

Covalon Technologies Ltd.

Consolidated Financial Statements

For the period ended March 31, 2011

(Unaudited)

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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.

Covalon Technologies Ltd.

Consolidated Balance Sheets

As at March 31, 2011 and September 30, 2010
(Unaudited)

	March 31, 2011	Audited September 30, 2010
Assets		
Current assets		
Cash and cash equivalents	\$ 3,431,454	\$ 5,838,578
Short term investments	500,000	500,000
Accounts receivable, net (Note 1)	626,162	422,729
Inventories (Note 4)	382,782	234,667
Prepaid expenses	78,864	31,523
Total Current Assets	5,019,262	7,027,497
Capital assets (Note 5)	747,720	808,201
Other assets (Note 6)	759,277	697,056
Deferred developments costs (Note 7)	1,722,335	1,787,038
Total Assets	\$ 8,248,594	\$ 10,319,792

Liabilities and Shareholders' Equity

Current		
Accounts payable and accrued liabilities	\$ 734,498	\$ 1,164,433
Deferred revenue (Note 8)	205,930	645,533
Total Current Liabilities	940,428	1,809,966
Deferred revenue (Note 8)	634,914	939,515
Total Liabilities	1,575,342	2,749,481
Shareholders' Equity		
Share capital (Note 9 (b))	29,455,316	29,455,316
Contributed surplus	1,805,586	1,771,496
Options (Note 9 (c))	1,348,665	1,219,963
Deficit	(25,936,315)	(24,876,464)
Total Shareholders' Equity	6,673,252	7,570,311
Total Liabilities and Shareholders' Equity	\$ 8,248,594	\$ 10,319,792

On behalf of the Board

(signed) "Martin C. Bernholtz" _____ Director

(signed) "Brian Pedlar" _____ Director

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

Covalon Technologies Ltd.

Interim Consolidated Statements of Operations and Comprehensive Loss

For the three and six months ended March 31, 2011 and March 31, 2010
(Unaudited)

	Three months ended March 31,		Six months ended March 31,	
	2011	2010	2011	2010
Revenue				
Product and Services				
Advanced wound care	\$ 267,134	\$ 332,501	\$ 562,500	\$ 576,895
Specialized medical device coatings	161,480	385,367	365,847	824,986
Licensing fee	582,822	110,657	744,204	221,314
Total revenue	<u>1,011,436</u>	<u>828,525</u>	<u>1,672,551</u>	<u>1,623,195</u>
Cost of Sales	<u>319,587</u>	<u>425,929</u>	<u>677,188</u>	<u>777,182</u>
Gross Profit	691,849	402,596	995,363	846,013
Operating Expenses				
Operations	138,234	121,095	291,310	273,499
Research and development activities	379,714	199,075	566,281	380,681
Recovery of refundable investment tax credit	-	(249,489)	-	(249,489)
Sales and Marketing	249,389	100,208	339,142	180,043
Amortization and depreciation	90,376	109,104	178,923	223,592
General and administrative	281,864	514,512	710,500	882,539
	<u>1,139,577</u>	<u>794,505</u>	<u>2,086,156</u>	<u>1,690,865</u>
Loss before undernoted	(447,728)	(391,909)	(1,090,793)	(844,852)
Loss on disposal of capital asset	-	9,290	-	9,290
Write-down of deferred development costs	-	1,700,350	-	1,700,350
Interest income	(17,118)	(8,615)	(30,942)	(18,200)
Net loss and comprehensive loss for the period	<u>\$ (430,610)</u>	<u>\$ (2,092,934)</u>	<u>\$ (1,059,851)</u>	<u>\$ (2,536,292)</u>
Basic and diluted loss per share (Note 9 (d))	<u>\$ (0.006)</u>	<u>\$ (0.028)</u>	<u>\$ (0.014)</u>	<u>\$ (0.034)</u>

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

Covalon Technologies Ltd.

