

**Covalon Technologies Ltd.**  
**Condensed Consolidated Interim Financial Statements**  
**(unaudited)**

For the three months ended December 31, 2012

NOTE TO READER

The interim financial statements for the three month period ended December 31, 2012 have been re-filed to correct one of the "Balance at dates" under Condensed Consolidated Interim Statement of Changes in Equity. These interim financial statements replace the previously filed interim financial statements.

**Covalon Technologies Ltd.**  
**CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**For the three months ended December 31, 2012**

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**Contents**

<b>Condensed Consolidated Interim Statement of Financial Position</b>	<b>3</b>
<b>Condensed Consolidated Interim Statement of Comprehensive Loss</b>	<b>4</b>
<b>Condensed Consolidated Interim Statement of Changes in Equity</b>	<b>5</b>
<b>Condensed Consolidated Interim Statement of Cash Flows</b>	<b>6</b>
<b>Notes to Condensed Consolidated Interim Financial Statements</b>	<b>7-22</b>

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**MANAGEMENT'S COMMENTS ON  
UNAUDITED INTERIM CONDENSED 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 condensed consolidated interim financial statements of Covalon Technologies Ltd. (the "Company") have been prepared by and are the responsibility of the Company's management. The unaudited condensed consolidated interim financial statements are prepared in accordance with International Financial Reporting Standards ("IFRS") and reflect management's best estimates and judgment based on information currently available. The Company's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

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# Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF FINANCIAL POSITION (UNAUDITED)

Expressed in Canadian Dollars

At December 31, 2012 and September 30, 2012

	December 31, 2012	September 30, 2012
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 727,024	\$ 1,142,667
Short-term investments	500,000	500,000
Accounts receivable, net (Note 5)	465,118	711,820
Prepaid expenses	39,237	53,126
Inventories (Note 8)	829,637	806,015
<b>Total current assets</b>	<b>2,561,016</b>	<b>3,213,628</b>
<b>Non-current assets</b>		
Restricted cash (Note 9)	63,000	63,000
Property, plant and equipment (Note 10)	581,997	602,135
Intangible assets (Note 11)	2,098,918	2,084,966
<b>Total non-current assets</b>	<b>2,743,915</b>	<b>2,750,101</b>
<b>Total Assets</b>	<b>\$ 5,304,931</b>	<b>\$ 5,963,729</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	\$ 1,076,053	\$ 1,611,125
Deferred revenue (Note 12)	900,944	674,283
<b>Total current liabilities</b>	<b>1,976,997</b>	<b>2,285,408</b>
<b>Non-current liabilities</b>		
Deferred revenue (Note 12)	392,292	443,774
<b>Total non-current liabilities</b>	<b>392,292</b>	<b>443,774</b>
<b>Total Liabilities</b>	<b>2,369,289</b>	<b>2,729,182</b>
<b>Shareholders' Equity</b>		
Share capital (Note 13 a))	32,165,573	31,911,359
Contributed surplus (Note 13 b) and c))	1,805,586	1,805,586
Stock Options (Note 13 a))	1,961,229	1,947,389
Warrants (Note 13 c))	227,522	
Accumulated deficit (Note 13 c))	(33,224,268)	(32,429,787)
<b>Total shareholders' equity</b>	<b>2,935,642</b>	<b>3,234,547</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 5,304,931</b>	<b>\$ 5,963,729</b>

On behalf of the Board

(signed) "Abe Schwartz" \_\_\_\_\_ **Director**

(signed) "Brian Pedlar" \_\_\_\_\_ **Director**

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

# Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF CHANGES IN EQUITY (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

	<b>Three months ended December 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Revenue</b>		
Product and Services		
Advanced wound care	\$ 520,523	\$ 235,714
Specialized medical device coatings	0	401,971
Licensing fees (Note 12)	51,482	51,482
<b>Total revenue</b>	<u>572,005</u>	<u>689,167</u>
<b>Cost of sales</b>	<u>353,997</u>	<u>398,137</u>
<b>Gross Profit</b>	<u>218,008</u>	<u>291,030</u>
<b>Operating Expenses</b>		
Operations	166,188	141,200
Research and development activities	130,909	153,633
Sales and marketing	355,924	406,091
General and administrative	365,730	405,698
	<u>1,018,751</u>	<u>1,106,623</u>
<b>Loss before undernoted</b>	(800,743)	(815,593)
Interest income	(6,262)	(15,539)
<b>Net loss and comprehensive loss for the period</b>	<u>\$ (794,481)</u>	<u>\$ (800,054)</u>
<b>Basic and diluted loss per share (Note 21)</b>	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

## Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF CHANGES IN EQUITY (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

	Share Capital	Contributed Surplus	Stock Options	Warrants	Accumulated Deficit	Total
<b>Balance at October 1, 2011</b>	\$ 31,911,359	\$ 1,805,586	\$ 1,736,801		\$ (28,438,405)	\$ 7,015,341
Share based payments			70,254			70,254
Comprehensive loss for the period					(800,054)	(800,054)
<b>Balance at December 31, 2011</b>	<u>\$ 31,911,359</u>	<u>\$ 1,805,586</u>	<u>\$ 1,807,055</u>		<u>\$ (29,238,459)</u>	<u>\$ 6,285,541</u>
<b>Balance at October 1, 2012</b>	\$ 31,911,359	\$ 1,805,586	\$ 1,807,055		\$ (29,238,459)	\$ 6,285,541
Share based payments			13,840			13,840
Comprehensive loss for the period					(794,481)	(794,481)
Issue common shares and warrants, net	254,214			227,522		481,736
<b>Balance at December 31, 2012</b>	<u>\$ 32,165,573</u>	<u>\$ 1,805,586</u>	<u>\$ 1,820,895</u>	<u>\$ 227,522</u>	<u>\$ (30,032,940)</u>	<u>\$ 5,986,636</u>

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

# Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF CASH FLOWS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

	December 31, December 31,	
	2012	2011
<b>Cash flows from operating activities</b>		
Net loss and comprehensive loss for the period	\$ (794,481)	\$ (800,054)
Adjustments to reconcile net loss and comprehensive loss to net cash used in operating activities:		
Depreciation - property, plant and equipment	37,173	29,967
Amortization - intangible assets	44,717	55,238
Share based payments	13,840	70,254
Foreign exchange loss (gain) on cash held	8,000	(1,262)
Cash used by operating activities before change in non-cash working capital balances	(690,751)	(645,857)
Change in non-cash working capital (Note 18)	(122,924)	(165,010)
<b>Total cash outflows from operating activities</b>	<b>(813,675)</b>	<b>(810,867)</b>
<b>Cash flows from investing activities</b>		
Purchase of property, plant and equipment	(17,035)	(649)
Purchase of intangible assets	(58,669)	(26,746)
<b>Total cash outflows from investing activities</b>	<b>(75,704)</b>	<b>(27,395)</b>
<b>Cash flows from financing activities</b>		
Net proceeds on issuance of share capital and warrants	481,736	
<b>Total cash inflows from financing activities</b>	<b>481,736</b>	-
Foreign exchange loss (gain) on cash held	(8,000)	1,262
<b>Total net decrease in cash and cash equivalents during the period</b>	<b>(415,643)</b>	<b>(837,000)</b>
<b>Cash and cash equivalents, beginning of the period</b>	<b>1,142,667</b>	<b>4,763,152</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 727,024</b>	<b>\$ 3,926,152</b>
<b>Represented by</b>		
Cash	\$ 311,986	\$ 570,783
Cash equivalents	415,038	4,192,369
	<b>\$ 727,024</b>	<b>\$ 4,763,152</b>

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

# Covalon Technologies Ltd.

NOTES TO THE CONSENSUED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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## 1. CORPORATE INFORMATION

Covalon Technologies Ltd. is incorporated under the laws of Ontario and is engaged in the business of developing, licensing and selling medical technologies. The consolidated financial statements of Covalon Technologies Ltd. for the three months ended December 31, 2012 comprise the results of the Company and its subsidiaries. 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. The Company is listed on the TSX Venture Exchange, having the symbol COV. The address of the Company's corporate office and principal place of business is 405 Britannia Road East, Suite 106, Mississauga, Ontario, Canada.

## 2. BASIS OF PRESENTATION

### Statement of Compliance

#### a) Statement of Compliance

These condensed interim financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") in general and in accordance with International Accounting Standard 34, Interim Financial Reporting ("IAS 34") as issued by the International Accounting Standards Board ("IASB") which sets out standards for interim financial statements. These interim condensed financial statements do not include all the information and disclosures required in the annual financial statements. These interim condensed financial statements should be read in conjunction with the Company's 2012 annual financial statements, which were prepared in accordance with International Financial Reporting Standards.

