

Covalon Technologies Ltd.

Management's Discussion and Analysis of Financial
Condition and Results of Operations

March 31, 2013

MANAGEMENT'S DISCUSSION & ANALYSIS

For the six months ended March 31, 2013

May 29, 2013

The following discussion of Covalon Technologies Ltd.'s ("Covalon" or the "Company") financial condition and results of operations should be read in conjunction with our audited consolidated financial statements for the year ended September 30, 2012 and with our unaudited condensed consolidated interim financial statements with related notes for the six month period ended March 31, 2013. Additional information on Covalon Technologies Ltd. can be obtained on SEDAR at www.sedar.com, as well as the Company's website at www.covalon.com. Unless otherwise indicated, all references to the terms "we", "us", "our", "Covalon" and "Company" refer to Covalon Technologies Ltd. and its subsidiaries.

In this MD&A, financial information for the six month period ended March 31, 2013 and 2012 is based on the unaudited condensed consolidated interim financial statements of the Company, which was prepared in accordance with International Financial Reporting Standards ("IFRS"), and is presented in Canadian dollars unless otherwise specified. In accordance with its terms of reference, the Audit Committee of the Company's Board of Directors reviews the contents of the MD&A and recommends its approval to the Board of Directors. The Board of Directors has approved this MD&A, on May 29, 2013. Disclosure contained in this document is current to that date, unless otherwise noted.

On January 1, 2011, as issued by the International Accounting Standards Board ("IASB"), IFRS became the basis of preparation of financial statements for publicly accountable enterprises in Canada. The information presented in this MD&A, including information relating to comparative periods in 2011, is presented in accordance with IFRS unless otherwise noted as being presented under Canadian generally accepted accounting principles ("Canadian GAAP") and not IFRS. A discussion regarding the Company's transition to IFRS, including the impact of significant accounting policies choices and the selection of IFRS 1 elections and exemptions, can be found in Note 24 of the audited consolidated financial statements.

Management's Responsibility for Financial Reporting

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

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

Non-IFRS Financial Measures

In this MD&A, we refer to terms that are not specifically defined under IFRS. These non-IFRS measures may not be comparable to similar measures presented by other companies.

Forward-looking Statements

This MD&A contains forward-looking statements, which reflect the Company's current expectations regarding future events. The forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect", "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in the industry; others are more specific to the Company. Investors should consult the "Risks & Uncertainties" section of this MD&A as well as the Company's ongoing quarterly filings for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. Management assumes no obligation to update or alter any forward-looking statements whether as a result of new information, further events or otherwise.

Company Overview

Nature of Our Business

Covalon Technologies Ltd. is a public medical technologies company that researches, patents, develops and commercializes advanced medical technologies that improve patient outcomes and save lives. Our offices and laboratories are located in Mississauga, Ontario, Canada.

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

Covalon has a broad footprint of proprietary technologies, intellectual property, and patents focused on large medical markets that are related to:

- *Advanced Wound Care products for chronic wounds and negative pressure wound therapy;*
 - *Sophisticated tissue repair products for advanced wound care dressings, trauma, and surgical applications;*
 - *Unique transparent film dressings with antimicrobials embedded in the silicone adhesive;*
 - *Cell therapy technology focused on regeneration of damaged tissue;*
- *Medical Coatings;*
 - *Superior medical coatings with customized physical properties, drug delivery capabilities and infection control applications that include temporary as well as implantable devices;*
 - *Infection Control & Drug Delivery;*

- *Covalon is known for novel photo-stable silver ion antimicrobial technology, which is used in both wound dressings and coatings for medical devices;*
- *Covalon has experience with the delivery of a number of therapeutics and biologics which is applied in both wound dressings and coatings for medical devices to make them therapeutically active;*
- *Innovations for over-the-counter offerings, antimicrobial consumer products and veterinary applications.*

Covalon distributes its products through third party distributors and licenses its technologies and products to some of the largest medical device companies in the world. Covalon also works with niche start-ups to create novel technology to advance their product offerings in the medical device markets. Covalon has worked with over twenty medical companies and our clients include leaders in vascular access devices, I.V. infusion, orthopedics, device and patient care distributors, wound care products, specialty medical device manufacturers and major contract manufacturers.

