

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

For the three and nine months ended June 30, 2016

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**MANAGEMENT'S COMMENTS ON
UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

Under National Instrument 51-102, Part 4, subsection 4.3(3) (a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

Expressed in Canadian Dollars

	June 30, 2016	September 30, 2015
Assets		
Current Assets		
Cash and cash equivalents	\$670,956	\$1,304,550
Short-term investments	-	547,040
Accounts receivable, net (Note 5)	2,545,329	2,124,550
Prepaid expenses	396,494	476,333
Inventories (Note 8)	1,690,304	836,361
Total current assets	5,303,083	5,288,834
Non-current assets		
Restricted cash (Note 9)	35,574	35,375
Other receivables (Note 17)	20,000	20,000
Property, plant and equipment (Note 10)	465,947	455,387
Intangible assets (Note 11)	1,833,623	1,831,002
Total non-current assets	2,355,144	2,341,764
Total Assets	\$7,658,227	\$7,630,598
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable and accrued liabilities	\$1,768,811	\$1,300,888
Convertible debenture (Note 13)	-	846,466
Deferred revenue (Note 12)	409,790	138,107
Total current liabilities	2,178,601	2,285,461
Non-current Liabilities		
Deferred revenue (Note 12)	420,011	457,146
Deferred rent	96,612	102,001
Total non-current liabilities	516,623	559,147
Total Liabilities	2,695,224	2,844,608
Shareholders' Equity		
Share capital (Note 14 a)	33,627,722	32,423,095
Contributed surplus (Note 14 b and c)	3,327,882	3,159,125
Stock Options (Note 15)	926,661	941,593
Equity component of convertible debentures	-	225,352
Accumulated deficit (Note 14 d)	(32,919,262)	(31,963,175)
Total shareholders' equity	4,963,003	4,785,990
Total Liabilities and Shareholders' Equity	\$7,658,227	\$7,630,598
On behalf of the Board (signed) "Abe Schwartz"	Director	
(signed) "Brian Pedlar"	Director	

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENTS OF OPERATIONS AND COMPREHENSIVE
(LOSS) (UNAUDITED)

Expressed in Canadian Dollars

	Three months ended June 30,		Nine months ended June 30,	
	2016	2015	2016	2015
Revenue				
Product	\$2,549,328	\$1,905,348	\$4,972,986	\$4,519,738
Medical coating systems	7,576	-	7,576	662,500
Services	-	-	115,299	-
Licensing and royalty fees	43,098	68,989	742,523	309,062
Total revenue	2,600,002	1,974,337	5,838,384	5,491,300
Cost of sales	930,896	787,382	2,066,633	1,976,715
Gross Profit	1,669,106	1,186,955	3,771,751	3,514,585
Operating Expenses				
Operations	180,470	182,288	582,907	501,808
Research and development activities	151,944	127,386	470,012	422,171
Sales and marketing	670,649	351,230	1,352,805	806,606
General and administrative	790,045	637,573	2,189,499	1,791,281
	1,793,108	1,298,477	4,595,223	3,521,866
(Loss) before undernoted	(124,002)	(111,522)	(823,472)	(7,281)
Interest income (expense)	(32,790)	(17,750)	(132,615)	(87,676)
Net (loss) and comprehensive (loss) for the period	(156,792)	\$(129,272)	(956,087)	(94,957)
Basic (loss) per share (Note 22)	\$ (0.02)	\$ (0.01)	\$ (0.09)	\$ (0.01)
Diluted (loss) per share (Note 22)	\$ (0.02)	\$ (0.01)	\$ (0.09)	\$ (0.01)

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

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CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CHANGES IN EQUITY (UNAUDITED)