These interim financial statements were authorized for issue by the Corporation's Board of Directors on February 28, 2013.

#### b) Basis of Measurement

The consolidated financial statements have been prepared on a historical cost basis.

#### c) Going Concern of Operations

These Consolidated Financial Statements have been prepared on a going-concern basis, which presumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of operations for the foreseeable future. The Company incurred a net loss of \$794,742 during the three months ended December 31, 2012 and, as of that date the Company's accumulated deficit was \$33,224,268. The Company's ability to continue as a going concern depends on its ability to achieve profitable operations through; (i) the success of its two recently cleared-for-sale products IV Clear and SurgiClear, as it earns revenue from these products in the form of royalties and product sales, (ii) continued growth in the form of revenues and cash collections from product sales of its cleared-for-sale products ColActive Plus and ColActive Plus Ag, (iii) the ability for the Company to significantly reduce its operating costs, and (iv) the ability to obtain additional capital through financing. Whether or when the Company can achieve the above is uncertain. The Company is still an early revenue stage medical device biotechnology commercialization company, and is subject to a number of risks and uncertainties that are inherent to the commercialization of new technology. The Company has invested in technology and patents which represent a large amount of the Company's value. The Company's current



## **Covalon Technologies Ltd.**

NOTES TO THE CONSENSUED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### **2. BASIS OF PRESENTATION (CONTINUED)**

business model includes a combination of distribution under the Covalon brand name and an OEM business model where it licenses and sells its technology to medical device companies and distributors. Most OEM sales models involve long sales cycles – from initial discussion, product evaluation, regulatory filings, contract negotiation and market roll-out and as such the timing of revenue agreements is unpredictable. There can be no assurance that the Company will have sufficient capital to fund its ongoing operations, develop or commercialize any further products without future financings. There can be no assurance, especially considering the current economic environment, that additional financing will be available on acceptable terms or at all. These material uncertainties cast significant doubt upon the Company's ability to continue as a going concern.

These Consolidated Financial Statements do not include any adjustments to the amounts and classification of assets and liabilities that would be necessary should the Company be unable to continue as a going concern

### **3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

There have been no changes in accounting policies since the Company's 2012 annual financial statements.

### **4. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS**

The preparation of financial statements requires that management makes estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the Consolidated Financial Statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from estimates and such differences would be material.

The effect of a change in an accounting estimate is recognized prospectively by including it in comprehensive income in the period of the change, if the change affects that period only, or in the period of the change and future periods, if the change affects both.

Information about critical judgments in applying accounting policies that have the most significant risk of causing material adjustment to the carrying amounts of assets and liabilities recognized in the consolidated financial statements within the next financial year are discussed below:

#### **i) Property, plant and equipment (PP&E)**

Measurement of PP&E involves the use of estimates for determining the expected useful lives of depreciable assets. Management's judgment is also required to determine depreciation methods and an asset's residual value and whether an asset is a qualifying asset for the purpose of capitalizing borrowing costs.

#### **ii) Intangible Assets**

The values calculated for intangible assets involve significant estimates and assumptions, including those with respect to future cash flows, discount rates and asset lives. These significant estimates and judgments could impact the Company's future results if the current estimates of future performance and fair value change and could affect the amount of amortization expense on intangible assets in future periods.

# Covalon Technologies Ltd.

NOTES TO THE CONSENSUED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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## 4. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS (CONTINUED)

### iii) Impairment of non-financial assets

The Company reviews the carrying value of non-financial assets for potential impairment when events or changes in circumstances indicate that the carrying amount may not be recoverable. The impairment test is carried out by comparing the carrying amount of the asset against the value computed using the discounted cash flow method values which requires numerous assumptions to estimate future cash flows. The recoverable amount is impacted significantly by the discount rate selected to be used in the discounted cash flow model, as well as the quantum and timing of expected future cash flows and the growth rate used for the extrapolation.

## 5. 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 \$1 million invested with two 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 December 31, 2012, ten customers accounted for 92% (Sept 30, 2012 - 90%) 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 \$812,794 (September 30, 2012 - \$812,794).

