Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

For the three and six months ended March 31, 2014

Contents

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

		March 31, 2014		September 30, 2013
Assets				
Current assets				
Cash and cash equivalents	**$**	**4,201,068**	$	633,103
Short-term investments		**500,000**		500,000
Accounts receivable, net (Note 5)		**1,201,297**		1,184,229
Prepaid expenses		**141,848**		84,743
Inventories (Note 7)		**867,347**		605,892
Total current assets		**6,911,560**		3,007,967
Non-current assets				
Restricted cash (Note 8)		**63,000**		63,000
Other receivable (Note 17)		**40,000**		40,000
Property, plant and equipment (Note 9)		**513,917**		558,249
Intangible assets (Note 10)		**1,939,840**		2,001,030
Total non-current assets		**2,556,757**		2,662,279
Total Assets	**$**	**9,468,318**	$	5,670,246
Liabilities and Shareholders' Equity				
Current liabilities				
Accounts payable and accrued liabilities	**$**	**1,197,535**	$	982,774
Deferred revenue (Note 11)		**895,974**		955,335
Total current liabilities		**2,093,509**		1,938,109
Non-current liabilities				
Convertible debenture (Note 12)		**584,017**		516,017
Deferred revenue (Note 11)		**231,490**		269,772
Total non-current liabilities		**815,507**		785,789
Total liabilities		**2,909,016**		2,723,898
Shareholders' Equity				
Share capital (Note 13 a))		**32,393,095**		32,393,095
Contributed surplus (Note 13 b) and c))		**2,224,645**		2,224,645
Stock options (Note 14 c))		**1,587,534**		1,526,210
Equity component of convertible debentures		**225,352**		225,352
Accumulated deficit (Note 13 d))		**(29,871,324)**		(33,422,954)
Total shareholders' equity		**6,559,302**		2,946,348
Total Liabilities and Shareholders' Equity	**$**	**9,468,318**	$	5,670,246

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF COMPREHENSIVE LOSS (UNAUDITED)

Expressed in Canadian Dollars

	Three months ended March 31,		Six months ended March 31,	
	2014	2013	**2014**	2013
Revenue				
Product and Services				
Advanced wound care	**$ 1,400,065**	$ 478,371	**$ 2,133,655**	$ 998,895
Specialized medical device coatings	**462,000**	-	**462,000**	-
Licensing fees (Note 11)	**179,526**	51,482	**3,968,137**	102,965
Total revenue	**2,041,591**	529,853	**6,563,792**	1,101,860
Cost of sales	**657,304**	304,725	**1,042,293**	658,722
Gross Profit	**1,384,287**	225,128	**5,521,499**	443,138
Operating Expenses				
Operations	**152,955**	84,772	**279,317**	250,960
Research and development activities	**108,748**	105,968	**224,720**	236,877
Sales and marketing	**247,410**	240,924	**438,352**	596,848
General and administrative	**427,034**	357,666	**987,170**	723,387
	936,146	789,330	**1,929,558**	1,808,072
Earnings (loss) before undernoted	**448,141**	(564,202)	**3,591,941**	(1,364,934)
Interest income (expense)	**(16,930)**	5,371	**(40,311)**	(11,633)
Net earnings (loss) and comprehensive gain (loss) for the period	**$ 431,211**	$ (558,831)	**$ 3,551,630**	$ (1,353,301)
Basic earnings (loss) per share (Note 22)	**$ 0.05**	$ (0.06)	**$ 0.38**	$ (0.15)
Diluted earnings (loss) per share (Note 22)	**$ 0.02**	$ (0.06)	**$ 0.19**	$ (0.15)

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY (UNAUDITED)

