

Covalon Technologies Ltd.

Consolidated Financial Statements

For the years ended

September 30, 2011 and 2010

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Tel: 416 865 0200
Fax: 416 865 0887
www.bdo.ca

BDO Canada LLP
Royal Bank Plaza, South Tower
200 Bay Street, 33rd Floor, PO Box 32
Toronto ON M5J 2J8 Canada

Independent Auditor's Report

To the Shareholders of
Covalon Technologies Ltd.

We have audited the accompanying consolidated financial statements of Covalon Technologies Ltd., which comprise the consolidated balance sheets as at September 30, 2011 and 2010 and the consolidated statements of operations and comprehensive loss, cash flows and shareholders' equity for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of Covalon Technologies Ltd. as at September 30, 2011 and 2010 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

BDO Canada LLP

Chartered Accountants, Licensed Public Accountants

Toronto, Ontario
January 26, 2012

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Covalon Technologies Ltd.

Consolidated Balance Sheets

September 30 2011 2010

Assets

Current assets

Cash and cash equivalents	\$ 4,763,152	\$ 5,838,578
Short term investments	500,000	500,000
Accounts receivable, net (Note 1)	461,810	422,729
Inventories (Note 5)	392,385	234,667
Prepaid expenses	54,819	31,523

Total Current Assets 6,172,166 7,027,497

Capital assets (Note 6) 692,008 808,201

Other assets (Note 7) 800,315 697,056

Deferred developments costs (Note 8) 1,657,632 1,787,038

Total Assets \$ 9,322,121 \$ 10,319,792

Liabilities and Shareholders' Equity

Current

Accounts payable and accrued liabilities	\$ 1,203,268	\$ 1,164,433
Deferred revenue (Note 9)	512,800	645,533

Total Current Liabilities 1,716,068 1,809,966

Deferred revenue (Note 9) 590,712 939,515

Total Liabilities 2,306,780 2,749,481

Shareholders' Equity

Share capital (Note 10 (b))	31,911,359	29,455,316
Contributed surplus	1,805,586	1,771,496
Options (Note 10 (c))	1,736,801	1,219,963
Deficit	(28,438,405)	(24,876,464)

Total Shareholders' Equity 7,015,341 7,570,311

Total Liabilities and Shareholders' Equity \$ 9,322,121 \$ 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.

Consolidated Statements of Operations and Comprehensive Loss

For the years ended September 30,	2011	2010
Revenue		
Product and Services		
Advanced wound care	\$ 887,582	\$ 1,378,094
Specialized medical device coatings	853,274	1,323,747
Licensing fee (Note 9)	847,169	529,226
Total revenue	<u>2,588,025</u>	<u>3,231,067</u>
Cost of Sales	<u>1,278,928</u>	<u>1,854,582</u>
Gross Profit	<u>1,309,097</u>	<u>1,376,485</u>
Operating Expenses		
Operations	591,530	495,426
Research and development activities	1,092,741	734,952
Recovery of refundable investment tax credit (Note 4)	-	(430,161)
Sales and Marketing	1,065,921	376,726
Amortization and depreciation	360,418	445,759
General and administrative	1,813,125	1,797,606
	<u>4,923,735</u>	<u>3,420,308</u>
Loss before undernoted	<u>(3,614,638)</u>	<u>(2,043,823)</u>
Loss on disposal of capital asset	-	1,910
Write-down of deferred development costs (Note 8)	-	1,700,350
Settlement Pay	-	242,178
Interest income	(52,697)	(53,314)
Net loss and comprehensive loss for the year	<u>\$ (3,561,941)</u>	<u>\$ (3,934,947)</u>
Basic and diluted loss per share (Note 10 (d))	<u>\$ (0.05)</u>	<u>\$ (0.05)</u>

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

Covalon Technologies Ltd.