Expressed in Canadian Dollars

	Share Capital	Contributed Surplus	Stock Options	Equity Component of Convertible Debentures	Accumulated Deficit	Total
Balance at October 1, 2014	\$32,423,095	\$2,679,565	\$1,220,779	\$225,352	\$(31,021,185)	\$5,527,606
Share based payments	-	-	115,177	-	-	115,177
Options naturally expired	-	89,007	(89,007)	-	-	-
Comprehensive (loss) for the period	-	-	-	-	(94,957)	(94,957)
Balance at June 30, 2015	\$32,423,095	\$2,768,572	\$1,246,948	\$225,352	\$(31,116,142)	\$5,547,825
Balance at October 1, 2015	\$32,423,095	\$3,159,125	\$941,593	\$225,352	\$(31,963,175)	\$4,785,990
Share based payments	-	-	153,825	-	-	153,825
Options naturally expired	-	168,757	(168,757)	-	-	-
Conversion of debt	1,204,627	-	-	(225,352)	-	979,275
Comprehensive (loss) for the period	-	-	-	-	(956,087)	(956,087)
Balance at June 30, 2016	\$32,627,722	\$3,327,882	\$926,661	-	\$(32,919,262)	\$4,963,003

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

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CONDENSED CONSOLIDATED INTERIM STATEMENT OF CASH FLOWS (UNAUDITED)

Expressed in Canadian Dollars

	Nine months ended June 30,	
	2016	2015
Cash flows from operating activities		
Net (loss) earnings and comprehensive (loss) income for the period	\$(956,087)	\$(94,957)
Adjustments to reconcile net earnings and comprehensive income to net cash used in operating activities:		
Depreciation - property, plant and equipment	73,174	72,220
Amortization - intangible assets	123,291	120,450
Non-cash interest (Note 13)	132,809	119,629
Share based payments	153,825	115,176
Foreign exchange (gain) on cash held	53,911	(32,550)
Cash (used) generated by operating activities before change in non-cash working capital balances	(419,077)	299,968
Change in non-cash working capital (Note 20)	(497,799)	(523,936)
Total cash flows from operating activities	(916,876)	(223,968)
Cash flows from investing activities		
Purchase of property, plant and equipment	(88,307)	(161,816)
Disposition of property, plant and equipment (net)	4,573	13,907
Purchase of intangible assets	(125,914)	(64,514)
Short term investments	547,040	(4,824)
Restricted cash	(199)	117,223
Total cash flows from investing activities	337,193	(100,024)
Total cash flows from financing activities	-	-
Foreign exchange gain on cash held	(53,911)	32,550
Total cash flows during the period	(633,594)	(291,442)
Cash and cash equivalents, beginning of the period	1,304,550	3,574,836
Cash and cash equivalents, end of the period	\$ 670,956	\$3,283,394
Represented by		
Cash	\$670,956	\$ 939,381
Cash equivalents	-	2,344,013
	\$670,956	\$3,283,394

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

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NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

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For the three and nine months ended June 30, 2016

1. CORPORATE INFORMATION

Covalon Technologies Ltd. (“the Company”) is incorporated under the laws of Ontario and is engaged in the business of developing, licensing, and selling medical technologies. The consolidated financial statements of Covalon Technologies Ltd. for the three and six months ended, June 30, 2016 comprise the results of the Company and its wholly owned subsidiaries. The Company has received regulatory approval on numerous products and is currently generating revenue. The Company has adopted a business model that contracts the manufacturing and distribution of its commercialized products through partners. The Company generates its revenues through development contracts, licensing agreements, and distribution contracts and sales. The Company is listed on the TSX Venture Exchange, having the symbol COV.

The address of the Company’s corporate office and principal place of business is 1660 Tech Avenue, Unit 5, Mississauga, Ontario, Canada. The Company’s development and commercialization centre is located at 405 Britannia Road East, Suite 106, Mississauga, Ontario, Canada.

2. BASIS OF PRESENTATION

a) Statement of Compliance

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

The consolidated financial statements were authorized for issue by the Board of Directors on August 18, 2016.

b) Basis of Measurement

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

c) Functional Currency

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

d) Critical accounting estimates and judgments

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

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NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

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3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

There have been no changes in the accounting policies since the Company's 2015 annual financial statements.

a) **Basis of Consolidation**

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Covalon Technologies Inc., COV Healthcare Innovations Corp., and Covalon Medical Device Shanghai Co., Ltd. and have been prepared using the acquisition method of consolidation. The assets and liabilities of the acquired companies are initially recorded at fair value at the date of acquisition. The results of operations of the acquired companies are included from the dates of acquisition. All significant intercompany transactions and balances have been eliminated on consolidation.

b) **Revenue Recognition**

Revenue is recognized on an accrual basis as follows:

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

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

c) **Cash and Cash Equivalents**

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

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d) Inventories

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

e) Property, Plant and Equipment

i) Recognition and Measurement

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

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

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

ii) Subsequent Costs

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

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

iii) Gains and Losses

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

iv) Depreciation

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

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

Depreciation methods, useful lives, and residual values are reviewed at each financial reporting date and adjusted if appropriate.