Expressed in Canadian Dollars

For the six months ended March 31, 2014

	Share Capital	Contributed Surplus	Stock Options	Equity Component of Convertible Debentures	Accumulated Deficit	Total
Balance at October 1, 2012	$ 31,911,359	$ 1,805,586	$ 1,947,389	$ -	$ (32,429,787)	$ 3,234,547
Share based payments	-	-	20,465	-	-	20,465
Issue common shares, net	481,736	-	-	-	-	481,736
Comprehensive loss for the period	-	-	-	-	(1,353,301)	(1,353,301)
Balance at March 31, 2013	$ 32,393,095	$ 1,805,586	$ 1,967,854	$ -	$ (33,783,088)	$ 2,383,447
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	-	-	61,324	-	-	61,324
Comprehensive gain for the period	-	-	-	-	3,551,630	3,551,630
Balance at March 31, 2014	$ 32,393,095	$ 2,224,645	$ 1,587,534	$ 225,352	$ (29,871,324)	$ 6,559,302

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

	Three months ended March 31,		Six months ended March 31,	
	2014	2013	**2014**	2013
Cash flows from operating activities				
Net earnings (loss) and comprehensive gain (loss) for the period	**$ 431,211**	$ (558,831)	**$ 3,551,630**	$ (1,353,301)
Adjustments to reconcile net earnings and comprehensive gain to net cash used in operating activities:				
Depreciation - property, plant and equipment	**28,214**	32,723	**56,389**	69,896
Amortization - intangible assets	**52,323**	46,660	**104,647**	91,376
Non-cash interest (Note 12)	**34,694**	-	**68,000**	-
Share based payments	**29,633**	6,625	**61,324**	20,465
Foreign exchange loss (gain) on cash held	**(27,400)**	(9,502)	**(51,203)**	(1,502)
Cash used by operating activities before change in non-cash working capital balances	**548,675**	(482,325)	**3,790,787**	(1,173,066)
Change in non-cash working capital (Note 20)	**(1,073,675)**	226,775	**(218,510)**	103,841
Total cash inflows (outflows) from operating activities	**(525,000)**	(255,550)	**3,572,277**	(1,069,225)
Cash flows from investing activities				
Purchase of property, plant and equipment	**(1,620)**	(40,441)	**(12,057)**	(57,476)
Purchase of intangible assets	**(17,761)**	(24,497)	**(43,458)**	(83,166)
Total cash outflows from investing activities	**(19,381)**	(64,938)	**(55,515)**	(140,642)
Cash flows from financing activities				
Net proceeds on issuance of share capital (Note 13)	**-**	-	**-**	481,736
Total cash inflows from financing activities	**$ -**	$ -	**-**	481,736
Foreign exchange loss on cash held	**27,400**	9,502	**51,203**	1,502
Total net increase (decrease) in cash and cash equivalents during the period	**(516,981)**	(310,986)	**3,567,965**	(726,629)
Cash and cash equivalents, beginning of the period	**4,718,049**	727,024	**633,103**	1,142,667
Cash and cash equivalents, end of period	**$ 4,201,068**	$ 416,038	**$ 4,201,068**	$ 416,038
Represented by				
Cash	**$ 987,730**	$ 74,251	**$ 987,730**	$ 74,251
Cash equivalents	**3,213,338**	341,787	**3,213,338**	341,787
	$ 4,201,068	$ 416,038	**$ 4,201,068**	$ 416,038

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

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 unaudited consolidated financial statements of Covalon Technologies Ltd. for the three and six months ended March 31, 2014 comprise the results of the Company and its subsidiaries. The Company has now received regulatory approval on numerous products and is currently generating revenue. The Company has adopted a business model that contracts the manufacturing and distribution of its commercialized products through partners. The Company generates its revenues through development contracts, licensing agreements and distribution contracts and sales. The Company is listed on the TSX Venture Exchange, having the symbol COV.

The address of the Company's corporate office and principal place of business is 405 Britannia Road East, Suite 106, Mississauga, Ontario, Canada.

2. BASIS OF PRESENTATION

a) Statement of Compliance

These condensed interim financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") in general and in accordance with International Accounting Standard 34, Interim Financial Reporting ("IAS 34") as issued by the International Accounting Standards Board ("IASB') which sets out standards for interim financial statements. These interim condensed financial statements do not include all the information and disclosures required in the annual financial statements. These interim condensed financial statements should be read in conjunction with the Company's 2013 annual financial statements, which were prepared in accordance with International Financial Reporting Standards.