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

	December 31, 2012	September 30, 2012
Current (net of allowance of \$50,275)	\$ 235,267	\$ 472,288
31-60 days past due	112,765	56,362
Over 60 days past due, (net of allowance for doubtful accounts of \$762,519, Sep 2012 - \$581,491)	117,086	183,170
	<u>\$ 465,118</u>	<u>\$ 711,820</u>

## Covalon Technologies Ltd.

NOTES TO THE CONSENSSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### 5. FINANCIAL RISK MANAGEMENT (CONTINUED)

#### 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.

#### 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:

	<b>December 31, 2012</b>	September 30, 2011
Accounts receivable, net	\$ 515,204	\$ 664,505
Accounts payable	290,351	599,542
Cash	204,780	400,392
Exchange rate (\$USD / \$CAD)	0.9949	0.9832

An increase of 5% and 10% in the US dollar exchange rate would result in a decrease of the net loss by approximately \$6,000 and \$12,000 respectively.

## **Covalon Technologies Ltd.**

NOTES TO THE CONSENSSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### **5. FINANCIAL RISK MANAGEMENT (CONTINUED)**

#### **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 December 31, 2012 the Company's financial instruments are cash and cash equivalents and short-term investments for an amount of \$1,290,024 (September 30, 2012 - \$1,705,667) 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.

### **6. MANAGEMENT OF CAPITAL**

The Company defines capital that it manages as its shareholders' equity comprising of share capital, options, warrants, 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 December 31, 2012 is \$2,935,642 (September 30, 2012 - \$3,234,547).

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, 2012.

## Covalon Technologies Ltd.

NOTES TO THE CONSENSUED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### 7. 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. During the three month period ended December 31, 2012 the Company received no OITC payments (year ended September 30, 2012 - \$217,058 for the fiscal years ended 2009 and 2010. )

### 8. INVENTORIES

Inventories consist of the following:

	December 31, 2012	September 30, 2012
Raw materials	\$ 338,012	\$ 339,798
Work in Process		2,109
Finished Goods	491,625	464,108
	<u>\$ 829,637</u>	<u>\$ 806,015</u>

Product expenses include \$318,580 in inventoried materials.

### 9. RESTRICTED CASH

The Company assigned \$63,000 of its cash equivalents as collateral to secure its credit card and automated clearing house (ACH) facilities with a major financial institution. These funds are expected to be restricted for more than one year.

## Covalon Technologies Ltd.

NOTES TO THE CONSENSSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### 10. PROPERTY PLANT AND EQUIPMENT

	Furniture and Fixtures \$	Lab Equipment \$	Leasehold Improvements \$	Total \$
<b>Cost</b>				
Balance at October 1, 2011	279,366	1,308,936	71,416	1,659,718
Additions	39,750	85,132	-	124,882
Balance at September 30, 2012	319,116	1,394,068	71,416	1,784,600
Additions	-	17,035	-	17,035
Balance at December 31, 2012	319,116	1,411,103	71,416	1,801,635
<b>Accumulated depreciation</b>				
Balance at October 1, 2011	176,002	805,081	71,416	1,052,499
Depreciation	26,390	103,576	-	129,966
Balance at September 30, 2012	202,392	908,657	71,416	1,182,465
Depreciation	7,156	30,017	-	37,173
Balance at December 31, 2012	209,548	938,674	71,416	1,219,638
<b>Carrying amounts</b>				
At October 1, 2011	103,364	503,855	-	607,219
At September 30, 2012	116,724	485,411	-	602,135
At December 31, 2012	109,568	472,429	-	581,997

## Covalon Technologies Ltd.

NOTES TO THE CONSENSSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### 11. INTANGIBLE ASSETS

	Deferred Development Costs \$	Patents \$	Trademarks \$	Computer Software \$	Total \$
<b>Cost</b>					
<b>Balance at October 1, 2011</b>	4,134,415	1,094,041	59,049	149,163	5,436,668
Impairment losses		698,340			698,340
Additions	-	128,218	8,348	-	136,566
<b>Balance at September 30, 2012</b>	4,134,415	523,919	67,397	149,163	4,874,894
Additions		57,709	960		58,669
<b>Balance at December 31, 2012</b>	4,134,415	581,628	68,357	149,163	4,933,563
<b>Accumulated amortization and impairment losses</b>					
<b>Balance at October 1, 2011</b>	2,476,783	352,775	-	64,374	2,893,932
Impairment losses	-	326,333			326,333
Amortization	129,405	75,966	-	16,958	222,329
<b>Balance at September 30, 2012</b>	2,606,188	102,408	-	81,332	2,789,928
Amortization	32,352	8,125	-	4,240	44,717
<b>Balance at December 31, 2012</b>	2,638,540	110,533	-	85,572	2,834,645
<b>Carrying amounts</b>					
At October 1, 2011	1,657,632	741,266	59,049	84,789	2,542,736
At September 30, 2012	1,528,227	421,511	67,397	67,831	2,084,966
At December 31, 2012	1,495,875	471,095	68,357	63,591	2,098,918