Interim Consolidated Statements of Cash Flows

For the three and six months ended March 31, 2011 and 2010

(Unaudited)

	Three months ended March 31,		Six months ended March 31,	
	2011	2010	2011	2010
Cash flows from operating activities				
Net loss for the year	\$ (430,610)	\$ (2,092,934)	\$ (1,059,851)	\$ (2,536,292)
Add (deduct) items not involving cash:				
Amortization of capital assets	41,480	48,961	81,890	103,059
Amortization of patent and technology rights	16,544	13,926	32,330	28,099
Amortization of deferred development costs	32,352	46,217	64,703	92,434
Write-down of deferred development costs	-	1,700,350	-	1,700,350
Loss on disposal of capital asset	-	9,290	-	9,290
Stock compensation expense	67,800	169,292	162,792	281,715
Foreign exchange loss on cash held	5,633	2,364	13,496	3,135
Cash provided by operating activities before change in non-cash working capital balances	(266,801)	(102,534)	(704,640)	(318,210)
Change in non-cash working capital (Note 13)	(1,195,129)	(197,307)	(1,573,028)	(618,725)
	(1,461,930)	(299,841)	(2,277,668)	(936,935)
Cash flows from investing activities				
Purchase of capital assets	(4,938)	(27,603)	(21,409)	(32,968)
Expenditure on deferred development costs	-	(109,179)	-	(162,602)
Purchase of other assets	(56,919)	(19,132)	(94,551)	(46,700)
	(61,857)	(155,914)	(115,960)	(242,270)
Cash flows from financing activities				
Net proceeds on issuance of share capital (Note 9(b))	-	-	-	116,337
Foreign exchange loss on cash held	(5,633)	(2,364)	(13,496)	(3,135)
Net Change in cash and cash equivalents during the period	(1,529,420)	(458,119)	(2,407,124)	(1,066,003)
Cash and cash equivalents, beginning of period	4,960,874	5,428,742	5,838,578	6,036,626
Cash and cash equivalents, end of period	\$ 3,431,454	\$ 4,970,623	\$ 3,431,454	\$ 4,970,623
Represented by				
Cash	\$ 263,176	\$ 118,609	\$ 263,176	\$ 118,609
Cash equivalents	3,168,278	4,852,014	3,168,278	4,852,014
	\$ 3,431,454	\$ 4,970,623	\$ 3,431,454	\$ 4,970,623

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

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

For the six months ended March 31, 2011 and year ended September 30, 2010

	Share Capital		Contributed Surplus	Options	Deficit	Total
	Number of Shares	Amount				
Balance, September 30, 2009	74,303,915	\$ 29,173,085	\$ 362,625	\$ 2,347,028	\$ (20,941,517)	\$ 10,941,221
Issue of common shares for cash pursuant to the exercise of stock options	587,793	282,231		(125,894)		156,337
Stock based compensation				407,700		407,700
Expired options			1,408,871	(1,408,871)		-
Net loss and comprehensive loss					(3,934,947)	(3,934,947)
Balance, September 30, 2010	74,891,708	29,455,316	1,771,496	1,219,963	(24,876,464)	7,570,311
Stock based compensation				162,792		162,792
Expired options			34,090	(34,090)		-
Net loss and comprehensive loss					(1,059,851)	(1,059,851)
Balance, March 31, 2011	74,891,708	\$ 29,455,316	\$ 1,805,586	\$ 1,348,665	\$ (25,936,315)	\$ 6,673,252

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

Covalon Technologies Ltd. Summary of Significant Accounting Policies

March 31, 2011 and September 30, 2010

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 disclosed two product segments which are advanced wound care and specialized medical device coatings. These unaudited interim consolidated statements should be read in conjunction with our audited financial statements for the year ended September 30, 2010.</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 \$25.9 million. The Company's ability to continue as a going concern will depend on management's ability to successfully execute its business plan and achieve profitable operations.</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>

Covalon Technologies Ltd. Summary of Significant Accounting Policies

March 31, 2011 and September 30, 2010

Revenue Recognition

Revenue is recognized on an accrual basis as follows:

- a) Revenue arising from product sales is recognized once the product has been shipped to the customer.
- b) Revenue arising from licensing fees and royalties is initially recorded as deferred revenue and recognized over the period of the relevant agreements.
- c) Revenue arising from development contracts is recognized once specific milestones are achieved.
- d) Revenue arising from interest is recognized as earned.