Consolidated Statements of Cash Flows

For the years ended September 30,	2011	2010
Cash flows from operating activities		
Net loss for the year	\$ (3,561,941)	\$ (3,934,947)
Add (deduct) items not involving cash:		
Amortization of capital assets	165,175	204,647
Amortization of patent and technology rights	65,837	56,244
Amortization of deferred development costs	129,406	184,868
Write-down of deferred development costs (Note 8)	-	1,700,350
Loss (gain) on disposal of capital assets	-	1,910
Stock compensation expense	550,928	407,700
Foreign exchange loss (gain) on cash held	(10,988)	9,945
Cash provided by operating activities before change in non-cash working capital balances	(2,661,583)	(1,369,283)
Change in non-cash working capital (Note 16)	(662,796)	1,311,082
	(3,324,379)	(58,201)
Cash flows from investing activities		
Purchase of capital assets	(48,982)	(25,589)
Expenditure on deferred development costs	-	(162,604)
Purchase of other assets	(169,096)	(98,046)
	(218,078)	(286,239)
Cash flows from financing activities		
Net proceeds on issuance of share capital (Note 10(b))	2,456,043	156,337
Foreign exchange loss (gain) on cash held	10,988	(9,945)
Net Change in cash and cash equivalents during the year	(1,075,426)	(198,048)
Cash and cash equivalents, beginning of year	5,838,578	6,036,626
Cash and cash equivalents, end of year	\$ 4,763,152	\$ 5,838,578
Represented by		
Cash	\$ 570,783	\$ 947,331
Cash equivalents	4,192,369	4,891,247
	\$ 4,763,152	\$ 5,838,578

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

Covalon Technologies Ltd.
Consolidated Statements of Shareholders' Equity

For the years ended September 30, 2011 and 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
Issue of common shares - private placement, net	8,320,000	2,456,043				2,456,043
Stock based compensation				550,928		550,928
Expired options			34,090	(34,090)		-
Net loss and comprehensive loss					(3,561,941)	(3,561,941)
Balance, September 30, 2011	83,211,708	\$ 31,911,359	\$ 1,805,586	\$ 1,736,801	\$ (28,438,405)	\$ 7,015,341

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

September 30, 2011 and 2010

Nature of Business

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.

Business Risk

Covalon is an early revenue stage medical device and biotechnology commercialization company and is subject to a number of risk and uncertainties that are inherent to the commercialization of new technology. The Company has invested in technology development and patents which represent a large amount of the Company's value. The Company's current business model is an OEM sales model where it licenses and sells its technology to medical device companies and distributors. The Company's sales model involves long sales cycles – from initial discussions, product evaluation, regulatory filings, contract negotiation and market roll-out and as such the timing of revenue agreements is unpredictable. Management has assessed the cash on-hand relative to its business plan and believes it has adequate cash resources as at September 30, 2011 to execute on its business plan for the foreseeable future.

Basis of Consolidation

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Covalon Technologies Inc. and COV Healthcare Innovations Corp. 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.

Use of 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.

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.

Covalon Technologies Ltd. Summary of Significant Accounting Policies

September 30, 2011 and 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

September 30, 2011 and 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 The Canadian dollar is the functional currency of the Company and its wholly owned subsidiaries. The subsidiaries are considered integrated for the purposes of 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 \$4,588 (2010 - \$44,716).

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 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

September 30, 2011 and 2010

Financial Instruments (cont'd) All of the Company's cash is maintained by two 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. In the year ended September 30, 2011, there were no impairment charges (2010 - \$1,700,350 relating to deferred development costs).

Covalon Technologies Ltd.

Notes to Consolidated Financial Statements

September 30, 2011 and 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 term deposits, savings account and provincial bonds, as per its practice of protecting its capital rather than maximizing investment yield, of \$4.7 million invested with three issuers; however, this risk is mitigated as the issuers are two major Canadian banks 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 September 30, 2011, three customers accounted for 98% (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. The Company has recorded an allowance for bad debts in the amount of \$14,513 (2010 – \$117,000).

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

	2011	2010
Current	\$ 291,877	\$ 267,933
31-60 days past due	135,588	57,188
Over 60 days past due (net of \$14,513 allowance for doubtful accounts, Sep 2010 - \$117,000)	34,345	97,608
	<u>\$ 461,810</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. This risk has not changed from the prior year.

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. This risk has not changed from the prior year.

Covalon Technologies Ltd.