## Covalon Technologies Ltd.

NOTES TO THE CONSENSUED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

### 12. DEFERRED REVENUE

Licensing fees are generally deferred and recognized over the term of the related agreement and deferred product and service revenue are recognized once the revenue recognition criteria are satisfied.

	(3 months) December 31, 2012	(12 months) September 30, 2012
Balance, beginning of period	\$ 1,118,057	\$ 1,103,512
Add:		
Deferred licensing fees		58,992
Deferred product and services revenue	226,661	985,375
Less:		
Recognition of technology transfer fee	-	-
Recognition of deferred product and services revenue		(823,892)
Recognition of deferred licensing fees	(51,482)	(205,930)
Balance, end of period	1,293,236	1,118,057
Amount to be recognized within one year	(900,944)	(674,283)
Long term balance	\$ 392,292	\$ 443,774

### 13. SHARE CAPITAL AND RESERVES

#### a) Common Shares and Share Purchase Warrants

The Company is authorized to issue an unlimited number of common shares with no par value.

On October 26, 2012 the Company raised gross proceeds of \$496,600 comprised of 9,550,000 units at a price of \$.052 per unit. Each unit is comprised of one common share and one share purchase warrant. Each purchase warrant entitles the holder to acquire an additional common share at a price of \$.10 for a period of five years from the closing date. All securities issued pursuant to the Offering were subject to a hold period expiring February 27, 2013. Directors and officers of Covalon participated in the non-brokered private placement for an aggregate of 1.8 million units. The remaining units were subscribed for by an individual who subsequently became a Director of the Company. Proceeds of the private placement will be used by Covalon to develop and commercialize new wound care products, expand international distribution channels and for general working capital.

Changes in common share capital from October 1, 2011 to December 31, 2012:

	Number of Shares	Issue Price	Amount
<b>Balance at October 1, 2011 and September 30, 2012</b>	83,211,708		\$31,911,359
Shares issued via private placement	9,550,000	\$0.05	496,600
Less value attributed to warrants			(227,522)
Less share and warrant issue costs			(14,865)
<b>Balance at December 31, 2012</b>	92,761,708		\$ 32,165,572



## Covalon Technologies Ltd.

NOTES TO THE CONSENSUED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### 13. SHARE CAPITAL AND RESERVES (CONTINUED)

Changes in warrants from October 1, 2011 to December 31, 2012:

	Number of Warrants	Exercise price Amount	Amount
<b>Balance at October 1, 2011 and September 30, 2012</b>	-		-
Warrants issued via private placement, net	9,550,000	\$0.10	\$ 227,522
<b>Balance at December 31, 2012</b>	9,550,000		\$ 227,522

#### b) Contributed Surplus

The following is a summary contributed surplus from October 1, 2011 to December 31, 2012:

Balance October 1, 2011 and September 30, 2012	<u>\$ 1,805,586</u>
Balance December 31, 2012	<u>\$ 1,805,586</u>

#### c) Nature and Purpose of Equity and Reserves

The reserves recorded in equity on the Company's balance sheet include 'Contributed Surplus', and 'Accumulated Deficit'.

'Contributed Surplus' is used to recognize the value of vested stock option grants that were not exercised.

'Accumulated Deficit' is used to record the Company's change in deficit from earnings (loss) from period to period.

### 14. SHARE-BASED PAYMENTS

#### a) Option Plan Details

The Company has an incentive Stock Option Plan ("the Plan") under which non-transferable options to purchase common shares of the Company may be granted to directors, officers, employees or service providers of the Company. The terms of the Plan provide that the Directors have the right to grant options to acquire common shares of the Company at not less than the closing market price of the shares on the day preceding the grant at terms of up to five years. No amounts are paid or payable by the recipient on receipt of the option, and the options granted are not dependent on any performance-based criteria. Unless the board of directors decides otherwise, options granted under the plan will vest as follows: 33% of the options vest in one year, with a further 33% vesting in each of the subsequent two years on the anniversary of the initial grant date.