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NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

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f) Intangible Assets

i) Patents, Trademarks, and Computer Software

Intangible assets include expenditures related to obtaining patents and technology rights associated with patents, trademarks, and computer software. Patents are amortized on a straight-line basis over the remaining life of the patent, being 20 years less the number of years since application for the patent, and are stated at cost less accumulated amortization and impairment. Trademarks are considered to have an indefinite useful life and as such are recorded at cost less accumulated impairment. Computer software is amortized using the 20% diminishing balance basis. Amortization methods, useful lives, and residual values are reviewed at each reporting date and adjusted if appropriate.

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

ii) Deferred Development Costs/Research and Development

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

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

Development expenditures not satisfying the above criteria are recognized in operations as incurred.

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

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

g) Impairment of Non-Financial Assets

Impairment tests on intangible assets with indefinite useful economic lives are undertaken annually at the financial year-end. Other non-financial assets, including property plant and equipment, computer

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software, patents, and deferred development costs are subject to impairment tests whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. Where the carrying value of an asset exceeds its recoverable amount, which is the higher of value in use and fair value less costs to sell, the asset is written down accordingly. Where it is not possible to estimate the recoverable amount of an individual asset the impairment test is carried out on the asset's cash-generating unit, which is the lowest group of assets in which the asset belongs for which there are separately identifiable cash inflows that are largely independent of the cash inflows from other assets. An impairment loss is charged to operations except to the extent it reverses gains previously recognized in other comprehensive income/loss.

h) Investment Tax Credits

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

i) Other Provisions

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

j) Income Taxes

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

Deferred tax assets and liabilities are recognized for the tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations for the year in which the change occurs.

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

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

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k) Foreign Currency Transactions

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

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

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

l) Financial Instruments

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

i) Loans and Receivables

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

ii) Financial Liabilities

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

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

m) Share Capital

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

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

n) Earnings (Loss) Per Share

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

o) Share-based Payments

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

p) Common Share Purchase Warrants

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

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

q) Standards, Amendments and Interpretations Not Yet Effective

Certain pronouncements were issued by the IASB or the IFRS Interpretations Committee that are mandatory for accounting periods beginning after January 1, 2016 or later periods. None of these are expected to have a significant effect on the consolidated financial statements, except for the following standards and interpretations that have been issued but are not yet effective:

i) IFRS 9 - Financial Instruments

IFRS 9, Financial Instruments is part of the IASB's wider project to replace IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 retains but simplifies the mixed

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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, 2018. The Company is in the process of evaluating the impact of the new standard.

ii) IFRS 15 - Revenue From Contracts with Customers

IFRS 15, Revenue From Contracts with Customers establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer. The standard is effective for annual periods beginning on or after January 1, 2018. The Company has not yet assessed the impact of adopting this standard.

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

4. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

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

ESTIMATES

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

i) Share-based Payment Transactions

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

ii) Intangible Assets

When the Company assesses the recoverable amount of intangible assets for impairment 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

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

iv) Income taxes

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

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

v) Allowance for doubtful accounts

The Company is exposed to credit risk associated with its trade receivables. The risk is reduced by having trade receivables insured when the Company determines that it is warranted. Management reviews the trade receivables at each reporting date and makes an allowance for doubtful accounts when the expected recovery could be less than the actual trade receivable. The expected recovery amount can vary from the actual cash received.

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

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each; the currency in which it purchases materials and pays its employees; its other sources and uses of cash flows; and, the geographic environment influencing each of its consolidated entities and products; and

ii) Provisions

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

iii) Revenue Recognition

Certain contracts may include terms regarding the timing of provision of goods or services and/or multiple deliverable elements and management is required to make significant judgements and estimates based on various assumptions including the timing of recognition of deliverables in satisfying the revenue recognition criteria as well as the relative fair value of each deliverable to which an allocation of the consideration is made.