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

Cash and Cash Equivalents

Cash and cash equivalents are defined as highly liquid investments and consist of cash and short-term interest bearing instruments that are cashable at any time without penalty.

Inventories

Raw materials and supplies are stated at the lower of average cost and net realizable value. Work in process and finished goods are stated at the lower of average cost and net realizable value in accordance with CICA Section 3031.

Capital Assets

Capital assets are recorded at cost less related investment tax credits. Amortization is based on the estimated useful life of the asset and is calculated as follows:

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

Other Assets

Other assets include expenditures related to obtaining patents and technology rights associated with the patents and are stated at cost less accumulated amortization. Amortization is being provided on a straight-line basis over the remaining life of the patent being 20 years less the number of years since application for the patent.

Deferred Development Costs /Research Development

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

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

Covalon Technologies Ltd. Summary of Significant Accounting Policies

March 31, 2011 and September 30, 2010

Investment Tax Credits Investment tax credits arising from qualifying research and experimental development costs are recorded in the period in which these tax credits are considered reasonably assured to be recovered.

Future Income Tax The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in operations in the year in which the change occurs.

Foreign Currency Translation Foreign currency accounts are translated into Canadian dollars as follows:

At the transaction date, each asset, liability, revenue and expense is translated into Canadian dollars by an estimate of the exchange rate in effect at that date. At the reporting date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate currently in effect. The resulting foreign exchange gains and losses are included in income in the current period. Included in General and Administrative costs are foreign exchange losses of \$35,638 (2010 - \$47,535)

Financial Instruments The Company's cash and cash equivalents are classified as held for trading and measured at fair value. Short-term investments are classified as held for trading and measured at fair value. Subsequent changes in fair value are recorded to net income or loss. Accounts receivable are classified as loans and receivables and are initially measured at fair value; subsequently measured at their amortized cost using the effective interest rate method. Accounts payable and accrued liabilities are classified as other liabilities and are initially measured at fair value, subsequently measured at their amortized cost using the effective interest rate method. The fair values of the financial assets and liabilities that are included in the balance sheet approximate their fair value due to their short term nature.

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

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

Covalon Technologies Ltd.
Summary of Significant Accounting Policies

March 31, 2011 and September 30, 2010

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

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

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

Loss per Common Share Loss per common share has been computed by dividing the loss applicable to common shareholders by the weighted average number of shares of common stock outstanding during the respective years. Diluted loss per common share is computed using the weighted average number of common and potential common shares outstanding during the year. Potential common shares consist of the incremental common shares issuable upon the exercise of stock options and warrants under the treasury stock method.

Impairment of Long-lived Assets:

An impairment charge is recognized for long-lived assets, including intangible assets with definite lives, when an event or change in circumstances causes the assets' carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. The impairment loss is calculated as the difference between the fair value of the asset and its carrying value. During the six month period ended March 31, 2011, impairment charges of \$Nil (2010-\$1,700,350) were recorded.

Covalon Technologies Ltd.

Notes to Consolidated Financial Statements

March 31, 2011 and September 30, 2010

1. FINANCIAL RISK MANAGEMENT

Risk factors

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

Credit risk

The Company's cash and cash equivalents and short-term investments do not subject the Company to significant credit risk. The Company has guaranteed investment certificates and provincial bonds, as per its practice of protecting its capital rather than maximizing investment yield, of \$3.9million 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 March 31, 2011, two customers accounted for 71% (September 2010 – three customers for 91%) of the accounts receivable balance. These customers, who are distributors and strategic partners of the Company, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers.