Notes to Consolidated Financial Statements

September 30, 2011 and 2010

1. FINANCIAL RISK MANAGEMENT (continued)

Currency risk

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

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

	2011	2010
Accounts receivable, net	\$ 268,853	\$ 355,860
Accounts payable	241,146	331,462
Cash	312,422	902,511
Exchange rate (\$USD / \$CAD)	1.0482	1.0290

An increase of 5% and 10% in the US dollar exchange rate would result in a decrease of the net loss by approximately \$11,000 and \$22,000 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 September 30, 2011 the Company's financial instruments are cash and cash equivalents and short-term investments for an amount of \$5,263,152 (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. This risk has not changed from the prior year.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2011 and 2010

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 September 30, 2011 is \$7,015,341 (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 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

In December 2009, the CICA issued EIC 175, Multiple Deliverable Revenue Arrangements, which replaced EIC 142, Revenue Arrangements with Multiple Deliverables. The amendments were made to: a) provide updated guidance on whether multiple deliverables exist, how the deliverables should be separated and the consideration allocated; b) require, in situations where a vendor does not have vendor-specific objective evidence or third-party evidence of selling price, that the entity allocate revenue in an arrangement using estimated selling prices of deliverables; c) eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method; and d) require expanded qualitative and quantitative disclosures regarding significant judgments made in applying this guidance.

The accounting changes summarized in EIC 175 are effective for fiscal years beginning on or after January 1, 2011 with early adoption permitted. Adoption may either be on a prospective basis or by retrospective application. The Company is currently examining the impact of these amendments on the consolidated financial statements.

In January 2009, the CICA issued Handbook Section 1582, Business Combinations, Section 1601, Consolidated Financial Statements, and Section 1602, Non-controlling Interests, which together replace Section 1600, Consolidated Financial Statements. Section 1582 establishes standards for the accounting for business combinations. It is equivalent to the business combinations accounting standard under IFRS. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in financial statements subsequent to a business combination. The sections apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011 with earlier application permitted. There is no material impact on the accounts of the Company related to these pronouncements.

Amendments have been issued to CICA Section 1625 and CICA Section 3251 to remove guidance no longer applicable and to make these standards consistent with Sections 1582, 1601, 1602 and 1625.

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2011 and 2010

3. FUTURE ACCOUNTING PRONOUNCEMENTS (continued)

International financial reporting standards (IFRS)

In February 2008, the Canadian AcSB confirmed that Canadian GAAP for publicly accountable enterprises will be fully converged into International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB"). The changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. As a result, the Company will be required to report under IFRS for its 2012 interim and annual financial statements. The Company will convert to these new standards according to the timetable set within these new rules. The Company continues to monitor changes arising from this convergence and, as required by CSA Staff Notice 52-320, the Company has included a discussion of the key elements and timing of its IFRS changeover plan in its Management's Discussion & Analysis ("MD&A").

The Company will issue consolidated financial statements in accordance with IFRS as issued by the International Accounting Standards Board ("IASB") for the first quarter ended December 31, 2011, with comparative information.

Progress in the changes related to IFRS is described in the MD&A for this reporting period.

4. REFUNDABLE INVESTMENT TAX CREDITS

The Company is eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% refundable in cash to the Company. The refundable tax credits received by the Company are subject to review by Canada Revenue Agency and the Ontario Ministry of Finance. The Company did not receive any payments during the year ended September 30, 2011, (2010 - \$430,161).

5. INVENTORIES

Inventories consist of the following:

	2011	2010
Raw materials	\$ 180,754	\$ 135,237
Work in process	26,006	-
Finished goods	185,625	99,430
	\$ 392,385	\$ 234,667

Product expenses include \$960,541 in inventoried materials in 2011 (2010 - \$1,455,350).