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 may hold guaranteed investment certificates and provincial bonds, as per its practice of protecting its capital rather than maximizing investment yield; however, this risk is mitigated as the issuers are major Canadian banks and the Province of Ontario.

The Company, in the normal course of business, is exposed to credit risk from its global customers in the medical device industry. The accounts and other receivables are subject to normal industry risks in each geographic region in which the Company operates. The Company attempts to manage these risks by dealing with creditworthy customers; however, due to the limited number of potential customers in each market this is not always possible. As at June 30, 2016, ten customers accounted for 93% (2015 – ten customers for 88%) 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

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allowance for bad debts in the amount of \$439,198 (September 2015 – \$442,861) resulting in a bad debt expense \$55,145 (2015 - \$nil). Management reviews the outstanding amounts on a regular basis and determines the collectability of the outstanding balances on a case by case basis.

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

	June 30, 2016	September 30, 2015
Current	2,217,409	\$1,591,862
30-60 days past due	11,910	380,868
Over 60 days past due, (net of allowance for doubtful accounts of \$439,198; Sep 2015 - \$442,861)	316,010	151,820
	\$2,545,329	\$2,124,550

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 future contractual commitments that the Company has are outlined in Note 18.

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.

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

	June 30, 2016	September 30, 2015
Accounts receivable, net	2,300,267	1,997,374
Accounts payable	(718,693)	(568,413)
Deferred Revenue	(270,016)	(59,517)
Cash	585,429	133,578
Exchange rate (\$USD / \$CAD)	1.29	1.34
	\$1,896,987	\$1,503,023

An increase of 5% and 10% in the US dollar exchange rate would result in an increase in net income by approximately \$94,849 (September 2015 – \$75,151) and \$189,699 (September 2015 - \$150,302) 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 June 30, 2016 is \$4,963,003 (2015 - \$5,547,825).

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.

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7. INVESTMENT TAX CREDITS

The Company is eligible for the Ontario Innovation Tax Credit (“OITC”) at the rate of 10% refundable in cash to the Company. The refundable tax credits received by the Company are subject to review by Canada Revenue Agency and the Ontario Ministry of Finance. During the nine months ended, June 30, 2016 the Company recognized \$34,972 (2015 – \$nil) in credits.

8. INVENTORIES

Inventories consist of the following:

	June 30, 2016	September 30, 2015
Raw materials	\$509,775	\$604,219
Finished Goods	1,180,529	232,142
	<u>\$1,690,304</u>	<u>\$836,361</u>

Cost of sales include \$1,736,879 (June 2015 - \$1,667,506) in inventoried materials.

9. RESTRICTED CASH

The Company assigned \$35,574 of its cash equivalents with a major financial institution as collateral to secure its credit cards. These funds are expected to be restricted for more than one year.

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10. PROPERTY PLANT AND EQUIPMENT

	Furniture and Fixtures	Lab Equipment	Leasehold Improvements	Total
	\$	\$	\$	\$
Cost				
Balance at October 1, 2014	319,116	1,490,555	71,416	1,881,087
Disposals	-	(564,440)	-	(564,440)
Additions	72,278	43,413	56,482	172,173
Balance at September 30, 2015	391,394	969,528	127,898	1,488,820
Disposals	-	(34,279)	-	(34,279)
Additions	4,758	76,392	7,157	88,307
Balance at June 30, 2016	396,152	1,011,641	135,055	1,542,848
Accumulated depreciation				
Balance at October 1, 2014	244,413	1,107,809	71,416	1,423,638
Depreciation	18,816	59,937	2,781	81,534
Disposals	-	(471,739)	-	(471,739)
Balance at September 30, 2015	263,229	696,007	74,197	1,033,433
Depreciation	20,311	44,596	8,267	73,174
Disposals	-	(29,706)	-	(29,706)
Balance at June 30, 2016	283,540	710,897	82,464	1,076,901
Carrying amounts				
At September 30, 2015	128,165	273,521	53,701	455,387
At June 30, 2016	112,612	300,744	52,591	465,947

