payments under new contracts and the timing of receipt of ongoing royalty payments. Over the nine month period ended June 30, 2010, we had a net operating cash inflow of \$538,137 compared to net operating cash outflow of \$3,355,999 for the same period in the prior year. For the three months ended June 30, 2010, the Company had net cash inflow of \$1,461,331.

On June 30, 2010 cash, cash equivalents, and short-term investments amounted to \$6,931,954. Covalon follows a policy of investing its surplus cash resources in high quality, liquid, short-term deposits. Cash equivalents as of June 30, 2010 and September 30, 2009 had less than one year to maturity and are cashable without penalty. As at June 30, 2010, there were no restrictions on the flow of these funds nor have any of these funds been committed in any way. Management believes that the Company has the capital resources and liquidity necessary to meet its current commitments, support its operations, and finance its current growth strategies.

Total assets at June 30, 2010 were \$11,537,534 compared to \$12,867,158 at September 30, 2009. The decline is mainly attributable to the \$1,700,000 non-cash charge related to EPAS1 deferred development costs. Cash and cash equivalents comprised almost 60% of total assets at June 30, 2010. Of the remaining assets, the Company's accounts receivable and inventory are liquid, with collection periods and turnover ratios in the 60 to 180 day range. The balance of our assets is comprised of capital assets and the Company's intangible assets. These have low liquidity but represent much of the intellectual property assets that are used to generate Covalon's revenue streams.

Deferred revenue increased by \$617,306 to \$1,776,879 at June 30, 2010 from the fiscal year ended September 30, 2009. The increase in deferred revenue is due to upfront fees received from two customers offset by amortization expense recorded during the period.

Commitments

Covalon has signed an offer to lease for its premises at 405 Britannia Road East, Mississauga commencing December 1, 2009 and expiring on November 30, 2014. The annual rental payment for the first year 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, June 30, 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 June 30, 2010, 150,000 shares valued at \$213,875 have been released from trust. No shares were released during the nine month period ended June 30, 2010. The remaining balance of 950,000 shares is 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.

Stock Option Plan

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

	Number of Shares	Value	Weighted Average Exercise Price
Balance, September 30, 2008	3,688,175	\$ 1,601,091	\$ 1.14
Granted to related parties	250,000	72,807	\$ 0.71
Granted to consultants	1,300,000	237,985	\$ 0.45
Granted to employees	250,000	88,158	\$ 0.75
Vested to related parties		310,311	\$ 1.91
Vested to employees		133,281	\$ 2.17
Expired	(19,582)	(33,621)	
Forfeited	(197,920)	(62,984)	
Balance, September 30, 2009	5,270,673	2,347,028	\$ 0.91
Granted to related parties	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

Total value of 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 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.

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 nine month period ended June 30, 2010.

During the nine month period ended June 30, 2010, a total of 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.

Sources and Uses of Cash

	Three month period ended June 30,		Nine month period ended June 30,	
	2010	2009	2010	2009
Cash Provided By (Used In)				
Operating Activities				
Cash used in operating activities before change in non-cash working capital	\$ (456,966)	\$ (911,100)	\$ (775,176)	\$ (3,062,237)
Change in non-cash working capital	1,932,038	(20,727)	1,313,313	(293,762)
	\$ 1,475,072	\$ (931,827)	\$ 538,137	\$ (3,355,999)
Investing Activities				
Purchase of capital assets, net	\$ -	\$ (171,440)	\$ (32,968)	\$ (652,261)
Expenditure on deferred development cost	-	(88,509)	(162,602)	(734,802)
Purchase of other assets	(19,443)	(25,484)	(66,143)	(56,467)
	\$ (19,443)	\$ (285,433)	\$ (261,713)	\$ (1,443,530)
Financing Activities				
Net proceeds on issuance of share capital	\$ -	\$ -	\$ 116,337	\$ 21,375
Foreign exchange gain (loss) on cash held	\$ 5,702	\$ (33,191)	\$ 2,567	\$ (49,672)
Increase (decrease) in cash and cash equivalents	\$ 1,461,331	\$ (1,250,451)	\$ 395,328	\$ (4,827,826)

Operating Activities

Cash used in operating activities during the third quarter of 2010 before change in non-cash working capital was \$456,966 compared to \$911,100 in the same period of the previous year.

Accounts receivable decreased to \$871,729 at June 30, 2010 from \$935,440 at March 30, 2010.

Inventories decreased to \$127,415 from \$341,587 at September 30, 2009 due mostly to increased sales and improved inventory turnover.

Accounts payable and accrued liabilities increased to \$1,518,330 at June 30, 2010 from \$698,195 at March 31, 2010.

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 nine month period ended June 30, 2010.

Off-Balance Sheet Arrangements

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

Financial Instruments

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

Short term investments consists of Ontario Savings Bonds (step up interest rates of 0.75%, 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.

Subsequent Event

There were no subsequent events.

Risks and Uncertainties

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

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

manufacturing, commercialization and/or distribution of its products and the risk of product liability claims. In addition, market prices for securities of biotechnology companies are generally volatile, and may or may not move in a manner consistent with the progress being made by such company.

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

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

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

Covalon cannot predict if profitability will ever be achieved and, if it is, whether or not it will be sustainable on a quarterly or an annual basis. Even if Covalon is not able to successfully further commercialize its products, Covalon believes that it has sufficient capital to fund its business and operations through at least 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;
- patents of others will not impede Covalon's ability to commercialize its technology.

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

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

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

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

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

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

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

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

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

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

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

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

These laws require, among other things:

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

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

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

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

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

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

Examples of such issues Include:

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

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

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

Accounting Policies

Accounting Policies adopted in the 2010 fiscal year

No new accounting policies were implemented the current period.

International Financial Reporting Standards (IFRS)

Background, Project Structure and Project Progress

In March 2006, the CICA released its plan to adopt International Financial Reporting Standards. After a five year transitional period, at the end of 2011, Canadian GAAP will cease to exist as a separate basis of financial reporting for public companies.

The Company will issue consolidated financial statements in accordance with IFRS as issued by the International Accounting Standards Board ("IASB") for the year ended September 30, 2012, with comparative information.

Preliminary Impact Assessment

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

The results of this assessment identified:

- Preliminary analysis of all Canadian GAAP to IFRS differences and IFRS 1 elections and resulting prioritization of high, medium and low impact areas of focus for the Company based on potential impact;
- Preliminary resource requirements;

- A preliminary IFRS Transition Plan (details outlined below).

IFRS Transition Plan

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

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

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

The Company has scheduled the solutions development and the implementation for the remainder of this year and the first quarter of next year. Specifically, the items identified are being analysed and any differences quantified.

Potential accounting changes as a result of transition to IFRS

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

Revenue Recognition – The Company has contracts which generate revenue from licensing fees. Many of these contracts provide upfront payments and under CGAAP have been deferred over the life of the contract. Each contract must be reviewed to ensure that the accounting is appropriate under IFRS to determine whether any differences in timing or amount of revenue recognized exist.

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

Foreign Exchange Translation - The Company sells products to customers in U.S. dollars and purchases some services and raw materials from suppliers invoiced in U.S. dollars. All

labour costs are denominated and settled in Canadian dollars. An analysis is currently underway to determine if there is any impact on the functional currency under IFRS.

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

The Company is currently reviewing illustrative IFRS financial statements with a view to preparing an opening balance sheet during Q4 2010. Process changes are being identified for any additional note disclosure requirements under IFRS.

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

The IASB has several projects slated for completion in 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 main drivers for systems changes include:

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

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

Impact on Reporting and Internal Controls

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

Impact on Business

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

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

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

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

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