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2011 and 2010

6. CAPITAL ASSETS

	2011		2010	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Furniture and fixtures	\$ 428,529	\$ 240,376	\$ 423,591	\$ 193,647
Lab equipment	1,308,936	805,081	1,264,892	686,635
Leasehold improvements	71,416	71,416	71,416	71,416
	1,808,881	1,116,873	1,759,899	951,698
Cost less accumulated amortization		\$ 692,008		\$ 808,201

7. OTHER ASSETS

	2011	2010
Patents and technology rights	\$ 1,153,090	\$ 983,994
Less: Accumulated amortization	352,775	286,938
	\$ 800,315	\$ 697,056

8. DEFERRED DEVELOPMENT COSTS

	2011	2010
Cost	\$ 2,434,065	\$ 4,134,415
Less: accumulated amortization	776,433	647,027
	1,657,632	3,487,388
Less: Write-down (net of \$Nil accumulated amortization; September 2010 - \$Nil)	-	1,700,350
	\$ 1,657,632	\$ 1,787,038

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2011 and 2010

8. 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 \$310,129 (2010 – \$238,493) net have not been written down because the Company continues to believe that the patents still have value.

9. DEFERRED REVENUE

During the year ended September 30, 2011, the Company ended its exclusive arrangement with Smith and Nephew. As a result, the remaining balance of the related deferred exclusivity fee in the amount of \$421,440 has been fully amortized into income through licensing fee revenue. The Company continues to supply product to Smith and Nephew on a non-exclusive basis.

Deferred licensing fees are generally deferred and recognized over the term of the related agreement and deferred product and services revenue are recognized once the revenue recognition criteria are satisfied.

For the years ended September 30,	2011		2010	
Balance, beginning of period	\$	1,585,048	\$	1,159,573
Add:				
Deferred licensing fees		58,764		1,029,650
Deferred product and services revenue		359,369		-
Less:				
Recognition of technology transfer fee		-		(74,949)
Recognition of deferred product and services revenue		(52,500)		-
Recognition of deferred licensing fees		(847,169)		(529,226)
Balance, end of year		1,103,512		1,585,048
Amount to be recognized within one year		(512,800)		(645,533)
Long term balance	\$	590,712	\$	939,515

Covalon Technologies Ltd.
Notes to Consolidated Financial Statements

September 30, 2011 and 2010

10. SHARE CAPITAL

a) Authorized – Unlimited number of Common Shares

b) Issued – Common shares

During fiscal 2011, the Company entered into a strategic alliance with Mitec Telecom Inc., (Mitec) a leading designer and manufacturer of mobile wireless components. Mitec invested \$2,496,000 into Covalon through a private placement, purchasing 8,320,000 shares at \$0.30 per share or approximately 9.9% of Covalon on a post-transaction basis. The related share issuance costs were \$39,957.

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 escrow to be released on various success milestones. At September 30, 2011, 150,000 (2010 – 150,000) shares valued at \$213,875 (2010 - \$213,875) have been released from trust. The remaining balance of 950,000 shares are still being held in trust.

There were no exercises of options to purchase common shares during the year ended September 30, 2011 (2010 - 587,793).

At September 30, 2011, there were no shares held in escrow (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:

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10. SHARE CAPITAL (continued)

	Number of Shares	Weighted Average Exercise Price
Balance, September 30, 2009	5,270,673	\$ 0.91
Granted to related parties	1,055,000	\$ 0.29
Granted to employees	2,380,000	\$ 0.20
Exercised	(587,793)	
Expired	(3,019,948)	
Forfeited	(162,932)	
Balance, September 30, 2010	<u>4,935,000</u>	\$ 0.45
Granted to related parties	710,000	\$ 0.20
Granted to consultants	1,405,000	\$ 0.16
Granted to employees	580,000	\$ 0.20
Expired	(100,000)	
Forfeited	<u>(300,000)</u>	
Balance, September 30, 2011	<u>7,230,000</u>	\$ 0.35

Range of Exercise Prices	Number of Options Outstanding	Weighted Average Exercise Price \$	Weighted Average Remaining Contractual Life (years)
\$0.14 - \$0.19	1,000,000	0.14	5.00
\$0.20 - \$0.50	5,840,000	0.26	3.79
\$0.56 - \$0.75	90,000	0.75	2.04
\$1.54 - \$2.79	300,000	2.79	1.50
	<u>7,230,000</u>	0.35	3.84

During the year ended September 30, 2010, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 2.12%, dividend rate NIL, average volatility – 128% and an average term of 4.75 years. The estimated forfeiture rate was revised during the year from 0% to 6%. This change has been accounted for as a change in estimate and thus a reduction of approximately \$64,000 to stock compensation expense was recorded in the year.

