

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

For the three and nine months ended June 30, 2015

Contents

| | |
|---------------------------------------------------------------------------|-------------|
| Condensed Consolidated Interim Statement of Financial Position | 3 |
| Condensed Consolidated Interim Statement of Comprehensive Earnings | 4 |
| Condensed Consolidated Interim Statement of Changes in Equity | 5 |
| Condensed Consolidated Interim Statement of Cash Flows | 6 |
| Notes to Condensed Consolidated Interim Financial Statements | 7-30 |

**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.

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF FINANCIAL POSITION (UNAUDITED)

Expressed in Canadian Dollars

| | June 30, 2015 | September 30, 2014 |
|---------------------------------------------------|--------------------|-----------------------|
| Assets | | |
| Current Assets | | |
| Cash and cash equivalents | \$3,283,394 | \$3,574,836 |
| Short-term investments | 545,824 | 541,000 |
| Accounts receivable, net (Note 5) | 1,033,091 | 644,903 |
| Prepaid expenses | 222,524 | 91,893 |
| Inventories (Note 8) | 753,429 | 545,259 |
| Total current assets | 5,838,262 | 5,397,891 |
| Non-current assets | | |
| Restricted cash (Note 9) | 35,286 | 152,509 |
| Other receivables (Note 17) | 30,000 | 30,000 |
| Property, plant and equipment (Note 10) | 533,139 | 457,449 |
| Intangible assets (Note 11) | 1,867,607 | 1,923,544 |
| Total non-current assets | 2,466,032 | 2,563,502 |
| Total Assets | \$8,304,294 | \$7,961,393 |
| Liabilities and Shareholders' Equity | | |
| Current Liabilities | | |
| Accounts payable and accrued liabilities | \$1,258,827 | \$777,024 |
| Deferred revenue (Note 12) | 412,095 | 596,363 |
| Total current liabilities | 1,670,922 | 1,373,387 |
| Non-current Liabilities | | |
| Convertible debenture (Note 13) | 780,145 | 660,517 |
| Deferred revenue (Note 12) | 232,544 | 399,883 |
| Deferred rent | 72,858 | - |
| Total non-current liabilities | 1,085,547 | 1,060,400 |
| Total Liabilities | 2,756,469 | 2,433,787 |
| Shareholders' Equity | | |
| Share capital (Note 14 a) | 32,423,095 | 32,423,095 |
| Contributed surplus (Note 14 b and c) | 2,768,572 | 2,679,565 |
| Stock Options (Note 15) | 1,246,948 | 1,220,779 |
| Equity component of convertible debentures | 225,352 | 225,352 |
| Accumulated deficit (Note 14 d) | (31,116,142) | (31,021,185) |
| Total shareholders' Equity | 5,547,825 | 5,527,606 |
| Total Liabilities and Shareholders' Equity | \$8,304,294 | \$7,961,393 |

On behalf of the Board
(signed) "Abe Schwartz"

Director

(signed) "Brian Pedlar"

Director

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)

Expressed in Canadian Dollars

| | Three months ended June 30, | | Nine months ended June 30, | |
|---------------------------------------------------------------------------|-----------------------------|--------------------|----------------------------|---------------------|
| | 2015 | 2014 | 2015 | 2014 |
| Revenue | | | | |
| Product and Services | | | | |
| Advanced wound care | \$1,741,133 | \$1,119,559 | \$4,250,897 | \$3,253,214 |
| Specialized medical device coatings | 164,215 | 14,100 | 931,341 | 476,100 |
| Licensing and royalty fees | 68,989 | 157,719 | 309,062 | 3,968,137 |
| Total Revenue | 1,974,337 | 1,291,378 | 5,491,300 | 7,855,170 |
| Cost of sales | 787,382 | 589,788 | 1,976,715 | 1,632,082 |
| Gross Profit | 1,186,955 | 701,590 | 3,514,585 | 6,223,088 |
| Operating Expenses | | | | |
| Operations | 182,288 | 139,482 | 501,808 | 418,798 |
| Research and development activities | 127,386 | 106,648 | 422,171 | 331,368 |
| Sales and marketing | 351,230 | 194,470 | 806,606 | 632,822 |
| General and administrative | 637,573 | 479,826 | 1,791,281 | 1,466,996 |
| | 1,298,477 | 920,426 | 3,521,866 | 2,849,984 |
| Earnings before undernoted | (111,522) | (218,836) | (7,281) | 3,373,104 |
| Interest (expense) | (17,750) | (21,320) | (87,676) | (61,631) |
| Net (loss) earnings and comprehensive (loss) income for the period | \$ (129,272) | \$(240,156) | \$ (94,957) | \$ 3,311,473 |
| Basic (loss) earnings per share (Note 22) | \$ (0.01) | \$ (0.03) | \$ (0.01) | \$ 0.36 |
| Diluted earnings (loss) per share (Note 22) | \$ (0.01) | \$ (0.01) | \$ (0.01) | \$ 0.22 |

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY (UNAUDITED)

Expressed in Canadian Dollars

| | Share Capital | Contributed Surplus | Stock Options | Equity Component of Convertible Debentures | Accumulated Deficit | Total |
|-----------------------------------|---------------------|------------------------|--------------------|-----------------------------------------------------|------------------------|--------------------|
| Balance at October 1, 2013 | \$32,393,095 | \$2,224,645 | \$1,526,210 | \$225,352 | \$(33,422,954) | \$2,946,348 |
| Share based payments | - | - | 91,241 | - | - | 91,241 |
| Comprehensive income | - | - | - | - | 3,311,473 | 3,311,473 |
| Balance at June 30, 2014 | \$32,393,095 | \$2,224,645 | \$1,617,451 | \$225,352 | \$(30,111,481) | \$6,349,062 |
| Balance at October 1, 2014 | \$32,423,095 | \$2,679,565 | \$1,220,779 | \$225,352 | \$(31,021,185) | \$5,527,606 |
| Share based payments | - | - | 115,176 | - | - | 115,176 |
| Options naturally expired | - | 89,007 | (89,007) | - | - | - |
| Comprehensive (loss) | - | - | - | - | (94,957) | (94,957) |
| Balance at March 31, 2015 | \$32,423,095 | \$2,768,572 | \$1,246,948 | \$225,352 | \$(31,116,142) | \$5,547,825 |

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF CASH FLOWS (UNAUDITED)