Business Model

We engage our customers by developing novel medical devices for clients, licensing our technology and products to medical companies and marketing and selling our own products through distribution channels. We sell our technologies and products globally to medical companies and distributors. Some medical companies and distributors license our technologies for incorporating into their own product offerings, which they sell to healthcare providers under their own brand names. Referred to by the industry as an OEM sales model (original equipment manufacturer), this approach assigns the major cost of selling to our customers, who are able to penetrate the market with a large sales force in geographical locations where Covalon does not have staff or offices. Our revenue streams are typically generated from product sales, services, technology licensing fees, and royalties from the sale or commercialization of products.

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

In addition to the OEM business model, Covalon has begun to develop distribution channels for Covalon branded products with the potential for Medicare & Medicaid reimbursement opportunities. Our distribution channels are early stage and revenue is still unpredictable. However, the Company has been successful in securing a number of distribution relationships in growth markets such as the United States, Middle East, Asia and Latin America.

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

Analysis of Operating and Financial Results

Covalon is transitioning from solely a research lab to a successful market focused technology business with a broad platform of patented technologies and products. The Company currently uses a combination of distribution under the Covalon brand name and an OEM business model to realize value in the marketplace. Covalon is developing an international distribution channel for its pipeline of products. The Company has 6 products in various stages leading up to regulatory approval, with SurgiClear® and

IVClear® recently cleared by the US FDA. A number of these products have good potential for product branding. Over the past 12 months the Company has set up distribution relationships with a number of companies in North America and in the Middle East and Asia and is in the process of expanding into other important global markets. The Company's attendance at important medical products trade shows has led to increased awareness of the Covalon brand and end user interest in its products. Covalon continues to also utilize an OEM revenue model based on selling our technologies to large medical companies. OEM models do not produce consistent revenues on a quarterly basis. Consequently, any one quarter's results are not particularly indicative of the Company's prospects. Most OEM sales models involve a long sales cycle – from initial discussion, product evaluation, regulatory filings, contract negotiation and then to market roll-out. This process generally takes twelve to eighteen months – although there are exceptions for both shorter and longer times for the completion of a project. The start and finish of projects is dependent on many factors, many of which are outside the control of Covalon.

On October 26, 2012, the Company announced the closing of a non-brokered private placement comprised of 9.55 million units at a price of \$0.052 per unit for gross proceeds of \$496,600. Each unit was comprised of one common share and one common share purchase warrant. Each common share purchase warrant entitled the holder to acquire an additional common share at a price of \$0.10 per share for a period of five years from the closing date. All securities issued pursuant to the Offering is 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.

Financial Highlights for three months ended December 31, 2012

Financial highlights:

- Total revenue for the three months ended March 31, 2013 decreased by \$560,185 or 51% to \$529,853 over the same period of the prior year. This decrease was primarily due to suspension of the medical coatings operations.
- Revenue from advanced wound care for the three months ended March 31, 2013 decreased \$45,876 or 8% over the same period of the prior year.
- Revenue from specialized medical device coatings were suspended during three months ended March 31, 2013. Sales for the same period of the prior year were \$514,309.
- Gross margin on product sales and services (excluding licensing fees) for the quarter increased to 47% compared to 44% for the same period of the prior year.
- Revenue from licensing fees remained consistent at \$51,482 for the three month periods ended March 31, 2013 and 2012.
- Operating expenses for the three months ended March 31, 2013 decreased \$282,586 or 26% to \$789,930 compared to \$1,071,915 for the same period of the prior year. This decrease reflects continued effort to reduce ongoing operating expenses.
- Loss per share for three month periods ended March 31, 2013 and 2012 was to \$0.01 and \$0.01 respectively.



Consolidated Statement of Comprehensive Loss

(Canadian \$)	Three months ended March 31,		Six months ended March 31	
	2013	2012	2013	2012
Revenue				
Product and Services				
Advanced wound care	\$ 478,371	\$ 524,247	\$ 998,895	\$ 759,961
Specialized medical device coatings	0	514,309	-	916,280
Licensing fees	51,482	51,482	102,965	102,964
Total revenue	529,853	1,090,038	1,101,860	1,779,205
Cost of sales	304,725	632,453	658,722	1,030,590
Gross Profit	225,128	457,585	443,138	748,615
Operating Expenses	789,330	1,071,915	1,808,072	2,178,538
Loss before undernoted	(564,202)	(614,330)	(1,364,934)	(1,429,923)
Interest income	(5,371)	(10,184)	(11,633)	(25,723)
Net loss and comprehensive loss for the period	\$ (558,831)	\$ (604,146)	\$ (1,353,301)	\$ (1,404,200)
Loss per share	\$ (0.01)	\$ (0.01)	\$ (0.02)	\$ (0.02)

Product and Service Revenue, Licensing and Gross Profit

Total product and service revenue decreased \$560,185 to \$529,853 for the three months ended March 31, 2013 compared to \$1,090,038 for the prior year. Quarter-to-quarter revenue continues to be inherently unpredictable due to our OEM business model and fluctuates from quarter to quarter depending on the composition of contractual arrangements entered into in each quarter and the timing of completed coating and development services in any period.