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10. SHARE CAPITAL (continued)

Total value of 2,380,000 options granted to employees during the year ended September 30, 2010 was \$411,362.

Total value of 1,055,000 options granted to related parties during the year ended September 30, 2010 was \$256,708.

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

During the year ended September 30, 2010, 3,019,948 options valued at \$1,408,871 expired and 162,932 options with expiry dates of October 15, 2013, March 31, 2013 and March 4, 2014 were forfeited.

As at September 30, 2010, 1,941,209 (Sep 2009 – 3,550,640) options with a weighted average exercise price of \$0.71 (2009 - \$0.93) were available for exercise.

During the year ended September 30, 2011, the fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 1.8%, dividend rate NIL, average volatility – 140% and an average term of 4.75 years. The estimated forfeiture rate is 6%.

Total value of 710,000 options granted to related parties during the year ended September 30, 2011 was \$122,262.

Total value of 1,405,000 options granted to consultants during the year ended September 30, 2011 was \$192,141.

Total value of 580,000 options granted to employees during the year ended September 30, 2011 was \$99,876.

During the year ended September 30, 2011, 100,000 options valued at \$34,090 expired and 300,000 options with expiry dates of October 15, 2013, December 11, 2014 and September 2, 2015 were forfeited.

As at September 30, 2011, 4,526,649 (Sep 2010 – 1,941,209) options with a weighted average exercise price of \$0.44 (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 year ended September 30, 2011, which is 75,757,900 (2010 – 74,607,942) shares. As the Company experienced losses for the years ended September 30, 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.

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10. SHARE CAPITAL (continued)

Details of anti-dilutive potential securities outstanding not included in diluted EPS calculations are as follows:

Anti-dilutive potential securities	2011	2010
Common shares potentially assumable: - under stock options	7,320,000	4,935,000

11. RELATED PARTY TRANSACTIONS

a. During the year the Company paid fees to related parties as follows:

- (i) Management fees totaling \$207,492 (2010 – \$377,346) to a corporation controlled by an officer and director, included in management fees is stock option benefits of \$32,492 (2010 – net reversal \$17,750).
- (ii) Directors fees include cash compensation of \$Nil (2010 - \$23,500) paid to certain of the independent directors and stock option benefits that have vested during the year amounted to \$123,008 (2010 – \$186,831).

b. The management fees are paid pursuant to a single management agreement, expiring August 31, 2012. 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.

12. COMMITMENTS

The Company has signed an offer to lease for its premises at 405 Britannia Rd, Mississauga commencing December 1, 2009 and expiring November 30, 2014. The annual rental payment for fiscal 2012 is \$85,264 and increases annually over the remaining term of the lease.

The Company has also entered into three operating leases for its equipment. The equipment is leased at a total cost of \$1,711 per month and expires in 2013 and 2014.

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Notes to Consolidated Financial Statements

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12. COMMITMENTS (continued)

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

2012	\$ 105,796
2013	108,379
2014	99,142
2015	15,271
	<u>\$ 328,588</u>

13. 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.

14. INCOME TAXES

(a) Reconciliation between statutory rate and actual rate

	<u>2011</u>	<u>2010</u>
Income tax recovery computed at statutory combined basis rate of 29% (2010 - 32%)	\$ (1,033,000)	\$ (1,259,200)
Permanent differences	183,100	132,600
Expiring losses	-	270,100
Change in future tax rates	106,200	228,400
Prior year adjustment for R & D claim	-	(314,100)
Other	104,000	86,100
Valuation allowance	639,700	856,100
	<u>\$ -</u>	<u>\$ -</u>

Covalon Technologies Ltd.
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14. INCOME TAXES (continued)

(b) Future tax assets

The tax effect of the temporary differences that gives rise to future tax assets (liabilities) as of September 30, 2011 and 2010 is presented below. No benefit has been recorded in these financial statements as there is no assurance that the Company will generate taxable income to utilize these differences.