Expressed in Canadian Dollars

| | Nine months ended June 30, | |
|--------------------------------------------------------------------------------------------------------|----------------------------|--------------|
| | 2015 | 2014 |
| Cash flows from operating activities | | |
| Net (loss) earnings and comprehensive (loss) income for the period | \$(94,957) | \$3,311,473 |
| Adjustments to reconcile net earnings and comprehensive gain to net cash used in operating activities: | | |
| Depreciation - property, plant and equipment | 72,220 | 84,603 |
| Amortization - intangible assets | 120,450 | 143,558 |
| Non-cash interest (Note 13) | 119,629 | 105,470 |
| Share based payments | 115,176 | 91,241 |
| Foreign exchange (gain) on cash held | (32,550) | (12,765) |
| Cash generated (used) by operating activities before change in non-cash working capital balances | 299,968 | 3,723,580 |
| Change in non-cash working capital (Note 20) | (523,936) | (47,877) |
| Total cash flows from operating activities | (223,968) | 3,675,703 |
| Cash flows from investing activities | | |
| Purchase of property, plant and equipment | (161,816) | (12,057) |
| Disposition of property, plant and equipment - net | 13,907 | - |
| Purchase of intangible assets | (64,514) | (69,467) |
| Total cash flows from investing activities | (212,423) | (81,524) |
| Cash flows from financing activities | | |
| Restricted cash | 117,223 | (85,274) |
| Short term investments | (4,824) | - |
| Total cash flows from financing activities | 112,399 | (85,274) |
| Foreign exchange gain on cash held | 32,550 | 12,765 |
| Total net (decrease) increase in cash and cash equivalents during the period | (291,442) | 3,521,670 |
| Cash and cash equivalents, beginning of the period | \$ 3,574,836 | \$ 633,103 |
| Cash and cash equivalents, end of the period | \$ 3,283,394 | \$ 4,154,773 |
| Represented by | | |
| Cash | \$ 939,381 | \$743,691 |
| Cash equivalents | 2,344,013 | 3,411,082 |
| | \$3,283,394 | \$4,154,773 |

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

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

1. CORPORATE INFORMATION

Covalon Technologies Ltd. (“the Company”) 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 and nine months ended, June 30, 2015 comprise the results of the Company and its subsidiaries. The Company has 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 1660 Tech Avenue, Unit 5, Mississauga, Ontario, Canada. The Company’s development and commercialization centre is located at 405 Britannia Road East, Suite 106, Mississauga, Ontario, Canada.

2. BASIS OF PRESENTATION

a) **Statement of Compliance**

These consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”) applicable to the preparation of interim financial statements, including IAS 34, Interim Financial Reporting.

The consolidated financial statements were authorized for issue by the Board of Directors on August 27, 2015.

b) **Basis of Measurement**

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

c) **Functional Currency**

These consolidated financial statements are presented in Canadian dollars, which is the Company’s functional currency, and are rounded to the nearest dollar (CAD \$), unless otherwise indicated.

d) **Critical accounting estimates and judgments**

The preparation of financial statements in compliance with IFRS requires management to make certain critical accounting estimates. It also requires management to exercise judgment in applying the Company’s accounting policies. The areas involving a higher degree of judgment, complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 4.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all years presented in these consolidated financial statements.

a) **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 acquisition method of consolidation. The assets and liabilities of the acquired companies are initially recorded at fair value at the date of acquisition. 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.

b) **Revenue Recognition**

Revenue is recognized on an accrual basis as follows:

- i) Revenue arising from product sales is recognized once the product has been shipped to the customer if the Company is responsible for arranging product shipment;
- ii) Revenue arising from product sales, when the customer is responsible for arranging product shipment, is recognized once the product shipment is segregated, the customer is notified that the shipment is ready for pick up, the customer has agreed that title to the goods has passed, and the shipment has been properly invoiced;
- iii) Revenue arising from licensing fees and royalties are recognized as earned under the contract terms. Where appropriate, payments are initially recorded as deferred revenue and recognized over the period of the relevant agreements;
- iv) Revenue arising from long term development contracts is recognized using the percentage of completion method; and
- v) Revenue arising from interest is recognized as earned.

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

c) **Cash and Cash Equivalents**

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

d) **Inventories**

Raw materials and supplies are stated at the lower of weighted average cost and net realizable value. Work in process and finished goods are stated at the lower of weighted average cost and net realizable value in accordance with IAS 2. Cost comprises all costs of purchase and costs of conversion which includes directly attributable production overheads.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

e) **Property, Plant and Equipment**

i) **Recognition and Measurement**

On initial recognition property, plant and equipment are valued at cost, being the purchase price and directly attributable cost of acquisition or construction required to bring the asset to the location and condition necessary to be capable of operating in the manner intended by the Company.

Property, plant and equipment is subsequently measured at cost less accumulated depreciation, and any accumulated impairment losses.

When parts of an item of property, plant and equipment have different useful lives they are accounted for as separate items (major components) of property, plant and equipment.

ii) **Subsequent Costs**

The cost of replacing part of an item of property, plant and equipment is recognized in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Company and the cost can be measured reliably. The carrying amount of the replaced part is derecognized. The costs of the day-to-day servicing of property, plant and equipment are recognized in operations as incurred.

All other repairs and maintenance costs are charged to operations during the financial period in which they are incurred.

iii) **Gains and Losses**

Gains and losses on disposal of an item of property, plant and equipment are determined by comparing the proceeds from disposition with the carrying amount and are recognized in operations.

iv) **Depreciation**

Depreciation is recognized in operations and is calculated using the following annual rates:

| | |
|------------------------|-------------------------------|
| Furniture and fixtures | 20% diminishing balance basis |
| Lab equipment | 20% diminishing balance basis |
| Leasehold improvements | 20% straight-line |

Depreciation methods, useful lives, and residual values are reviewed at each financial year-end and adjusted if appropriate.

f) **Intangible Assets**

i) **Patents, Trademarks, and Computer Software**

Intangible assets include expenditures related to obtaining patents and technology rights associated with patents, trademarks, and computer software. Patents are amortized on a

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

straight-line basis over the remaining life of the patent, being 20 years less the number of years since application for the patent, and are stated at cost less accumulated amortization and impairment. Trademarks are considered to have an indefinite useful life and as such are recorded at cost less accumulated impairment. Computer software is amortized using the 20% diminishing balance basis. Amortization methods, useful lives, and residual values are reviewed at each reporting date and adjusted if appropriate.