Sales of advanced wound care products decreased 8% over the same period last year to \$478,371. The Company is encouraged by revenues being delivered by new distributors resulting from sales and marketing investments made by the Company over the past twenty-one months. Revenue growth continues to be fairly unpredictable as the Company is early stage in its execution of the Covalon branded distribution business model.

Sales of specialized medical device coatings remained suspended during the three months ended March 31, 2013. Sales for the same period last year were \$514,309. Specialized medical coatings consisted of revenue derived from development services funded by customers and from ongoing coating manufacturing services. The Company's customer for coating manufacturing services did not place any purchase orders during the quarter as a result of a slow-down in the demand for the coated medical device, which the customer informs the Company is temporary in nature. At the same time, since the customer-funded development projects underway during the last quarter of fiscal 2012 were completed, no revenue was recognized during the three months ended March 31, 2013.

Licensing fees remained consistent at \$51,482 for the three months ended March 31, 2013 and 2012.

The products and services revenue mix changes reflect the sales and marketing efforts of the past 12 months. The changes from the comparative period are as follows:

- 100% of product and services revenue in the second quarter of 2013 was derived from advanced wound care compared with 50% in the same period of the previous year;
- There was no revenue from specialized medical device coatings products and services in the current period. In the second period of 2012, 50% of the revenue came from this line of services.

Gross margin on product sales and services, which does not include licensing fees, fluctuates as a result of the mix of products sold in any given quarter by product type and geography. The Gross margin was 47% in the three months ended March 31, 2013 compared to 44% in the same period of the prior year. Gross margin is highly influenced by product mix between advanced wound care and specialized medical device coatings; the mix of silver-based and non-silver based collagen dressings sold in the periods; and the amount of funded coating services included in revenue and costs.

The Company disclosed two product segments, namely, Advanced Wound Care and Specialized Medical Device Coatings. These segments have been disclosed based on the underlying technology of the product.

Interest Income

Interest income on investments was \$5,371 in the three months ended March 31, 2013 compared to \$10,184 in the same period of the previous year. All investments are made in accordance with the Company's Audit Committee investment guidelines of investing cash of the Company in low-risk interest-bearing instruments.

Operating expenses

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
Operations				
Wages, benefits and consulting fees	\$ 85,526	\$ 131,080	\$ 222,647	\$ 249,655
Depreciation and amortization	2,830	3,460	6,290	6,921
Other	(3,584)	19,554	22,022	38,719
	<u>84,772</u>	<u>154,094</u>	<u>250,960</u>	<u>295,295</u>
Research and development activities				
Wages, benefits and consulting fees	80,492	125,184	193,091	250,775
Depreciation and amortization	9,489	10,323	20,889	20,646
Other	15,987	7,016	22,898	24,735
	<u>105,968</u>	<u>142,523</u>	<u>236,877</u>	<u>296,156</u>
Sales and marketing				
Wages, benefits and consulting fees	194,745	322,071	465,146	610,305
Travel	7,949	46,182	44,217	112,150
Other	38,230	68,246	87,486	120,135
	<u>240,924</u>	<u>436,499</u>	<u>596,848</u>	<u>842,590</u>
General and administrative				
Wages, benefits and consulting fees	163,004	167,226	338,014	331,233
Directors compensation	-	11,458	62,400	37,245
Professional fees	48,779	34,043	81,260	117,515
Facility	51,861	42,901	92,792	85,193
Depreciation and amortization	19,565	27,929	39,085	55,984
Other	74,457	55,242	109,836	117,327
	<u>357,666</u>	<u>338,799</u>	<u>723,387</u>	<u>744,497</u>
Total Operating Expenses	<u>\$ 789,330</u>	<u>\$ 1,071,915</u>	<u>\$ 1,808,072</u>	<u>\$ 2,178,538</u>

Total operating expenses for the three month period and year ended March 31, 2013 decreased 26% or \$282,586 from the same period last year. Management has taken steps to reduce operating costs, including reducing headcount, use of outside professional services, travel and other expenses. A number of these initiatives have the potential to impact future quarters operating expenses.