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

	March 31, 2011	Audited September 30, 2010
Current	\$ 217,361	\$ 267,933
31-60 days past due	137,068	57,188
Over 60 days past due (net of \$117,000 allowance for doubtful accounts)	271,733	97,608
	<u>\$ 626,162</u>	<u>\$ 422,729</u>

Liquidity risk

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

Interest rate risk

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

Currency risk

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

Covalon Technologies Ltd.

Notes to Consolidated Financial Statements

March 31, 2011 and September 30, 2010

1. FINANCIAL RISK MANAGEMENT (continued)

natural hedge. The Company believes the remaining risk is acceptable and does not use financial instruments to hedge these risks.

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

	March 2011	Audited September 2010
Accounts receivable, net	\$ 543,473	\$ 355,860
Accounts payable	145,462	331,462
Cash	18,902	902,511
Exchange rate (\$USD / \$CAD)	0.9696	1.0290

An increase of 5% and 10% in the US dollar exchange rate would result in an increase of the net loss by approximately \$8,000 and \$16,000 respectively.

Fair Value

The Company categorizes its financial assets and liabilities measured at the fair value into one of three different levels depending on the observation of the inputs used in the measurement. As at March 31, 2011 the Company's financial instruments are cash and cash equivalents and short-term investments for an amount of \$3,931,454 (September 2010 - \$6,338,578) which are considered to be Level 1 investments. There were no transfers between levels during the year.

The three levels are defined as follows:

Level 1: Fair value is based on unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2: Fair value is based on inputs other than quoted prices included within Level 1 that are not observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and

Level 3: Fair value is based on valuation techniques that require one or more significant unobservable inputs.

Commodity risk

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

2. MANAGEMENT OF CAPITAL

The Company defines capital that it manages as its shareholders' equity comprising of share capital, options, contributed surplus and deficit. Its objectives when managing capital are to ensure that the Company will continue as a going concern, so that it can provide services to its customers and returns to its shareholders. The capital at March 31, 2011 is \$6,673,252 (September 2010 - \$7,570,311)

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

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

March 31, 2011 and September 30, 2010

2. MANAGEMENT OF CAPITAL (continued)

capital structure as deemed appropriate under the specific circumstances. The Company's investment policy is to invest only in investment grade, highly liquid money market instruments.

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

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, 2010.

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.

4. INVENTORIES

Inventories consist of the following:

	March 31, 2011	Audited September 30, 2010
Raw materials	\$ 181,815	\$ 135,237
Finished Goods	146,009	99,430
Work in Process	54,958	-
	<u>\$ 382,782</u>	<u>\$ 234,667</u>

Product expenses include \$571,219 in inventoried materials in 2011 (March 2010 - \$632,399).

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

March 31, 2011 and September 30, 2010

5. CAPITAL ASSETS

	March 31, 2011		September 30, 2010	
	Accumulated		Audited Accumulated	
	Cost	Amortization	Cost	Amortization
Furniture and fixtures	\$ 428,529	\$ 216,888	\$ 423,591	\$ 193,647
Lab equipment	1,281,364	745,285	1,264,892	686,635
Leasehold improvements	71,416	71,416	71,416	71,416
	1,781,309	1,033,589	1,759,899	951,698
Cost less accumulated amortization		\$ 747,720		\$ 808,201

6. OTHER ASSETS

	March 31, 2011	September 30, 2010
	Audited	Audited
Patents and technology rights	\$ 1,078,544	\$ 983,994
Less: Accumulated amortization	319,267	286,938
	\$ 759,277	\$ 697,056

7. DEFERRED DEVELOPMENT COSTS

	March 31, 2011	September 30, 2010
	Audited	Audited
Cost	\$ 2,434,065	\$ 4,134,415
Less: accumulated amortization	711,730	647,027
	1,722,335	3,487,388
Less: Write-down (net of \$Nil accumulated amortization; September 2010 - \$Nil)	-	1,700,350
	\$ 1,722,335	\$ 1,787,038

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

March 31, 2011 and September 30, 2010

7. DEFERRED DEVELOPMENT COSTS (continued)

During the second quarter of the previous 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 previous 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 \$314,621 net have not been written down because the Company continues to believe that the patents still have value.