Gains and losses on disposal of an item of other intangible assets are determined by comparing the proceeds from disposition with the carrying amount and are recognized net within other income in operations.

ii) Deferred Development Costs/Research and Development

Expenditures on research activities, undertaken with the prospect of gaining new scientific or technical knowledge and understanding, are recognized in operations as incurred.

Development activities involve a plan or design for the production of new, or substantially improved, products and processes related to the Company's technology platforms, advanced wound dressings, and specialized medical device coatings. Development expenditure is capitalized only if development costs can be measured reliably, the product or process is technically and commercially feasible, future economic benefits are probable, and the Company intends to and has sufficient resources to complete development and to use or sell the asset. The capitalized expenditures include the cost of materials, direct labour, and overhead costs that are directly attributable to preparing the asset for its intended use.

Development expenditures not satisfying the above criteria, and expenditures on the research phase of internal projects, are recognized in operations as incurred.

Capitalized development expenditures are amortized from the beginning of commercial production and sales, and are amortized on a straight-line basis over the remaining life of the related patent(s).

Gains and losses on disposal, of an item of deferred development costs, are determined by comparing the proceeds from disposition with the carrying amount and are recognized net within other income in operations.

g) Impairment of Non-Financial Assets

Impairment tests on intangible assets with indefinite useful economic lives are undertaken annually at the financial year-end. Other non-financial assets, including property plant and equipment, computer software, patents, and deferred development costs are subject to impairment tests whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. Where the carrying value of an asset exceeds its recoverable amount, which is the higher of value in use and fair value less costs to sell, the asset is written down accordingly. Where it is not possible to estimate the recoverable amount of an individual asset the impairment test is carried out on the asset's cash-generating unit, which is the lowest group of assets in which the asset belongs for which there are

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

separately identifiable cash inflows that are largely independent of the cash inflows from other assets. The Company has identified two cash-generating units for which impairment testing is performed: (1) advanced wound care; and, (2) specialized medical device coatings. An impairment loss is charged to operations except to the extent it reverses gains previously recognized in other comprehensive income/loss.

h) Investment Tax Credits

From time to time the Company receives investment tax credits. Investment tax credits are accrued when there is reasonable assurance of realization and these are reflected as a reduction of the related expense. In the event the investment tax credits received are less than the amount previously recognized, the difference will be reflected in operations for the period in which it is determined.

i) Other Provisions

Provisions are recognized for liabilities of uncertain timing or amount that have arisen from past transactions, including legal or constructive obligations. The provision is measured at the best estimate of the expenditure required to settle the obligation at the reporting date.

j) Income Taxes

Current income taxes are recognized for the estimated income taxes payable or receivable on taxable income, or loss, for the current year and any adjustment to income taxes payable in respect of previous years. Current income taxes are determined using tax rates and tax laws that have been enacted or substantively enacted by the year-end date.

Deferred tax assets and liabilities are recognized for the tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred 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 deferred tax assets and liabilities of a change in tax rates is recognized in operations for the year in which the change occurs.

Recognition of deferred tax assets is restricted to those instances where it is probable that taxable profit will be available against which the temporary difference or loss can be utilized.

Current and deferred taxes are recognized in net income except to the extent that they relate to items recognized directly in equity or in other comprehensive loss/income.

k) Foreign Currency Transactions

Foreign currency amounts are translated into Canadian dollars (the functional currency) as follows:

At the transaction date each asset, liability, revenue, and expense denominated in a foreign currency is translated into Canadian dollars by the use of the exchange rate in effect at that date. At the reporting date unsettled monetary assets and liabilities are translated into Canadian dollars by using the

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

exchange rate in effect at the reporting date and the related translation differences are recognized in net income.

Non-monetary assets and liabilities that are measured at historical cost are translated into Canadian dollars by using the exchange rate in effect at the date of the initial transaction and are not subsequently restated.

l) Financial Instruments

Financial instruments are classified into one of the following categories based on the purpose for which the assets were acquired. All transactions related to financial instruments are recorded on a trade date basis. The Company's accounting policy for each category is as follows:

i) Loans and Receivables

Cash and cash equivalents, restricted cash, short term investments, and accounts receivable are classified as loans and receivables. They are initially recognized at fair value and subsequently carried at amortized cost, using the effective interest rate method, less any impairment losses. Amortized cost is calculated taking into account any discount or premium on acquisition, fees that are an integral part of the effective interest rate, and transaction costs. Gains and losses are recognized in operations when the loans and receivables are derecognized, impaired, or through the amortization process; and,

ii) Financial Liabilities

Accounts payable and accrued liabilities are classified as other financial liabilities. They are initially recognized at fair value (net of any transaction costs) then subsequently carried at amortized cost using the effective interest rate method.

Accounts payable and accrued liabilities represent liabilities for goods and services provided to the Company prior to the end of the period which are unpaid. Accounts payable amounts are unsecured and are usually paid within payment terms negotiated with the supplier.

m) Share Capital

Financial instruments issued by the Company are classified as equity only to the extent that they do not meet the definition of a financial liability or financial asset. The Company's common shares are classified as equity instruments.

Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.

n) Earnings (Loss) Per Share

Earnings (loss) per share is computed by dividing the net income (loss) applicable to common shares of the Company by the weighted average number of common shares outstanding for the relevant

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

period. Diluted earnings (loss) per share is computed similar to basic earnings (loss) per share except that the weighted average shares outstanding are increased to include additional shares for the assumed exercise of stock options and warrants, if dilutive. The number of additional shares is calculated by assuming that outstanding stock options and warrants were exercised and that the proceeds from such exercises were used to acquire common stock at the average market price during the reporting periods.

o) Share-based Payments

Where equity-settled share options are awarded to employees, the fair value of the options at the date of grant is charged to the statement of comprehensive loss over the vesting period.

Where equity instruments are granted to employees, they are recorded at the fair value of the equity instrument granted at the grant date. The grant date fair value is recognized in comprehensive income/loss over the vesting period, described as the period during which all the vesting conditions are to be satisfied.

When the value of goods or services received in exchange for the share-based payment cannot be reliably estimated, the fair value is measured by use of a valuation model. The expected life used in the model is adjusted based on management's best estimates for the effects of non-transferability, exercise restrictions, and behavioural considerations.

p) Common Share Purchase Warrants

The Company periodically issues units to investors consisting of common shares combined with common share purchase warrants. Gross proceeds received from the issuance of units are accounted for as an increase in share capital. No separate valuation of the warrants is made for accounting purposes.