	2011	2010
Non-capital loss carry forwards	\$ 3,740,200	\$ 2,944,100
Capital loss carry forwards	120,400	120,400
Capital and other assets	135,400	287,200
Deferred development costs	1,205,100	1,050,500
Deferred revenue and other liabilities	283,700	442,900
Valuation allowance	(5,484,800)	(4,845,100)
	\$ -	\$ -

(c) The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2011 of approximately \$14,962,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

Year	Canada Amount	US Amount
2014	\$ 816,000	\$ -
2015	1,997,000	-
2026	1,499,000	-
2028	2,132,000	-
2029	3,342,000	-
2030	1,219,000	-
2031	3,889,000	68,000
	\$ 14,894,000	\$ 68,000

(d) The Company has capital losses carry forward for income tax purposes as at September 30, 2011 of approximately \$962,833 (2010 - \$962,833) which are available to reduce taxable capital gains in future years. These losses do not expire.

Covalon Technologies Ltd. Notes to Consolidated Financial Statements

September 30, 2011 and 2010

14. INCOME TAXES (continued)

(e) The Company is eligible for a 20% federal credit on its SR&ED expenditures which can only be used to offset against income taxes payable. The Company is also eligible for the Ontario

Innovation Tax Credit ("OITC") at the rate of 10% and refundable in cash to the Company. The refundable tax credits ultimately received by the Company are subject to review by Canada Revenue Agency and the Ontario Ministry of Finance.

Under the Income Tax Act of Canada, certain expenditures are classified as SR&ED expenditures and for tax purposes are grouped into a pool, which is 100% deductible in the year incurred. This SR&ED expenditure pool can also be carried forward indefinitely and deducted in full in any subsequent year. The balance of the SR&ED expenditure pool at September 30, 2011 is \$6,315,569 (2010 - \$4,776,209).

At September 30, 2011, the Company has \$1,214,294 (2010 - \$1,214,294) of unclaimed investment tax credits available to reduce federal income taxes payable in future years. If not utilized, these investment tax credits will start expiring in 2013.

15. SUPPLEMENTAL CASH FLOW INFORMATION

There were no non-cash transactions during the years ended September 30, 2010 and September 30, 2011.

16. CHANGE IN NON-CASH OPERATING WORKING CAPITAL ITEMS

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

For the years ended September 30,	2011	2010
Accounts receivable, net	\$ (39,081)	\$ 338,625
Inventory	(157,718)	106,920
Prepaid expenses	(23,296)	41,993
Accounts payable and accrued liabilities	38,835	398,069
Deferred revenue	(481,536)	425,475
	<u>\$ (662,796)</u>	<u>\$ 1,311,082</u>

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17. 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.

Information on product segments is as follows:

For the years ended	2011			2010		
	Advanced Wound Care	Specialized Medical Device Coatings	Total	Advanced Wound Care	Specialized Medical Device Coatings	Total
	\$	\$	\$	\$	\$	\$
Product and Services	887,582	853,274	1,740,856	1,378,094	1,323,747	2,701,841
Licensing Fee	641,239	205,930	847,169	439,602	89,624	529,226
	<u>1,528,821</u>	<u>1,059,204</u>	<u>2,588,025</u>	<u>1,817,696</u>	<u>1,413,371</u>	<u>3,231,067</u>
Segment earnings before the following	<u>907,623</u>	<u>401,474</u>	<u>1,309,097</u>	<u>788,614</u>	<u>587,871</u>	<u>1,376,485</u>
Operations			591,530			495,426
Research and development activities			1,092,741			734,952
Recovery of refundable investment tax credit			-			(430,161)
Marketing			1,065,921			376,726
Amortization and depreciation			360,418			445,759
General and administrative			1,813,125			1,797,606
Loss on disposal of capital asset			-			1,910
Write-down of deferred development cost			-			1,700,350
Settlement pay			-			242,178
Interest income			(52,697)			(53,314)
Net loss for the year			<u>(3,561,941)</u>			<u>(3,934,947)</u>

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