Related Party Transactions

The following is a summary of the Company's related party transactions related to key management compensation for the three and six month periods ended March 31, 2013 and 2012:

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
Short term employee benefits	\$ 79,181	\$ 127,342	\$ 256,770	\$ 254,684
Share-based payments	3,893	23,602	8,564	61,534
	\$ 83,074	\$ 150,944	\$ 265,334	\$ 316,218

Critical Accounting Estimates and Judgements

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 14 of the Consolidated Financial Statements.

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.

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.

iv) **Income taxes**

The Company recognizes deferred tax assets, related tax-loss carry forwards 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 tax income and expense 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 provisions 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.

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 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.

Summary of Quarterly Results and Financial Position

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

	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
	2013	2013	2012	2012	2012	2012	2011	2011	2011
(in Canadian \$)	Second	First	Fourth	Third	Second	First	Fourth	Third	Third
	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter
Revenue (1)	\$ 535,224	\$ 578,268	\$ 951,134	\$ 1,085,791	\$ 1,100,222	\$ 704,706	\$ 581,599	\$ 355,630	
Operating loss before amortization	\$ 479,449	\$ 712,592	\$ 1,406,202	\$ 650,181	\$ 528,710	\$ 730,388	\$ 1,212,961	\$ 1,129,389	
Net loss	\$ 558,831	\$ 794,481	\$ 1,854,874	\$ 732,308	\$ 604,146	\$ 800,054	\$ 1,294,531	\$ 1,207,559	
Net loss per share	\$ (0.01)	\$ (0.01)	\$ (0.02)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.01)	\$ (0.02)
Cash and cash equivalents	\$ 416,038	\$ 727,024	\$ 1,142,667	\$ 1,594,075	\$ 2,851,504	\$ 3,926,152	\$ 4,763,152	\$ 2,659,901	
Net working capital	\$ (2,815)	\$ 584,019	\$ 928,220	\$ 2,338,111	\$ 3,069,155	\$ 3,732,626	\$ 4,456,098	\$ 2,939,202	
Current Ratio	1.0	1.3	1.4	2.5	2.6	3.1	3.6	3.8	

(1) includes Product Revenue, Licensing Revenue and interest income for comparative purposes to prior quarters

Revenue of the Company continues to be inherently unpredictable due to our business model and fluctuates from quarter to quarter depending on the composition of contractual arrangements entered into in each quarter and the timing of completed coating and development services milestone in any period.

The Current Ratio is a model for measuring the liquidity of the Company by calculating the ratio between all current assets and all current liabilities. It is an indicator of our ability to pay short-term obligations. Current assets include cash and cash equivalents, short-term investments, accounts receivable, inventories and prepaid expenses. Current liabilities include accounts payable and accrued liabilities, and the current portion of deferred revenue. Net Working Capital is calculated as current assets minus current liabilities. At March 31, 2013, the Company had 1 times the current assets needed to pay its current liabilities.

Liquidity & Capital Resources

(Canadian \$)	As at		
	March 31, 2013	September 30, 2012	October 1, 2011
Cash and cash equivalents	\$ 416,038	\$ 1,142,667	\$ 4,763,152
Short-term investments	\$ 500,000	\$ 500,000	\$ 500,000
Total assets	\$ 5,043,520	\$ 5,963,729	\$ 9,322,121
Deferred revenue	\$ 1,207,647	\$ 1,118,057	\$ 1,103,512

Highlights

Cash flows, as a result of entering into customer contracts will continue to be unpredictable quarter-to-quarter, due to the timing of receipt of upfront payments under new contracts and the timing of receipt of royalty payments.

On March 31, 2013 cash, cash equivalents, restricted cash and short-term investments amounted to \$979,038. Covalon follows a policy of investing its surplus cash resources in high quality, liquid, short-term deposits. Cash equivalents as of March 31, 2013 had less than three months to maturity and are cashable without penalty. At March 31, 2013, the Company had \$63,000 assigned as collateral to secure the Company's 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 and are not included in Cash and cash equivalents.

The Condensed Consolidated Interim 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 \$558,831 during the three month period ended March 31, 2013 and, as of that date the Company's accumulated deficit was \$33,783,088. 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 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.