Similarly, the Company periodically issues units to investors consisting of debentures convertible into common shares combined with common share purchase warrants. Gross proceeds are allocated to the discounted current value of the debt and the equity component representing the value of the convertible feature of the debenture. No separate valuation of the warrants is made for accounting purposes.

q) Standards, Amendments and Interpretations Not Yet Effective

Certain pronouncements were issued by the IASB or the IFRS Interpretations Committee that are mandatory for accounting periods beginning after October 1, 2014 or later periods. None of these are expected to have a significant effect on the consolidated financial statements, except for the following standards and interpretations that have been issued but are not yet effective:

i) IFRS 9 - Financial Instruments

IFRS 9, Financial Instruments is part of the IASB's wider project to replace IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 retains but simplifies the mixed measurement model and establishes two primary measurement categories for financial assets: amortized cost and fair value. The basis of classification depends on the entity's business model

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

and the contractual cash flow characteristics of the financial asset. The standard is effective for annual periods beginning on or after January 1, 2018. The Company is in the process of evaluating the impact of the new standard.

ii) IFRS 15 - Revenue From Contracts with Customers

IFRS 15, Revenue From Contracts with Customers establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer. The standard is effective for annual periods beginning on or after January 1, 2017. The Company has not yet assessed the impact of adopting this standard.

There are no other IFRSs or IFRIC interpretations that are not yet effective that would be expected to have a material impact on the Company.

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.

ESTIMATES

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.

i) Share-based Payment Transactions

The Company measures the cost of equity-settled transactions with directors, officers and employees by reference to the fair value of the equity instruments at the date at which they are granted. Estimating fair value for share-based payment transactions requires determining the most appropriate valuation model, which is dependent on the terms and conditions of the grant. This estimate also requires determining the most appropriate inputs to the valuation model including the expected life of the share option, volatility and dividend yield and making assumptions about them. The assumptions and models used for estimating fair value for share-based payment transactions are disclosed in Note 15.

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 CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

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 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.

iv) Income taxes

The Company recognizes deferred tax assets, related tax-loss carryforwards, and other deductible temporary differences where it is probable that sufficient future taxable income can be generated in order to fully utilize such losses and deductions. This requires significant estimates and assumptions regarding future earnings and the ability to implement certain tax planning opportunities in order to assess the likelihood of utilizing such losses and deductions.

Uncertainties exist with respect to the interpretation of complex tax regulations and the amount and timing of future taxable income. Given the cross border business relationships, differences arising between the actual results and the assumptions made, or future changes in such assumptions, could necessitate future adjustments to taxable income and deductions already recorded. The Company established provisions, based on reasonable estimates, for possible consequences of audits by the tax authorities of the restive countries in which it operates. The amount of such provision is based on various factors, such as experience of previous tax audits and differing interpretations of tax regulations by the taxable entity and the responsible tax authority. Such differences of interpretation may arise on a wide variety of issues depending on the conditions prevailing in the respective Company domicile.

JUDGMENTS

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) Foreign Currency translation:

The determination of functional currency for each of the Company's entities requires considerable judgment. The functional currency is determined based on the currency of the primary economic environment in which that entity operates. As the Company generates and expends cash in both the US and Canadian currencies, management considers several factors, including: the currency in which it receives its various revenue streams and the magnitude of each; the currency in which it purchases materials and pays its employees; and, the geographic environment influencing each of its consolidated entities and products; and

ii) Provisions

A provision is a liability of uncertain timing or amount. Provisions are recognized when the Company has a present obligation (legal or constructive) as a result of a past event, it is probable that the Company will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. A legal obligation can arise through a contract, legislation, or other operation of law. A constructive obligation arises from an entity's actions; whereby, through an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated it will accept certain responsibilities and has thus created a valid expectation that it will discharge those responsibilities. The amount

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

recognized as a provision is the best estimate, at each period end, of the expenditures required to settle the present obligation considering the risks and uncertainties associated with the obligation. Judgment is necessary to determine the likelihood that pending litigation or other claims will succeed or a liability will arise and then to estimate the amount.

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 \$3,675,826 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 receivables 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 the nine months ended June 30, 2015, ten customers accounted for 88% (2014 – ten customers for 87%) 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 \$379,118 (2014 – \$1,121) resulting in a provision for doubtful accounts expense of \$nil (2014 - \$nil). Management reviews the outstanding amounts on a regular basis and determines the collectability of the outstanding balances on a case by case basis.

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

| | June 30, 2015 | September 30, 2014 |
|----------------------------------------------------------------------------------------------------|--------------------------|-----------------------|
| Current | 1,003,347 | \$553,506 |
| 30-60 days past due | 15,452 | 21,762 |
| Over 60 days past due, (net of allowance for doubtful accounts of \$379,118; Sep 2014 - \$379,118) | 14,292 | 69,635 |
| | \$1,033,091 | \$644,903 |

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

Liquidity risk

The Company continually monitors working capital to ensure sufficient cash is available to meet operational and capital expenditure requirements.

The Company has contractual obligations related to accounts payable and accrued liabilities that are due within a year.

On December 5, 2014 the Company negotiated a lease renewal for its premises at 405 Britannia Rd, Mississauga. The revised lease has a term of five years commencing January 1, 2015 and expires December 31, 2019. The annual rent will be: \$94,354 (2015); \$96,863 (2016); \$99,481 (2017); \$102,208 (2018); and \$104,935 (2019).

On November 17, 2014 the Company signed an offer to lease for its premises at 1660 Tech Avenue, Mississauga which will commence June 1, 2015. The lease agreement is for a period of 10 years and will expire May 31, 2025. The minimum lease payments for the first five years will be \$159,250 annually and increase to \$202,125 for year's six to ten.

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:

| | June 30, 2015 | September 30, 2014 |
|-------------------------------|---------------------------|-----------------------|
| Accounts receivable, net | 928,450 | 494,350 |
| Accounts payable | (586,689) | (222,555) |
| Deferred Revenue | (80,933) | (125,723) |
| Cash | 750,703 | 94,577 |
| Exchange rate (\$USD / \$CAD) | 1.25 | 1.12 |
| | <u>\$1,011,530</u> | <u>\$240,649</u> |

An increase of 5% and 10% in the US dollar exchange rate would result in an increase in net income by approximately \$ 50,577 (2014 – \$52,075) and \$ 101,153 (2014 - \$104,149) respectively.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

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, contributed surplus, equity component of convertible debentures, and accumulated 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 June 30, 2015 is \$ 5,547,825 (2014 - \$6,349,062).