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11. INTANGIBLE ASSETS

	Deferred Development Costs	Patents	Trademarks	Computer Software	Total
	\$	\$	\$	\$	\$
Cost					
Balance at October 1, 2014	4,134,415	722,777	77,637	149,163	5,083,992
Additions	-	67,204	326	-	67,530
Balance at September 30, 2015	4,134,415	789,981	77,963	149,163	5,151,522
Additions	-	125,149	765	-	125,914
Balance at June 30, 2016	4,134,415	915,130	78,728	149,163	5,277,436
Accumulated amortization and impairment losses					
Balance at October 1, 2014	2,849,602	167,459	-	143,387	3,160,448
Amortization	121,703	37,219	-	1,150	160,072
Balance at September 30, 2015	2,971,305	204,678	-	144,537	3,320,520
Amortization	91,277	31,318	-	696	123,291
Balance at June 30, 2016	3,062,582	235,996	-	145,233	3,443,811
Carrying amounts					
At September 30, 2015	1,163,110	585,303	77,963	4,626	1,831,002
Balance at June 30, 2016	1,071,833	679,134	78,728	3,930	1,833,623

12. DEFERRED REVENUE

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

	June 30 2016	September 30 2015
Balance, beginning of period	\$ 595,253	\$ 996,246
Add:		
Deferred licensing fees	-	-
Deferred product and services revenue	438,693	1,272,082
Less:		
Recognition of deferred product and services revenue	(157,780)	(1,371,163)
Recognition of deferred licensing fees	(46,365)	(301,912)
Balance, end of period	829,801	595,253
Amount to be recognized within one year	(409,790)	(138,107)
Long term balance	\$ 420,011	\$ 457,146

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13. CONVERTIBLE DEBENTURE UNITS

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

On January 6, 2016, 150 units were converted into shares of the Company. The converted amount was comprised of \$150,000 related to principal and \$51,167 related to the interest component.

From June 2, 2016 to June 7, 2016 the remaining 600 units of the Company's convertible debentures were converted into shares. The converted amount was comprised of \$600,000 related to principal and \$227,419 related to the interest component.

14. SHARE CAPITAL AND RESERVES

a) Common Shares

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

From June 2, 2016 to June 7, 2016 the Company issued 4,098,010 common share to satisfy the conversion of the remaining outstanding units of convertible debt. The converted amount was comprised of \$600,000 related to principal and \$227,410 related to the interest component which converted into 3,870,600 and 227,410 shares respectively.

On January 6, 2016, the Company issued 1,018,817 common shares to satisfy the conversion of a portion of the total convertible debt outstanding. The converted amount was comprised of \$150,000 related to the principal and \$51,167 related to the interest which converted into 967,650, and 51,167 common shares respectively.

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

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

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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. During the year ended September 30, 2014, 30,000 warrants were exercised for total proceeds of \$30,000.

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

The following is a summary of common share capital from September 30, 2014 to June 30, 2016:

	Number of Shares (#)	Average Issue Price (\$)	Amount (\$)
Balance at September 30, 2014	9,306,171		32,423,095
Balance at September 30, 2015	9,306,171		32,423,095
Conversion of debt	5,116,827	.24	1,204,627
Balance at and June 30, 2016	14,422,998		33,627,722

b) Contributed Surplus

The following is a summary of changes in contributed surplus from September 30, 2014 to June 30, 2016:

Balance September 30, 2014	\$2,679,565
Options naturally expired	479,560
Balance September 30, 2015	\$3,159,125
Options naturally expired	\$168,757
Balance June 30, 2016	\$ 3,327,882

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c) Share Purchase Warrants

The following is a summary of warrants from September 30, 2014 to June 30, 2016:

	Number of Warrants
Balance at September 30, 2014	5,793,250
Balance at September 30, 2015	5,763,250
Balance at June 30, 2016	5,763,250

d) Nature and Purpose of Equity and Reserves

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

'Contributed Surplus' is used to recognize the value of vested stock option grants that have naturally expired.