8. DEFERRED REVENUE

During the three month period ended March 31, 2011, the Company ended its exclusive arrangement with Smith and Nephew. As a result, the remaining balance of the related deferred exclusivity fee was fully amortized. The Company continues to supply product to Smith and Nephew on a non-exclusive basis.

The Company received upfront licensing fees totaling Cdn. \$1,029,650 during the year ending September 30, 2010. The Company had recorded the exclusivity payment as deferred revenue and is recording this licensing fee revenue monthly over the five year term of the agreement.

	March 31, 2011	Audited September 30, 2010
Balance, beginning of period	\$ 1,585,048	\$ 1,159,573
Add:		
Up front payments	-	1,029,650
Less:		
Technology transfer fee recognized	-	(74,949)
Amortization of license and supply agreements	(744,204)	(529,226)
Balance, end of period	840,844	1,585,048
Amount to be recognized within one year	(205,930)	(645,533)
Long term balance	\$ 634,914	\$ 939,515

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

March 31, 2011 and September 30, 2010

9. SHARE CAPITAL

a) Authorized – Unlimited number of Common Shares

b) Issued – Common shares

Included in Common Shares are 950,000 shares held in trust related to the Company's acquisition of technology from Perfusion Therapeutics Inc. in 2006.

At March 31, 2011, there were no shares held in escrow (September 2010 – 1,123,101).

c) Stock Option Plan

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

	Number of Shares	Value	Weighted Average Exercise Price
Balance, September 30, 2009	5,270,673	\$ 2,347,028	\$ 0.91
Granted to related parties	1,055,000	198,712	\$ 0.29
Granted to employees	2,380,000	64,611	\$ 0.20
Vested to related parties		48,445	\$ 2.05
Vested to consultants		180,799	\$ 0.50
Vested to employees		26,257	\$ 1.62
Exercised	(587,793)	(125,894)	
Expired	(3,019,948)	(1,408,871)	
Forfeited	(162,932)	(111,124)	
Balance, September 30, 2010	<u>4,935,000</u>	<u>1,219,963</u>	\$ 0.91
Vested to related parties		27,051	\$ 0.71
Vested to consultants		24,159	\$ 0.50
Vested to employees		111,582	\$ 0.32
Expired	(100,000)	(34,090)	
Forfeited	<u>(170,000)</u>	<u>-</u>	
Balance, March 31, 2011	<u>4,665,000</u>	<u>\$ 1,348,665</u>	\$ 0.45

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Notes to Consolidated Financial Statements

March 31, 2011 and September 30, 2010

9. SHARE CAPITAL (continued)

Range of Exercise Prices	Number of Options Outstanding	Weighted Average Exercise Price \$	Weighted Average Remaining Contractual Life (years)
\$0.20 - \$0.50	4,265,000	0.28	3.93
\$0.56 - \$0.75	100,000	0.75	2.55
\$1.54 - \$2.79	300,000	2.79	2.00
	4,665,000	0.45	3.78

During the six month period ending March 31, 2011, 100,000 options valued at \$34,090 expired and 170,000 options with an expiry date of September 30, 2015 were forfeited. As at March 31, 2011, 2,438,302 (Sep 2010 – 1,941,209) options with a weighted average exercise price of \$0.67 (Sep 2010 - \$0.71) were available for exercise.

(d) Loss per Share

Loss per share is calculated using the weighted average number of common shares outstanding during the six month period ended March 31, 2011, which is 74,891,708 (March 2010 – 74,512,727) shares. As the Company experienced losses for the periods ended March 31, 2011 and 2010, 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 March 31, 2011 and March 31, 2010 are as follows:

	2011	2010
Anti-dilutive potential securities		
Common shares potentially assumable:		
- under stock options	4,665,000	3,599,577

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10. RELATED PARTY TRANSACTIONS

- a. During the six month period ended, the Company paid fees to related parties as follows:
- (i) Management fees totaling \$99,865 (2010 – \$221,473) to a corporation controlled by an officer and director. Included in management fees are stock option benefits that have been valued at \$12,365 (2010 – \$21,473).
 - (ii) Directors fee include cash compensation of \$Nil (2010 - \$23,500) paid to certain of the independent directors and stock option benefits that have vested during the period amounted to \$14,686 (2010 - \$94,944).
- b. The management fees are paid pursuant to a single management agreement, expiring August 31, 2011. The commitment for the 2011 fiscal year is \$175,000.