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.

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 year ended September 30, 2014, the Company recognized \$55,597 (2014 - \$Nil) in credits.

8. INVENTORIES

Inventories consist of the following:

| | June 30, 2015 | September 30, 2014 |
|----------------|--------------------------|-----------------------|
| Raw materials | \$250,712 | \$364,850 |
| Finished Goods | 502,717 | 241,042 |
| | \$753,429 | \$545,259 |

Product expenses include \$1,667,506 (2014 - \$1,309,755) in inventoried materials.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

9. RESTRICTED CASH

The Company assigned \$35,286 of its cash equivalents with a major financial institution as collateral to secure its credit cards. These funds are expected to be restricted for more than one year.

10. PROPERTY PLANT AND EQUIPMENT

| | Furniture and Fixtures | Lab Equipment | Leasehold Improvements | Total |
|---------------------------------|---------------------------------------|--------------------------|-----------------------------------|--------------|
| | \$ | \$ | \$ | \$ |
| Cost | | | | |
| Balance at October 1, 2013 | 319,116 | 1,478,500 | 71,416 | 1,869,032 |
| Additions | - | 12,055 | - | 12,055 |
| Balance at September 30, 2014 | 319,116 | 1,490,555 | 71,416 | 1,881,087 |
| Disposals | - | (94,075) | - | (94,075) |
| Additions | 71,203 | 35,760 | 54,854 | 161,816 |
| Balance at June 30, 2015 | 390,319 | 1,432,240 | 126,270 | 1,948,829 |
| Accumulated depreciation | | | | |
| Balance at October 1, 2013 | 225,737 | 1,013,630 | 71,416 | 1,310,783 |
| Depreciation | 18,676 | 94,179 | - | 112,855 |
| Balance at September 30, 2014 | 244,413 | 1,107,809 | 71,416 | 1,423,638 |
| Depreciation | 13,760 | 57,774 | 686 | 72,220 |
| Disposals | - | (80,168) | - | (80,168) |
| Balance at June 30, 2015 | 258,173 | 1,085,415 | 72,102 | 1,415,690 |
| Carrying amounts | | | | |
| At September 30, 2014 | 74,703 | 382,746 | - | 457,449 |
| At June 30, 2015 | 132,146 | 346,825 | 54,168 | 533,139 |

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

11. INTANGIBLE ASSETS

| Cost | Deferred | Patents | Trademarks | Computer | Total |
|-------------------------------------------------------|-------------|---------|------------|----------|-----------|
| | Development | | | Software | |
| | Costs | | | | |
| | \$ | \$ | \$ | \$ | \$ |
| Balance at October 1, 2013 | 4,134,415 | 621,803 | 72,782 | 149,163 | 4,978,164 |
| Additions | - | 100,973 | 4,855 | - | 105,828 |
| Balance at September 30, 2014 | 4,134,415 | 722,776 | 77,637 | 149,163 | 5,083,992 |
| Additions | - | 64,188 | 326 | - | 64,514 |
| Balance at June 30, 2015 | 4,134,415 | 786,964 | 77,963 | 149,163 | 5,148,505 |
| Accumulated amortization and impairment losses | | | | | |
| Balance at October 1, 2013 | 2,727,891 | 133,366 | - | 115,877 | 2,977,134 |
| Amortization | 121,711 | 34,093 | - | 27,510 | 183,314 |
| Balance at September 30, 2014 | 2,849,602 | 167,459 | - | 143,387 | 3,160,448 |
| Amortization | 91,277 | 28,308 | - | 865 | 120,450 |
| Balance at June 30, 2015 | 2,940,879 | 195,767 | - | 144,252 | 3,280,898 |
| Carrying amounts | | | | | |
| At September 30, 2014 | 1,284,813 | 555,318 | 77,637 | 5,776 | 1,923,544 |
| At June 30, 2015 | 1,193,536 | 591,197 | 77,963 | 4,911 | 1,867,607 |

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.

| | June 30, 2015 | September 30, 2014 |
|------------------------------------------------------|------------------|-----------------------|
| Balance, beginning of period | \$ 783,431 | \$1,225,107 |
| <u>Add:</u> | | |
| Deferred licensing fees | - | 207,638 |
| Deferred product and services revenue | 508,390 | 49,532 |
| <u>Less:</u> | | |
| Recognition of deferred product and services revenue | (510,056) | (235,584) |
| Recognition of deferred licensing fees | (137,126) | (250,447) |
| Balance, end of period | 644,639 | 996,246 |
| Amount to be recognized within one year | (412,095) | (596,363) |
| | \$ 232,544 | \$399,883 |

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

13. CONVERTIBLE DEBENTURE UNITS

On August 30, 2013 the Company issued a private placement consisting of 750 units for gross proceeds of \$750,000. Units were priced at \$1,000 each. Each unit consists of a \$1,000 secured convertible debenture and 6,451 warrants. Each convertible debenture unit bears interest at 12% payable on maturity and is convertible into 6,451 common shares of the Company at a conversion price of \$0.155 at any time prior to August 31, 2016. Each warrant entitles the holder to acquire one common share at a price of \$0.155 at any time prior to August 31, 2016. A portion of the units were issued to related parties.

The debenture is secured, ranking senior to all indebtedness of the Company.

| | June 30, 2015 | September 30, 2014 |
|-----------------------------------------------------------------|--------------------------|-----------------------|
| Face value of convertible debenture at maturity August 31, 2016 | \$750,000 | \$750,000 |
| Fair value of the convertible debenture at date of issue, net | 524,648 | 524,648 |
| Less transaction costs | (19,733) | (19,733) |
| Interest at 12% accrued and compounded annually | 1198,629 | 97,500 |
| Accretion | 115,601 | 58,102 |
| | 780,145 | 660,517 |
| Fair value of Equity component | 225,352 | 225,352 |

14. SHARE CAPITAL AND RESERVES

a) Common Shares

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

On August 30, 2013 the Company issued a private placement consisting of 750 units for gross proceeds of \$750,000. Units were priced at \$1,000 each. Each unit consists of a \$1,000 secured convertible debenture and 6,451 warrants. Each convertible debenture unit bears interest at 12% payable on maturity and is convertible into 6,451 common shares of the Company at a conversion price of \$0.155 at any time prior to August 31, 2016. Each warrant entitles the holder to acquire one common share at a price of \$0.155 at any time prior to August 31, 2016. The units are subject to a hold period expiring December 31, 2013. See Note 13.