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

15. SHARE-BASED PAYMENTS

a) Option Plan Details

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

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The following is a summary of changes from October 1, 2014 to September 30, 2015:

Grant Date	Expiry Date	Exercise Price	Opening Balance	During the period				Closing Balance	Vested	Unvested
				Granted	Exercised	Expired	Forfeited			
11-Dec-09	11-Dec-14	\$ 2.90	1,007	-	-	(1,007)	-	-	-	-
27-Jan-10	27-Jan-15	\$ 3.10	85,500	-	-	(85,500)	-	-	-	-
01-Sep-10	01-Sep-15	\$ 2.00	120,000	-	-	(120,000)	-	-	-	-
02-Sep-10	02-Sep-15	\$ 2.00	26,996	-	-	(26,996)	-	-	-	-
10-Jun-11	10-Jun-16	\$ 2.00	27,000	-	-	-	-	27,000	27,000	-
13-Jun-11	13-Jun-16	\$ 2.00	71,000	-	-	-	-	71,000	71,000	-
27-Sep-11	27-Sep-16	\$ 1.40	100,000	-	-	-	-	100,000	100,000	-
16-Aug-13	16-Aug-18	\$ 0.16	64,500	-	-	-	-	64,500	43,000	21,500
26-Sep-13	26-Sep-18	\$ 0.85	235,000	-	-	-	-	235,000	156,667	78,333
13-Jun-14	13-Jun-19	\$ 2.00	97,500	-	-	-	(2,500)	95,000	31,667	63,333
26-Mar-15	26-Mar-20	\$ 1.40	-	150,500	-	-	-	150,500	-	150,500
			828,498	150,500	-	(233,503)	(2,500)	743,000	297,333	445,167
Weighted Average Exercise Price			\$ 1.57	\$ 1.40	\$ -	\$ 2.41	\$ 2.00	\$ 1.27	\$ 1.26	\$ 1.30

The following is a summary of changes in options from October 1, 2015 to June 30, 2016:

Grant Date	Expiry Date	Exercise Price	Opening Balance	During the period				Closing Balance	Vested	Unvested
				Granted	Exercised	Expired	Forfeited			
10-Jun-11	10-Jun-16	\$ 2.00	27,000	-	-	(27,000)	-	-	-	-
13-Jun-11	13-Jun-16	\$ 2.00	71,000	-	-	(71,000)	-	-	-	-
27-Sep-11	27-Sep-16	\$ 1.40	100,000	-	-	-	-	100,000	100,000	-
16-Aug-13	16-Aug-18	\$ 0.16	64,500	-	-	-	-	64,500	43,000	21,500
26-Sep-13	26-Sep-18	\$ 0.85	235,000	-	-	-	-	235,000	156,667	78,333
13-Jun-14	13-Jun-19	\$ 2.00	95,000	-	-	-	-	95,000	63,333	31,667
26-Mar-15	26-Mar-20	\$ 1.40	150,500	-	-	-	-	150,500	50,167	100,333
07-Mar-16	07-Mar-21	\$ 1.13	-	192,500	-	-	-	192,500	-	192,500
23-Jun-16	23-Jun-21	\$ 1.29	-	200,000	-	-	-	200,000	-	200,000
			743,000	392,500	-	(98,000)	-	1,037,500	381,500	656,000
Weighted Average Exercise Price			\$ 1.27	\$ 1.21	\$ -	\$ 2.00	\$ -	\$ 1.18	\$ 1.15	\$ 1.20

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b) Fair Value of Options Issued During the Period

During the nine months ended, June 30, 2016, the Company issued two tranches of options:

- On June 23, 2016, the Company issued 200,000 options with a weighted average fair value of \$1.16 were granted. Trading price of the stock at the time of the grant was \$1.29. The fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 0.72%, dividend rate NIL, average volatility – 155.43% and an average term of 5 years. The estimated forfeiture rate is 7.13%.
- On March 7, 2016, the Company issued 192,500 options with a weighted average fair value of \$1.03 were granted. Trading price of the stock at the time of the grant was \$1.13. The fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 0.51%, dividend rate NIL, average volatility – 158.71% and an average term of 5 years. The estimated forfeiture rate is 7.86%.

c) Expenses Arising from Share-based Payment Transactions

Total expenses arising from share-based payment transactions recognized during the nine months ended, June 30, 2016, as part of employee benefit expense were \$153,825 (2015 - \$115,176).