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

11. 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 three fiscal years are as follows:

2012	90,988
2013	95,965
2014	91,627
	\$ 278,580

12. CONTINGENCIES

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

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13. CHANGE IN NON-CASH OPERATING WORKING CAPITAL ITEMS

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

	For the three months ended March 31,		For the six months ended March 31,	
	2011	2010	2011	2010
Accounts receivable, net	\$ (372,128)	\$ 15,659	\$ (203,433)	\$ (174,086)
Inventory	(80,992)	100,789	(148,115)	151,223
Prepaid expenses	(46,167)	(1,553)	(47,341)	(17,074)
Refundable investment tax credit	-	(249,489)	-	(249,489)
Accounts payable and accrued liabilities	(113,020)	87,759	(429,935)	(68,171)
Deferred revenue	(582,822)	(150,472)	(744,204)	(261,128)
	<u>\$ (1,195,129)</u>	<u>\$ (197,307)</u>	<u>\$ (1,573,028)</u>	<u>\$ (618,725)</u>

14. SEGMENTED INFORMATION

Starting October 1, 2009, the Company disclosed two product segments, Advanced Wound Care and Specialized Medical Device Coatings. Product segments have been identified based on the underlying technology of the product. Assets and other operating expenses are not allocated by segment for internal reporting purposes and therefore have not been presented.

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14. SEGMENTED INFORMATION (continued)

Information on product segments is as follows:

For the three months ended March 31, 2011 and 2010

	2011			2010		
	Advanced Wound Care \$	Specialized Medical Device Coatings \$	Total \$	Advanced Wound Care \$	Specialized Medical Device Coatings \$	Total \$
Product and Services	267,134	161,480	428,614	332,501	385,367	717,868
Licensing Fee	531,339	51,483	582,822	110,657	-	110,657
	798,473	212,963	1,011,436	443,158	385,367	828,525
Segment earnings before the following	624,542	67,307	691,849	240,398	162,198	402,596
Operations			138,234			121,095
Research and development activities			379,714			199,075
Recovery of refundable investment tax credit			-			(249,489)
Marketing			249,389			100,208
Amortization and depreciation			90,376			109,104
General and administrative			281,864			514,512
Loss on disposal of capital asset			-			9,290
Write-down of deferred development costs			-			1,700,350
Interest income			(17,118)			(8,615)
Net loss for the period			(430,610)			(2,092,934)

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14. SEGMENTED INFORMATION (continued)

For the six months ended March 31, 2011 and 2010

	2011			2010		
	Advanced Wound Care \$	Specialized Medical Device Coatings \$	Total \$	Advanced Wound Care \$	Specialized Medical Device Coatings \$	Total \$
Product and Services	562,500	365,847	928,347	576,895	824,986	1,401,881
Licensing Fee	641,239	102,965	744,204	221,314	-	221,314
	1,203,739	468,812	1,672,551	798,209	824,986	1,623,195
Segment earnings before the following	818,518	176,845	995,363	411,458	434,555	846,013
Operations			291,310			273,499
Research and development activities			566,281			380,681
Recovery of refundable investment tax credit			-			(249,489)
Marketing			339,142			180,043
Amortization and depreciation			178,923			223,592
General and administrative			710,500			882,539
Loss on disposal of capital asset			-			9,290
Write-down of deferred development costs			-			1,700,350
Interest income			(30,942)			(18,200)
Net loss for the period			(1,059,851)			(2,536,292)

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.

15. COMPARATIVE FIGURES

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