On July 16, 2013 the Company consolidated its issued and outstanding common shares on the basis of one post-consolidation common share for each 10 pre-consolidation common shares. These Consolidated Financial Statements are prepared based on the number of post-consolidation shares, options and warrants outstanding.

On October 26, 2012 the Company issued 955,000 units at a price of \$0.52 per unit for gross proceeds of \$496,600. 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 \$1.00 for a

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

period of five years expiring October 26, 2017. During the year ended September 30, 2014, 30,000 warrants were exercised for total proceeds of \$30,000.

In fiscal 2006, Covalon acquired technology from Perfusion Therapeutics Inc. for 110,000 fully paid non-assessable common shares of Covalon Technologies Ltd., issued in escrow to be released on various success milestones. At June 30, 2015, 15,000 (2014 – 15,000) shares valued at \$213,875 (2013 - \$213,875) have been released from trust. The remaining balance of 95,000 shares are still being held in trust.

The following is a summary of changes in common share capital from September 30, 2013 to June 30, 2015:

| | Number of Shares # | Issue Price \$ | Amount \$ |
|---------------------------------------------------------|--------------------------|----------------------|--------------|
| Balance at September 30, 2013 | 9,276,171 | | 32,393,095 |
| Shares issued from exercise of warrants | 30,000 | 1.00 | 30,000 |
| Balance at September 30, 2014, and June 30, 2015 | 9,306,171 | | 32,423,095 |

b) Contributed Surplus

The following is a summary of changes in contributed surplus from September 30, 2013 to June 30, 2015:

| | |
|-----------------------------------|---------------------|
| Balance September 30, 2013 | \$ 2,224,645 |
| Options naturally expired | 454,920 |
| Balance September 30, 2014 | \$ 2,679,565 |
| Options naturally expired | 89,007 |
| Balance June 30, 2015 | \$ 2,768,572 |

c) Share Purchase Warrants

The following is a summary of changes in warrants from September 30, 2013 to June 30, 2015:

| | Number of Warrants | Exercise Price | Expiry Date |
|---------------------------------------------------------|-----------------------|-------------------|------------------|
| Balance at September 30, 2013 | 5,793,250 | | |
| Warrants exercised | 30,000 | \$1.00 | October 26, 2017 |
| Balance at September 30, 2014, and June 30, 2015 | 5,763,250 | | |

d) 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 have naturally expired.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

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

15. 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.

The following is a summary of changes from October 1, 2013 to September 30, 2014

| Grant Date | Expiry Date | Exercise Price | Opening Balance | During the period | | | | Closing Balance | Vested | Unvested |
|---------------------------------|-------------|----------------|-----------------|-------------------|-----------|-----------|-----------|-----------------|---------|----------|
| | | | | Granted | Exercised | Expired | Forfeited | | | |
| 15-Oct-08 | 15-Oct-13 | \$ 7.50 | 6,000 | - | - | (6,000) | - | - | - | |
| 22-May-09 | 22-May-14 | \$ 4.00 | 120,000 | - | - | (120,000) | - | - | - | |
| 11-Dec-09 | 11-Dec-14 | \$ 2.90 | 1,007 | - | - | - | 1,007 | 1,007 | - | |
| 27-Jan-10 | 27-Jan-15 | \$ 3.10 | 85,500 | - | - | - | 85,500 | 85,500 | - | |
| 01-Sep-10 | 01-Sep-15 | \$ 2.00 | 120,000 | - | - | - | 120,000 | 120,000 | - | |
| 02-Sep-10 | 02-Sep-15 | \$ 2.00 | 28,496 | - | - | - | (1,500) | 26,996 | 26,996 | |
| 10-Jun-11 | 10-Jun-16 | \$ 2.00 | 26,995 | - | - | - | - | 26,995 | 26,995 | |
| 13-Jun-11 | 13-Jun-16 | \$ 2.00 | 71,000 | - | - | - | - | 71,000 | 71,000 | |
| 27-Sep-11 | 27-Sep-16 | \$ 1.40 | 100,000 | - | - | - | - | 100,000 | 100,000 | |
| 16-Aug-13 | 16-Aug-18 | \$ 0.16 | 74,500 | - | - | - | (10,000) | 64,500 | 21,500 | 43,000 |
| 26-Sep-13 | 26-Sep-18 | \$ 0.85 | 235,000 | - | - | - | - | 235,000 | 78,333 | 156,667 |
| 13-Jun-14 | 13-Jun-19 | \$ 2.00 | - | 102,500 | - | - | (5,000) | 97,500 | - | 97,500 |
| | | | 868,498 | 102,500 | - | (126,000) | (16,500) | 828,498 | 531,331 | 297,167 |
| Weighted Average Exercise Price | | | \$ 1.57 | \$ - | \$ 1.89 | \$ 2.00 | \$ - | \$ 4.13 | \$ 0.88 | \$ 1.57 |

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

The following is a summary of changes in options from October 1, 2014 to three and nine months ended, June 30, 2015:

| Grant Date | Expiry Date | Exercise Price | Opening Balance | During the period | | | | Closing Balance | Vested | Unvested |
|---------------------------------|-------------|----------------|-----------------|-------------------|-----------|----------|-----------|-----------------|---------|----------|
| | | | | Granted | Exercised | Expired | Forfeited | | | |
| 11-Dec-09 | 11-Dec-14 | \$ 2.90 | 1,007 | - | - | (1,007) | - | - | - | - |
| 27-Jan-10 | 27-Jan-15 | \$ 3.10 | 85,500 | - | - | (85,500) | - | - | - | - |
| 01-Sep-10 | 01-Sep-15 | \$ 2.00 | 120,000 | - | - | - | - | 120,000 | 120,000 | - |
| 02-Sep-10 | 02-Sep-15 | \$ 2.00 | 26,996 | - | - | - | - | 26,996 | 26,996 | - |
| 10-Jun-11 | 10-Jun-16 | \$ 2.00 | 26,995 | - | - | - | - | 26,995 | 26,995 | - |
| 13-Jun-11 | 13-Jun-16 | \$ 2.00 | 71,000 | - | - | - | - | 71,000 | 71,000 | - |
| 27-Sep-11 | 27-Sep-16 | \$ 1.40 | 100,000 | - | - | - | - | 100,000 | 100,000 | - |
| 16-Aug-13 | 16-Aug-18 | \$ 0.16 | 64,500 | - | - | - | - | 64,500 | 21,500 | 43,000 |
| 26-Sep-13 | 26-Sep-18 | \$ 0.85 | 235,000 | - | - | - | - | 235,000 | 78,333 | 156,667 |
| 13-Jun-14 | 13-Jun-19 | \$ 2.00 | 97,500 | - | - | - | (2,500) | 95,000 | - | 95,000 |
| 26-Mar-15 | 26-Mar-20 | \$ 1.40 | - | 150,500 | - | - | - | 150,500 | - | 150,500 |
| | | | 828,498 | 150,500 | - | (86,507) | (2,500) | 889,991 | 444,824 | 445,167 |
| Weighted Average Exercise Price | | | \$1.57 | \$1.40 | \$- | \$3.10 | \$2.00 | \$1.39 | \$1.57 | \$ 1.21 |

b) Fair Value of Options Issued During the Period

During the nine months ended June 30, 2015, the Company issued one tranche of options:

- i) 150,500 options with a weighted average fair value of \$1.29 were granted. Trading price of the stock at the time of the grant was \$1.40. 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 – 0.53%, dividend rate NIL, average volatility – 163.38% and an average term of 5 years. The estimated forfeiture rate is 8.56%.

During the year ended September 30, 2014, the Company issued one tranche of options:

- i) 102,500 options with a weighted average fair value of \$1.89 were granted. Trading price of the stock at the time of the grant was \$2.00. 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 – 1.31%, dividend rate NIL, average volatility – 169.38% and an average term of 5 years. The estimated forfeiture rate is 8.01%.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

c) Expenses Arising from Share-based Payment Transactions

Total expenses arising from share-based payment transactions recognized during the period as part of employee benefit expense were \$115,176 (2014 - \$91,241).

16. INCOME TAXES

The Company computes an income tax provision in each of the jurisdictions in which it operates. The operations in Canada and the United States are subject to income tax at average rates of 26.5% - 39.5% (2013 - 26.5% - 39.5%) for the year ended September 30, 2014.

a) Reconciliation between statutory rate and actual rate

| | September 31, | |
|-------------------------------------------------------------|---------------|--------------|
| | 2014 | 2013 |
| Income tax expense computed at statutory combined tax rates | \$ 615,700 | \$ (279,500) |
| Permanent differences | 42,900 | 800 |
| Provision to return adjustment | 11,400 | - |
| Losses expired | 4,900 | - |
| Other | (100) | (2,000) |
| Change in deferred tax assets not recognized | (674,800) | 280,700 |
| | \$ - | \$ - |

b) Deferred tax assets

The tax effect of the temporary differences that gives rise to deferred tax assets (liabilities) as of September 30, 2014 and 2013 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.

| | September 31, | |
|----------------------------------------|---------------|--------------|
| | 2014 | 2013 |
| Non-capital loss carry forwards | \$ 4,401,300 | \$ 5,107,700 |
| Capital loss carry forwards | 127,600 | 127,600 |
| Capital and other assets | 49,000 | 100,600 |
| Deferred development costs | 1,577,000 | 1,441,100 |
| Deferred revenue and other liabilities | 273,000 | 340,700 |
| Convertible debenture | (49,600) | (64,600) |
| Deferred tax assets not recognized | (6,378,300) | (7,053,100) |
| | \$ - | \$ - |

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2014 of approximately \$16,369,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

| <u>Year</u> | <u>Canada Amount</u> | <u>US Amount</u> |
|-------------|--------------------------|----------------------|
| 2015 | 242,000 | |
| 2026 | 1,499,000 | |
| 2027 | - | |
| 2028 | 2,132,000 | |
| 2029 | 3,309,000 | |
| 2030 | 601,000 | |
| 2031 | 3,874,000 | 68,200 |
| 2032 | 3,267,000 | 140,000 |
| 2033 | 859,000 | 127,000 |
| 2034 | 89,000 | 161,800 |
| | <u>\$ 15,872,000</u> | <u>\$ 497,000</u> |

- (c) The Company has capital losses carry forward for income tax purposes as at September 30, 2014 of approximately \$962,883 (2013 - \$962,883), which are available to reduce taxable capital gains in future years. These losses do not expire.
- (d) The Company is eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% on its research and development expenditures and refundable in cash to the Company. The Company is also eligible for a 20% federal research and development investment tax credit and a 4.5% Ontario Research and Development Tax Credit ("ORDTC") which are available to offset federal income taxes payable and Ontario income taxes payable, respectively, in the future.

The tax credits ultimately received by the Company are subject to review by Canada Revenue Agency and the Ontario Ministry of Finance.

At September 30, 2014, the Company has \$1,517,784 (2013 - \$1,414,446) 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 2023. These unclaimed investment tax credits have not been recognized as receivables.

At September 30, 2014, the Company has \$114,426 (2013 - \$90,115) of unclaimed ORDTC available to reduce Ontario income taxes payable in future years. If not utilized, these ORDTC will start expiring in 2029. These unclaimed ORDTC have not been recognized as receivables.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

17. RELATED PARTY TRANSACTIONS

Key management personnel are persons responsible for planning, directing and controlling the activities of an entity, and include directors.

Key management personnel compensation comprised:

| | Three months ended June 30, | | Nine months ended June 30, | |
|-----------------------------------------------------|-----------------------------|-----------|----------------------------|-----------|
| | 2015 | 2014 | 2015 | 2014 |
| Salaries, benefits, management and director fees | \$161,044 | \$146,681 | \$322,087 | \$570,044 |
| Share-based payments | 11,042 | 27,379 | 32,982 | 82,136 |
| | \$172,086 | \$174,060 | \$355,069 | \$652,180 |

During the year end September 30, 2013 a non interest bearing loan of \$50,000 was made to a key employee. The principal is repayable in annual instalments of \$10,000 commencing August 16, 2014 with the final payment due August 16, 2018.

A portion of the Convertible Debenture Units (Note 12) were issued to related parties.