# Covalon Technologies Ltd.

NOTES TO THE CONSENSUED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

## 14. SHARE-BASED PAYMENTS (CONTINUED)

Changes in options from October 1, 2012 to December 31, 2012

Grant Date	Expiry Date	Exercise Price	Opening Balance	During the Period				Closing Balance	Vested and	
				Granted	Exercised	Expired	Forfeited		Exercisable	Unvested
31-Mar-08	31-Mar-13	\$ 2.79	300,000	-	-	-	-	300,000	300,000	-
15-Oct-08	15-Oct-10	\$ 0.75	-	-	-	-	-	-	-	-
15-Oct-08	15-Oct-13	\$ 0.75	80,000	-	-	-	-	80,000	80,000	-
22-May-09	22-May-14	\$ 0.40	1,200,000	-	-	-	-	1,200,000	1,200,000	-
11-Dec-09	11-Dec-14	\$ 0.29	80,000	-	-	-	-	80,000	80,000	-
27-Jan-10	27-Jan-15	\$ 0.31	855,000	-	-	-	-	855,000	855,000	-
01-Sep-10	01-Sep-15	\$ 0.20	1,400,000	-	-	-	-	1,400,000	933,332	466,668
02-Sep-10	02-Sep-15	\$ 0.20	498,333	-	-	-	(36,667)	461,666	329,994	131,672
10-Jun-11	10-Jun-16	\$ 0.20	985,000	-	-	-	-	985,000	328,327	656,673
13-Jun-11	13-Jun-16	\$ 0.20	710,000	-	-	-	-	710,000	710,000	-
27-Sep-11	27-Sep-16	\$ 0.14	1,000,000	-	-	-	-	1,000,000	1,000,000	-
			7,108,333	-	-	-	(36,667)	7,071,666	5,816,653	1,255,013
Weighted Average Exercise Price		\$ 0.35	\$ -	\$ -	\$ -	\$ -	\$ 0.25	\$ 0.36	\$ 0.39	\$ 0.20

Changes in options from October 1, 2011 to September 30, 2012:

Grant Date	Expiry Date	Exercise Price	Opening Balance	During the Period				Closing Balance	Vested and	
				Granted	Exercised	Expired	Forfeited		Exercisable	Unvested
31-Mar-08	31-Mar-13	\$ 2.79	300,000	-	-	-	-	300,000	300,000	-
15-Oct-08	15-Oct-10	\$ 0.75	100,000	-	-	(100,000)	-	-	-	-
15-Oct-08	15-Oct-13	\$ 0.75	100,000	-	-	-	(20,000)	80,000	80,000	-
22-May-09	22-May-14	\$ 0.40	1,200,000	-	-	-	-	1,200,000	1,200,000	-
11-Dec-09	11-Dec-14	\$ 0.29	100,000	-	-	-	(20,000)	80,000	80,000	-
27-Jan-10	27-Jan-15	\$ 0.31	855,000	-	-	-	-	855,000	855,000	-
01-Sep-10	01-Sep-15	\$ 0.20	1,400,000	-	-	-	-	1,400,000	933,332	466,668
02-Sep-10	02-Sep-15	\$ 0.20	880,000	-	-	-	(381,667)	498,333	333,327	165,006
10-Jun-11	10-Jun-16	\$ 0.20	-	985,000	-	-	-	985,000	328,327	656,673
13-Jun-11	13-Jun-16	\$ 0.20	-	710,000	-	-	-	710,000	710,000	-
27-Sep-11	27-Sep-16	\$ 0.14	-	1,000,000	-	-	-	1,000,000	1,000,000	-
			4,935,000	2,695,000	-	(100,000)	(421,667)	7,108,333	5,819,986	1,288,347
Weighted Average Exercise Price		\$ 0.45	\$ 0.18	\$ -	\$ 0.75	\$ 0.23	\$ 0.36	\$ 0.39	\$ 0.39	\$ 0.20

## Covalon Technologies Ltd.

NOTES TO THE CONSENSSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### 14. SHARE-BASED PAYMENTS (CONTINUED)

b) **Fair Value of Options Issued During the Period**

No options were granted during the three month period ended December 31, 2012 (year ended September 30, 2012 – nil.)

c) **Expenses Arising from Share-based Payment Transactions**

Total expenses arising from share-based payment transactions recognized during the three month period as part of employee benefit expense were \$13,840 (year ended September 30, 2012 - \$210,588.)