These interim financial statements were authorized for issue by the Corporation's Board of Directors on May 27, 2014.

b) Basis of Measurement

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

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

There have been no changes in accounting policies since the Company's 2013 annual financial statements.

4. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

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

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 13.

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 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 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.

Expressed in Canadian Dollars

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 $3,776,338 invested with two issuers; however, this risk is mitigated as the issuers are two major Canadian banks and the Province of Ontario.

The Company, in the normal course of business, is exposed to credit risk from its global customers in the medical device industry. The accounts and other receivable are subject to normal industry risks in each geographic region in which the Company operates. The Company attempts to manage these risks by dealing with creditworthy customers; however, due to the limited number of potential customers in each market this is not always possible. As at March 31, 2014, ten customers accounted for 89% (2013 – ten customers for 92%) 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 $1,121 (2013 – $1,121) resulting in a provision for doubtful accounts expense of $nil (2013 - $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, accounts receivable, net, are aged as follows:

		March 31, 2014		September 30, 2013
Accounts receivable, net	**$**	**647,941**	$	1,093,765
Accounts payable		**(487,490)**		(319,154)
Deferred Revenue		**(120,453)**		(313,500)
Cash		**801,994**		221,812
Exchange rate ($USD / $CAD)		**1.1055**		1.0303

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. The Company has contractual obligations related to its signed offer to lease for its premises at 405 Britannia Rd. Mississauga and for its operating leases which are payable from 2014 to 2015 in the amounts of $41,450 and $21,063 respectively.

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:

	March 31, 2014	September 30, 2013
Accounts receivable, net	**$ 647,941**	$ 1,093,765
Accounts payable	**(487,490)**	(319,154)
Deferred Revenue	**(120,453)**	(313,500)
Cash	**801,994**	221,812
Exchange rate ($USD / $CAD)	**1.1055**	1.0303

An increase of 5% and 10% in the US dollar exchange rate would result in an increase of the net gain by approximately $42,100 (2013– $34,146) and $84,199 (2013 - $68,292) respectively.

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 March 31, 2014 is $6,559,302 (September 30, 2013 - $2,946,348).

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.

Expressed in Canadian Dollars

7. INVENTORIES

Inventories consist of the following:

		March 31, 2014		September 30, 2013
Raw materials	**$**	**430,850**	$	364,850
Finished Goods		**436,497**		241,042
	$	**867,347**	$	605,892

Direct product expense included in cost of sales is $548,314 (2013 - $251,814) and $832,573 (2013 - $561,121) for the three and six months periods ended March 31, 2014 respectively.

8. RESTRICTED CASH

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

Expressed in Canadian Dollars

9. PROPERTY PLANT AND EQUIPMENT

	Furniture and Fixtures $	Lab Equipment $	Leasehold Improvements $	Total $
Cost				
Balance at October 1, 2012	319,116	1,394,068	71,416	1,784,600
Additions	-	84,432	-	84,432
Balance at September 30, 2013	319,116	1,478,500	71,416	1,869,032
Additions	-	12,057	-	12,057
Balance at March 31, 2014	319,116	1,490,557	71,416	1,881,089
Accumulated depreciation				
Balance at October 1, 2012	202,392	908,657	71,416	1,182,465
Depreciation	23,345	104,973	-	128,318
Balance at September 30, 2013	225,737	1,013,630	71,416	1,310,783
Depreciation	9,338	47,051	-	56,389
Balance at March 31, 2014	235,075	1,060,681	71,416	1,367,172
Carrying amounts				
At September 30, 2013	93,379	464,870	-	558,249
At March 31, 2014	84,041	429,876	-	513,917