18. COMMITMENTS

On December 5, 2014 the Company negotiated a lease renewal for its premises at 405 Britannia Rd, Mississauga. The revised lease has a term of five years commencing January 1, 2015 and expires December 31, 2019. The annual rent will be: \$94,354 (2015); \$96,863 (2016); \$99,481 (2017); \$102,208 (2018); and \$104,935 (2019).

On November 17, 2014 the Company signed an offer to lease for its premises at 1660 Tech Avenue, Mississauga which will commence June 1, 2015. The lease agreement is for a period of 10 years and will expire May 31, 2025. The minimum lease payments for the first five years will be \$159,250 annually and increase to \$202,125 for year's six to ten.

The Company has also entered into one operating lease for its equipment. The equipment is leased at a total cost of \$4,956 per year and expires in 2018.

19. CONTINGENCIES

From time to time, 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 types of proceedings is currently not determinable. Legal fees are expensed by the Company in the period for which they are incurred and any loss resulting from these proceedings will be charged to operations in the period the loss is determined.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

20. CHANGE IN NON-CASH WORKING CAPITAL ITEMS

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

| | For the nine months ended June 30, | |
|------------------------------------------|------------------------------------|------------|
| | 2015 | 2014 |
| Accounts receivable, net | \$(388,189) | \$165,521 |
| Prepaid expenses | (130,631) | (7,955) |
| Inventories | (208,170) | (204,089) |
| Accounts payable and accrued liabilities | 481,803 | 122,293 |
| Deferred revenue | (351,607) | (123,647) |
| Deferred Rent | 72,858 | - |
| | \$(523,936) | \$(47,877) |

21. 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 June 30,

| | 2015 | | | 2014 | | |
|----------------------------------------|---------------------|-------------------------------------|------------------|---------------------|-------------------------------------|-----------|
| | Advanced Wound Care | Specialized Medical Device Coatings | Total | Advanced Wound Care | Specialized Medical Device Coatings | Total |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| Product and Services | 1,741,133 | 164,215 | 1,905,348 | 1,119,559 | 14,100 | 1,133,659 |
| Licensing Fee | 5,894 | 63,095 | 68,989 | 36,912 | 120,807 | 157,719 |
| | 1,747,027 | 227,310 | 1,974,337 | 1,156,471 | 134,907 | 1,291,378 |
| Segment earnings before the following: | 959,645 | 227,310 | 1,186,955 | 566,683 | 134,907 | 701,590 |
| Operations | | | 182,288 | | | 139,482 |
| Research and development activities | | | 127,386 | | | 106,648 |
| Sales and marketing | | | 351,230 | | | 194,470 |
| General and administrative | | | 637,573 | | | 479,826 |
| Interest (expense) income | | | (17,750) | | | (21,320) |
| | | | (129,272) | | | (240,156) |

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

For the nine months ended June 30,

| | 2015 | | | 2014 | | |
|-------------------------------------------|---------------------------------|----------------------------------------------------|------------------|---------------------------------|----------------------------------------------------|------------------|
| | Advanced Wound Care \$ | Specialized Medical Device Coatings \$ | Total \$ | Advanced Wound Care \$ | Specialized Medical Device Coatings \$ | Total \$ |
| Product and Services | 4,250,897 | 931,341 | 5,182,238 | 3,253,214 | 476,100 | 3,729,314 |
| Licensing Fee | 34,248 | 274,814 | 309,062 | 3,806,862 | 318,994 | 4,125,856 |
| | 4,285,145 | 1,206,155 | 5,491,300 | 7,060,076 | 795,094 | 7,855,170 |
| Segment earnings before the following: | 2,308,430 | 1,206,155 | 3,514,585 | 5,427,994 | 795,094 | 6,223,088 |
| Operations | | | 501,808 | | | 418,798 |
| Research and development activities | | | 422,171 | | | 331,368 |
| Sales and marketing | | | 806,606 | | | 632,822 |
| General and administrative | | | 1,791,281 | | | 1,466,996 |
| Interest (expense) income | | | (87,676) | | | (61,631) |
| | | | (94,957) | | | 3,311,473 |

During the three months ended June 30, 2015 there were 2 (2014 - 3) customers who individually accounted for more than 10% of revenue. The major customers accounted for \$1,195,808 (2014 - \$1,156,471) related to advanced wound care; and, \$nil (2014 - \$134,907) related to specialized coatings.

During the nine months ended June 30, 2015, there were 3 (2014 - 1) customers who individually accounted for more than 10% of revenue. The major customers accounted for \$2,763,596 (2014 - \$7,060,076) related to advanced wound care; and, \$662,500 (2014 - \$795,094) related to specialized coatings.

The Company generated revenue of \$772,273 (2014- \$1,048,235) in the US, \$1,200,411 (2014 - \$243,143) internationally, and \$1,653 (2014- nil) in Canada during the three months ended June 30, 2015.

The Company generated revenue of \$2,555,722 (2014- \$6,475,518) in the US, \$2,269,737 (2014 - \$1,379,652) internationally, and \$665,841 (2014- nil) in Canada during the nine months ended June 30, 2015.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars

22. EARNINGS PER SHARE

Earnings per share is calculated using the weighted average number of shares outstanding during the period. There were nil shares issued during the nine months ended June 30, 2015 (year ended September 30, 2014 – 30,000). Shares issued and outstanding at June 30, 2015 were 9,306,171 (September 30, 2014 - 9,276,171).

| | Three months ended June 30, | | Nine months ended June 30, | |
|-----------------------------------|-----------------------------|------------|----------------------------|------------|
| | 2015 | 2014 | 2015 | 2014 |
| Number of shares used for: | | | | |
| Basic earnings (loss) per share | 9,306,171 | 9,276,171 | 9,306,171 | 9,276,171 |
| Diluted earnings (loss) per share | 17,888,145 | 19,050,032 | 18,233,473 | 15,582,923 |

Details of anti-dilutive potential securities outstanding not included in diluted EPS the nine months ended June 30, 2015, calculations are as follows:

| Potentially dilutive securities | June 30, 2015 | June 30, 2014 |
|----------------------------------------|------------------|------------------|
| Common shares potentially assumable | | |
| - under stock options | 140,106 | 850,998 |
| - under warrants | 4,497,618 | 5,793,250 |
| - under terms of convertible debenture | 4,289,577 | 4,838,710 |
| | 8,927,302 | 11,482,958 |