### 15. INCOME TAXES

The Company has non-capital losses carry forward available for income tax purposes as at December 31, 2012 of approximately \$18,126,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

<u>Year</u>	<u>Canada</u> <u>Amount</u>	<u>US</u> <u>Amount</u>
2014	\$ 805,000	\$
2015	1,997,000	
2026	1,499,000	
2028	2,132,000	
2029	3,309,000	
2030	601,000	
2031	3,874,000	68,000
2032	3,655,000	140,000
	<u>\$ 17,872,000</u>	<u>\$ 208,000</u>

## Covalon Technologies Ltd.

NOTES TO THE CONSENSSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### 15. INCOME TAXES (CONTINUED)

The Company had capital losses carry forward for income tax purposes as at December 31, 2012 of approximately \$962,883 which are available to reduce taxable capital gains in future years. These losses do not expire.

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 December 31, 2012 was \$6,844,635.

At December 31, 2012, the Company had \$1,214,294 (2012 - \$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.

### 16. 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 2013 is \$108,379 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.

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

2013	\$	81,284
2014		99,142
2015		15,271
	\$	<u>195,697</u>

### 17. 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.

## Covalon Technologies Ltd.

NOTES TO THE CONSENSSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### 18. CHANGE IN NON-CASH WORKING CAPITAL ITEMS

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

For the three months ended December 31,	2012	2011
Accounts receivable, net	\$ 246,702	\$ (24,949)
Prepaid expenses	13,889	(75,657)
Inventories	(23,622)	(42,000)
Accounts payable and accrued liabilities	(535,072)	18,027
Deferred revenue	175,179	(40,431)
	<u>\$ (122,924)</u>	<u>\$ (165,010)</u>

### 19. RELATED PARTY TRANSACTIONS

Key management personnel are persons responsible for planning, directing and controlling the activities of the entity. Directors are included in key management. Compensation for key management follows:

	Three months ended December 31,	
	2012	2011
Short term employee benefits	\$ 177,589	\$ 127,342
Share-based payments	4,671	37,932
	<u>\$ 182,260</u>	<u>\$ 165,274</u>

## Covalon Technologies Ltd.

NOTES TO THE CONSENSSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

### 20. OPERATING SEGMENTS

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 allocated to operating segments.

For the three months ended December 31,	2012			2011		
	Advanced Wound Care \$	Specialized Medical Device Coatings \$	Total \$	Advanced Wound Care \$	Specialized Medical Device Coatings \$	Total \$
Product and Services	520,523	-	520,523	235,714	401,971	637,685
Licensing Fee	-	51,482	51,482	-	51,482	51,482
	<u>520,523</u>	<u>51,482</u>	<u>572,005</u>	<u>235,714</u>	<u>453,453</u>	<u>689,167</u>
Segment earnings before the following:	<u>195,237</u>	<u>22,773</u>	<u>218,009</u>	<u>92,733</u>	<u>198,297</u>	<u>291,030</u>
Operations			166,188			141,200
Research and development activities			130,909			153,633
Sales and marketing			355,924			406,091
General and administrative			365,730			405,698
Interest income			<u>(6,262)</u>			<u>(15,539)</u>
			<u>(794,481)</u>			<u>(800,054)</u>

During the three months ended December 31, 2012, there were four customers who individually account for more than 10% of product and services revenue (2011 – 3 customers); \$424,692 relates to advanced wound care (2011 - \$175,000) and \$0 relates to specialized medical device coatings (2011 - \$401,263).

## Covalon Technologies Ltd.

NOTES TO THE CONSENSSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2012

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### 21. LOSS PER SHARE

Loss per share is calculated using the weighted average number of shares outstanding during the period. There were 9,550,000 shares issued during the three months ended December 31, 2012 (year ended September 30, 2012 – nil). Shares issued and outstanding at December 31, 2012 were 92,761,708 (September 30, 2012 - 83,211,708). As the Company experienced losses for the periods ended December 31, 2012 and September 30, 2012 all potential common shares outstanding from dilutive securities are considered anti-dilutive and are excluded from the calculation of loss per share for those periods.

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

Anti-dilutive potential securities	September 30, 2012	December 31, 2012
Common shares potentially assumable		
- under stock options	7,071,666	7,071,666
- under warrants	9,550,000	
	16,621,666	7,071,666