Expressed in Canadian Dollars

10. INTANGIBLE ASSETS

	Deferred Development Costs	Patents	Trademarks	Computer Software	Total
	$	$	$	$	$
Cost					
Balance at October 1, 2012	4,134,415	523,919	67,397	149,163	4,874,894
Additions	-	97,885	5,385	-	103,270
Balance at September 30, 2013	4,134,415	621,804	72,782	149,163	4,978,164
Additions		41,306	2,152		43,458
Balance at March 31, 2014	4,134,415	663,110	74,934	149,163	5,021,622
Accumulated amortization and impairment losses					
Balance at October 1, 2012	2,606,188	102,408	-	81,332	2,789,928
Amortization	121,703	30,958	-	34,545	187,206
Balance at September 30, 2013	2,727,891	133,366	-	115,877	2,977,134
Amortization	60,852	17,007	-	26,789	104,648
Balance at March 31, 2014	2,788,743	150,373	-	142,666	3,081,782
Carrying amounts					
At September 30, 2013	1,406,524	488,438	72,782	33,286	2,001,030
At March 31, 2014	1,345,672	512,737	74,934	6,497	1,939,840

Expressed in Canadian Dollars

11. 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.

	March 31, 2014	September 30, 2013
Balance, beginning of period	**$ 1,225,107**	$ 1,118,057
Add:		
Deferred licensing fees	**-**	192,744
Deferred product and services revenue	**699,473**	1,044,093
Less:		
Recognition of deferred product and services revenue	**(680,544)**	(910,252)
Recognition of deferred licensing fees	**(116,572)**	(219,535)
Balance, end of period	**1,127,464**	1,225,107
Amount to be recognized within one year	**(895,974)**	(955,335)
Long term balance	**$ 231,490**	$ 269,772

12. 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.

Expressed in Canadian Dollars

The convertible debenture units are reflected in the financial statements as follows:

	March 31, 2014	September 30, 2013
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	**52,500**	7,500
Accretion	**26,602**	3,602
	584,017	516,017
Fair value of Equity component	**225,352**	225,352

13. 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. See Note 12.

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 period of five years expiring October 26, 2017.

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 March 31, 2014, 15,000 (2012 – 15,000) shares valued at $213,875 (2012 - $213,875) have been released from trust. The remaining balance of 95,000 shares are still being held in trust.

Expressed in Canadian Dollars

The following is a summary of changes in common share capital from September 30, 2012 to March 31, 2014:

	Number of Shares	Issue Price	Amount
Balance at September 30, 2012	8,321,171		$31,911,359
Shares issued via private placement	955,000	$0.52	496,600
Less issue costs			(14,864)
Balance at September 30, 2013 and March 31, 2014	9,276,171		$ 32,393,095

b) Contributed Surplus

The following is a summary of changes in contributed surplus from September 30, 2012 to March 31, 2014:

Balance September 30, 2012	$ 1,805,586
Options naturally expired	419,059
Balance September 30, 2013 and March 31, 2014	$ 2,224,645

c) Share Purchase Warrants

The following is a summary of changes in warrants from September 30, 2012 to March 31, 2014:

	Number of Warrants	Exercise Price	Expiry Date
Balance at September 30 , 2012	-	-	-
Warrants issued October 26, 2012	955,000	$ 1.00	October 26, 2017
Warrants issued August 30, 2013	4,838,250	$ 0.155	August 31, 2016
Balance at September 30, 2013 and March 31, 2014	5,793,250		

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.

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

Expressed in Canadian Dollars

14. SHARE-BASED PAYMENTS

a) Option Plan Details

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

The following is a summary of changes in options from October 1, 2012 to September 30, 2013:

				During the Period						
Grant Date	Expiry Date	Exercise Price	Opening Balance	Granted	Exercised	Expired	Forfeited	Closing Balance	Vested and Exercisable	Unvested
31-Mar-08	31-Mar-13	$ 27.90	30,000	-	-	-	-	30,000	30,000	-
15-Oct-08	15-Oct-13	$ 7.50	9,000	-	-	-	(1,000)	8,000	8,000	-
22-May-09	22-May-14	$ 4.00	120,000	-	-	-	-	120,000	120,000	-
11-Dec-09	11-Dec-14	$ 2.90	9,000	-	-	-	(1,000)	8,000	8,000	-
27-Jan-10	27-Jan-15	$ 3.10	85,500	-	-	-	-	85,500	85,500	-
01-Sep-10	01-Sep-15	$ 2.00	140,000	-	-	-	-	140,000	93,333	46,667
02-Sep-10	02-Sep-15	$ 2.00	60,000	-	-	-	(10,167)	49,833	33,332	16,501
10-Jun-11	10-Jun-16	$ 2.00	98,500	-	-	-	-	98,500	32,833	65,667
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	-
			723,000	-	-	-	(12,167)	710,833	581,998	128,835
Weighted Average Exercise Price			$ 3.50	$ -	$ -	$ -	$ 2.50	$ 3.60	$ 3.90	$ 2.00