Total assets at March 31, 2013 were \$5,043,520 compared to \$5,963,729 at September 30, 2012. Cash and cash equivalents and short-term investments comprised 18% of total assets at March 31, 2013. Of the remaining assets, the Company's accounts receivable and inventories are liquid, with collection periods and turnover ratios in the 60 to 180 day range. The balance of our assets is comprised of property, plant and equipment and the Company's intangible assets. These have low liquidity but represent much of the intellectual property assets that are used to generate Covalon's revenue streams.

Deferred revenue increased by \$89,590 to \$1,207,647 at March 31, 2013 compared to \$1,118,057 at September 30, 2012.

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.

In fiscal 2006, Covalon acquired technology from Perfusion Therapeutics Inc. for 1,100,000 fully paid non-assessable common shares of Covalon Technologies Ltd., issued in escrow to be released on various success milestones. At December 31, 2012, 150,000 (September 30, 2012 – 150,000) shares valued at \$213,875 (2012 - \$213,875) have been released from trust. The remaining balance of 950,000 shares are still held in trust.

During the six months end March 31, 2013 the Company raised gross proceeds of \$496,600 through a non-brokered private placement comprised of 9.55 million units at a price of \$0.052 per unit. Each unit is comprised of one common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to acquire an additional common share at a price of \$0.10 per share 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. Net proceeds raised from the offering were \$481,736 and allocated as follows:

Share Capital	\$254,214
Warrants	\$227,522

The following is a summary of changes in common share capital from October 1, 2011 to March 31, 2013:

	Number of Warrants	Exercise price Amount	Amount
Balance at October 1, 2011 and September 30, 2012	-		-
Warrants issued via private placement, net	9,550,000	\$0.10	\$ 227,522
Balance at March 31, 2013	9,550,000	\$	227,522

b) *Contributed Surplus*

There were no changes in Contributed Surplus from October 1, 2011 to March 31, 2013:

Balance October 1, 2011 and September 30, 2012	\$ 1,805,586
Balance March 31, 2013	\$ 1,805,586

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.

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

No options were granted during the three months ended March 31, 2013 or 2012

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

Total expenses arising from share-based payment transactions recognized during the period were \$6,625 (three months ended March 31, 2012: \$55,754).

Sources and Uses of Cash

For the three months ended,

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
Cash flows from operating activities				
Net loss and comprehensive loss for the period	\$ (558,831)	\$ (604,146)	\$ (1,353,301)	\$ (1,404,200)
Adjustments to reconcile net loss and comprehensive loss to net cash used in operating activities:				
Depreciation - property, plant and equipment	32,723	30,507	69,896	60,474
Amortization - intangible assets	46,660	55,113	91,376	110,351
Share based payments	6,625	55,754	20,465	126,008
Foreign exchange loss (gain) on cash held	(9,502)	2,979	(1,502)	1,717
Cash used by operating activities before change in non-cash working capital balances	(482,326)	(459,793)	(1,173,066)	(1,105,650)
Change in non-cash working capital (Note 17)	226,775	(462,659)	103,841	(627,669)
Total cash outflows from operating activities	(255,550)	(922,452)	(1,069,225)	(1,733,319)
Cash flows from investing activities				
Purchase of property, plant and equipment	(40,441)	(56,496)	(57,476)	(57,145)
Purchase of intangible assets	(24,497)	(29,721)	(83,166)	(56,467)
Total cash outflows from investing activities	(64,938)	(86,217)	(140,642)	(113,612)
Cash flows from financing activities				
Restricted cash (Note 9)		(63,000)		(63,000)
Net proceeds on issuance of share capital and warrants			481,736	
Total cash inflows from financing activities	\$ -	(63,000)	481,736	(63,000)
Foreign exchange loss (gain) on cash held	9,502	(2,979)	1,502	(1,717)
Total net decrease in cash and cash equivalents during the period	(310,986)	(1,074,648)	(726,629)	(1,911,648)
Cash and cash equivalents, beginning of the period	727,024	3,926,152	1,142,667	4,763,152
Cash and cash equivalents, end of period	\$ 416,038	\$ 2,851,504	\$ 416,038	\$ 2,851,504

Operating Activities

Cash used in operating activities for the three months ended March 31, 2013 was \$255,550 compared to \$922,452 in the same period of the prior year.

Investing Activities

Expenditures on property, plant and equipment relate to furniture and fixtures and lab equipment and expenditures on intangible assets relate to patents and trademarks.