Expressed in Canadian Dollars

The following is a summary of changes in options from October 1, 2013 to March 31, 2014:

Changes from October 1, 2013 to March 31, 2014

Grant Date	Expiry Date	Exercise Price	Opening Balance	During the Period: Granted	Exercised	Expired	Forfeited	Closing Balance	Vested and Exercisable	Unvested
15-Oct-08	15-Oct-13	$ 7.50	6,000	-	-	(6,000)	-	-	-	-
22-May-09	22-May-14	$ 4.00	120,000	-	-	-	-	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	-	-	-	- 1,500.00	26,996	26,996	-
10-Jun-11	10-Jun-16	$ 2.00	26,995	-	-	-	-	26,995	17,997	8,998
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	-	64,500
26-Sep-13	26-Sep-18	$ 0.85	235,000	-	-	-	-	235,000	-	235,000
			868,498	-	-	(6,000)	(11,500)	850,998	542,500	308,498
Weighted Average Exercise Price			$ 1.89	$ -	$ -	$ -	$ -	$ 1.87	$ 2.51	$ 0.74

b) Fair Value of Options Issued During the Period

During the year ended September 30, 2013, the Company issued two tranches of options:

1) 74,500 options with a weighted average fair value of $0.1466 were granted. Trading price of the stock at the time of the grant was $0.155. 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 – 1.57%, dividend rate NIL, average volatility – 179.9% and an average term of 5 years. The estimated annualized forfeiture rate is 8.01%.

2) 235,000 options with a weighted average fair value of $0.8035 were granted. Trading price of the stock at the time of the grant was $0.85. 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 – 1.72%, dividend rate NIL, average volatility – 179.5% and an average term of 5 years. The estimated annualized forfeiture rate is 8.01%.

No options were granted during the three or six month periods ended March 31, 2014.

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 $ 61,324 (2013 - $20,465) for the six months ended March 31, 2014.

Expressed in Canadian Dollars

15. INCOME TAXES

The Company had non-capital losses carry forward available for income tax purposes as at September 30, 2013 of approximately $19,113,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

Year	Canada Amount	US Amount
2014	$ 805,000	$
2015	1,997,000	
2026	1,499,000	
2028	2,132,000	
2029	3,309,000	
2030	601,000	
2031	3,874,000	68,000
2032	3,653,000	140,000
2033	908,000	127,000
	$ 18,778,000	$ 335,000

The Company had capital losses carry forward for income tax purposes as at September 30, 2013 of approximately $962,883 (2012 - $962,883) which are available to reduce taxable capital gains in future years. These losses do not expire.

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, 2013, the Company had $1,414,446 (2012 - $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, 2013, the Company had $90,115 (2012 – $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.

Expressed in Canadian Dollars

16. 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 March 31,		Six months ended March 31,	
	2014	2013	**2014**	2013
Salary, benefits, management and directors fees	**$ 146,681**	$ 79,181	**$ 423,362**	$ 256,770
Share-based payments	**27,379**	3,893	**54,758**	8,564
	$ 174,060	$ 83,074	**$ 478,120**	$ 265,334

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.

17. COMMITMENTS

The Company signed an offer to lease for its premises at 405 Britannia Rd, Mississauga which commenced December 1, 2009 and expires November 30, 2014. The remaining rental payment for fiscal 2014 through expiry is $41,450.

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

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

2014	$ 62,620
2015	20,227
2016	4,956
2017	4,956
thereafter	3,717
	$ 96,476

18. 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 generally not determinable. Any loss resulting from these proceedings will be charged to operations in the period the loss is determined.