Financing Activities

The Company raised net proceeds of \$481,736 through a private placement that comprised of 9.55 million units. Each unit entitles the holder to one common share and one warrant to purchase an additional common share at a \$.10 per share for a period of 5 years.

Off-Balance Sheet Arrangements

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

Financial Instruments

Unless otherwise noted, it is Management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments. The Company is exposed to currency risk

arising from fluctuations in foreign exchange rates and the degree of volatility in those rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

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

All of the Company's cash is maintained by two of the major financial institutions.

The Company has not entered into any futures or forward contracts, or other derivative instruments as at the date of this MD&A.

Risks and Uncertainties

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

Medical Device and Biotechnology companies in the early revenue stage are subject to a number of risks and uncertainties that are inherent to the development of any new technology. General business risks include, among other things, uncertainty in product development and related clinical trials, the regulatory environment including delays or denial of approval to market products, the impact of technological change and competing technologies, the ability to protect and enforce its patent portfolio and intellectual property assets, the availability of capital to finance continued and new product development, the ability to secure strategic collaborators and its reliance on these collaborators for the development, regulatory approval, testing, manufacturing, commercialization and/or distribution of its products and the risk of product liability claims. In addition, market prices for securities of biotechnology companies are generally volatile, and may or may not move in a manner consistent with the progress being made by such company.

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

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

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

Covalon cannot predict if profitability will ever be achieved and, if it is, whether or not it will be sustainable on a quarterly or an annual basis. Even if Covalon is not able to successfully further commercialize its products, Covalon believes that it has sufficient capital to fund its business and operations through at least fiscal 2013. However, Covalon may need to raise additional capital in the future. Additional financing may not be available, and even if available, may not be on acceptable terms.

Any failure to obtain or protect intellectual property could adversely affect Covalon.

Covalon's success depends, in part, on its ability to obtain patents, or licenses to patents, maintain trade secret protection, and enforce its rights against others. Covalon has filed and is actively pursuing patent applications in Canada, the United States and other jurisdictions. Covalon may not be able to obtain patent protection for key elements of its technology.

There can be no assurance that:

- patent applications will result in the issuance of patents;
- additional proprietary products developed will be suitably protected from infringement;
- patents issued will provide adequate protection or any competitive advantages;
- patents will not be successfully challenged by any third parties; and
- patents of others will not impede Covalon's ability to commercialize its technology.

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

Covalon's intellectual property includes trade secrets and know-how that may not be protected by patents. There can be no assurance that Covalon will be able to protect its trade secrets. To help protect its rights, Covalon requires employees, consultants, advisors and collaborators to enter into confidentiality agreements. These agreements may not adequately protect Covalon's trade secrets, know-how, or other proprietary information in the event of any unauthorized use or disclosure.

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

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

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

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

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

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

- discontinue processes incorporating infringing technology;
- obtain licenses to the infringed intellectual property.

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

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

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

These laws require, among other things:

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

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

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

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

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

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

Examples of such issues include:

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

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

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

International Financial Reporting Standards 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, 2011 or later periods. None of these is 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:

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 and the contractual cash flow characteristics of the financial asset. The standard is effective for annual periods beginning on or after January 1, 2015. The Company is in the process of evaluating the impact of the new standard.

IFRS 13 Fair Value Measurement

IFRS 13 aims to improve consistency and reduce complexity by providing a precise definition of fair value and a single source of fair value measurement and disclosure requirements for use across IFRSs. The requirements which are largely aligned between IFRSs and US GAAP, do not extend the use of fair value accounting but provide guidance on how it should be applied where its use is already required or permitted by other standards within IFRSs or US GAAP. The Company is yet to assess the full impact of IFRS 13 and intends to adopt the standard no later than the accounting period beginning October 1, 2013.

The Company is currently assessing the impact of the adoption of these standards on its Consolidated Financial Statements.

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.

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

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

The Company continues to formalize procedures and control measures that are already in place and to introduce new ones to ensure good evaluation and control practices. As of September 30, 2012, the Company's management evaluated the effectiveness of the design and operation of its disclosure controls and procedures as defined under the rules. The evaluation was performed under the supervision, and with the participation, of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on the evaluation of the DC&P, the CEO and the CFO have concluded that, subject to the fact that an evaluation of controls can provide only reasonable, not absolute, assurance that all control issues and instances of fraud or error, if any, within the Company have been detected, the Company's DC&P are effective in providing reasonable assurance that material information relating to the Company is made known to management. Changes and new controls are evaluated and implemented as required to provide greater business control.

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