Expressed in Canadian Dollars

19. CHANGE IN NON-CASH WORKING CAPITAL ITEMS

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

	For the three months ended March 31, **2014**	For the three months ended March 31, 2013	For the six months ended March 31, **2014**	For the six months ended March 31, 2013
Accounts receivable, net	**$ (623,786)**	$ 195,580	**$ (17,068)**	$ 442,282
Prepaid expenses	**(62,076)**	(18,638)	**(57,105)**	(4,759)
Inventories	**(163,920)**	(240,951)	**(261,455)**	(264,573)
Accounts payable and accrued liabilities	**230,401**	376,373	**214,761**	(158,699)
Deferred revenue	**(454,294)**	(85,589)	**(97,643)**	89,590
	$ (1,073,675)	$ 226,775	**$ (218,510)**	$ 103,841

20. OPERATING SEGMENTS

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

For the three months ended March 31,	**2014**			2013		
	Advanced Wound Care $	**Specialized Medical Device Coatings $**	**Total $**	Advanced Wound Care $	Specialized Medical Device Coatings $	Total $
Product and Services	**1,400,065**	**462,000**	**1,862,065**	478,371	-	478,371
Licensing Fees and Royalties	**70,484**	**109,042**	**179,526**	-	51,482	51,482
	1,470,549	**571,042**	**2,041,591**	478,371	51,482	529,853
Segment earnings before the following:	**813,245**	**571,042**	**1,384,287**	173,646	51,482	225,128
Operations			**152,955**			84,772
Research and development activities			**108,748**			105,968
Sales and marketing			**247,410**			240,924
General and administrative			**427,034**			357,666
Interest income			**(16,930)**			(5,371)
			431,211			(558,831)

Expressed in Canadian Dollars

For the six months ended March 31,	**2014**			2013		
	Advanced Wound Care	**Specialized Medical Device Coatings**	**Total**	Advanced Wound Care	Specialized Medical Device Coatings	Total
	$	**$**	**$**	$	$	$
Product and Services	**2,133,655**	**462,000**	**2,595,655**	998,895	-	998,895
Licensing Fees and Royalties	**3,769,950**	**198,187**	**3,968,137**	-	102,965	102,965
	5,903,605	**660,187**	**6,563,792**	998,895	102,965	1,101,860
Segment earnings before the following:	**4,861,312**	**660,187**	**5,521,499**	340,173	102,965	443,138
Operations			**279,317**			250,960
Research and development activities			**224,720**			236,877
Sales and marketing			**438,352**			596,848
General and administrative			**987,170**			723,387
Interest income			**40,311**			(11,633)
			3,551,630			(1,353,301)

During the three and six month periods ended March 31, 2014, there were four and one (2013–four) customers respectively who individually accounted for more than 10% of revenue. $1,396,500 and $4,501,115 (2013 - $424,692) relates to advanced wound care; $462,000 (2013 - nil) and nil (2013 - nil) relates to specialized coatings.

The Company generated revenue of $1,201,193 (2013 - $389,331) and $5,440,099 (2013 – $955,080) in the US and $840,398 (2013 – $140,522) and $1,123,693 (2013 - $146,780) internationally for the three and six month periods ended March 31, 2014 respectively.

21. EARNINGS PER SHARE

Share data used in calculating earnings (loss) per share is shown below:

	Three months ended March 31,		**Six months ended March 31,**	
	2014	2013	**2014**	2013
Number of shares used for:				
Basic darnings (loss) per share	**9,276,171**	9,276,171	**9,276,171**	8,830,505
Diluted earnings (loss) per share	**18,861,333**	9,276,171	**18,643,584**	8,830,505

As the Company experienced a loss for the three and six month periods March 31, 2012 all potentially dilutive securities were considered anti-dilutive and were excluded from the calculation of loss per share.

Expressed in Canadian Dollars

Details of potentially dilutive securities outstanding are as follows:

Anti-dilutive potential securities	**March 31, 2014**	March 31, 2013
Common shares potentially assumable		
- under stock options	**850,998**	666,000
- under warrants	**5,793,250**	955,000
- under terms of convertible debenture	**4,838,710**	-
	11,482,958	1,621,000