16. INCOME TAXES

The Company computes an income tax provision in each of the jurisdictions in which it operates. The operations in Canada and the United States are subject to income tax at average rates of 26.5% - 39.5% for the year ended September 30, 2015 (2014 – 26.5% - 39.5%).

a) Reconciliation between statutory rate and actual rate

	September 30,	
	2015	2014
Income tax expense computed at statutory combined tax rates	\$(281,200)	\$615,700
Permanent differences	55,500	42,900
Provision to return adjustment	1,000	11,400
Losses expired	-	4,900
Other	2,000	(100)
Change in deferred tax assets not recognized	222,700	(674,800)
	\$ -	\$ -

b) Deferred tax assets

The tax effect of the temporary differences that gives rise to deferred tax assets (liabilities) as of September 30, 2015 and 2014 is presented below. No benefit has been recorded in these financial statements as there is no assurance that the Company will generate taxable income to utilize these differences.

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	September 30,	
	2015	2014
Non-capital loss carry forwards	\$ 4,614,400	\$ 4,401,300
Capital loss carry forwards	127,600	127,600
Capital and other assets	90,200	49,000
Deferred development costs	1,609,200	1,577,000
Deferred revenue and other liabilities	188,700	273,000
Convertible debenture	(29,100)	(49,600)
Deferred tax assets not recognized	(6,601,000)	(6,378,300)
	<u>\$ -</u>	<u>\$ -</u>

The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2015 of approximately \$16,639,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

<u>Year</u>	Canada Amount	US Amount
2016	1,365,000	-
2017	-	-
2018	2,132,000	-
2019	3,309,000	-
2020	601,000	68,000
2021	3,874,000	140,000
2022	3,267,000	127,000
2023	859,000	-
2024	89,000	162,000
2025	814,000	246,000
	<u>\$ 15,896,000</u>	<u>\$ 743,000</u>

- (c) The Company has capital losses carry forward for income tax purposes as at September 30, 2015 of approximately \$962,883 (2014 - \$962,883), which are available to reduce taxable capital gains in future years. These losses do not expire.
- (d) The Company is eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% on its research and development expenditures and refundable in cash to the Company. The Company is also eligible for a 20% federal research and development investment tax credit and a 4.5% Ontario Research and Development Tax Credit ("ORDTC") which are available to offset federal income taxes payable and Ontario income taxes payable, respectively, in the future.

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

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At September 30, 2015, the Company has \$1,392,700 (2014 - \$1,517,784) 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, 2015, the Company has \$114,426 (2014 - \$114,426) 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.

17. RELATED PARTY TRANSACTIONS

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

Key management personnel compensation comprised:

	Three months ended June,		Nine months ended June,	
	2016	2015	2016	2015
Short term employee benefits	\$218,134	\$161,044	\$620,501	\$322,087
Share-based payments	15,453	11,042	48,263	32,982
	\$233,586	\$172,086	\$668,764	\$355,069

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.

During the nine months ended June 30, 2016, related parties converted 600 units of the convertible debt instrument (Note 13). The converted amount was comprised of \$600,000 related to the principal and \$221,731 related to the interest which was converted into 3,870,600, and 221,731 common shares respectively.

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18. COMMITMENTS

The Company has signed lease agreements for two locations in Mississauga, Ontario and one in Shanghai, China. The leases range from a term of two years to a term of ten years. The Company has also entered into three operating leases for equipment with terms ranging from three to five years. The minimum annual lease payments for the next five years are as follows:

<u>Year</u>	<u>Annual Commitment</u>
2016	\$888,169
2017	486,874
2018	369,642
2019	368,684
2020	262,518
Thereafter	1,425,165

19. CONTINGENCIES

From time to time, the Company is party to legal proceedings arising out of the normal course of business. The results of these litigations cannot be predicted with certainty, and management is of the opinion that the outcome of these types of proceedings is generally not determinable. Any loss resulting from these proceedings will be charged to operations in the period the loss is determined.

20. CHANGE IN NON-CASH WORKING CAPITAL ITEMS

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

	<u>Nine months ended June 30,</u>	
	<u>2016</u>	<u>2015</u>
Accounts receivable, net	\$(420,779)	\$(388,189)
Prepaid expenses	79,839	(130,631)
Inventories	(853,943)	(208,170)
Accounts payable and accrued liabilities	467,923	481,803
Deferred revenue	234,548	(351,607)
Deferred Rent	(5,387)	72,858
	\$(497,799)	\$(523,936)

21. OPERATING SEGMENTS

As the business model for the Company evolves and the strategic focus changes, management has revisited the disclosure of operational units to ensure that the information is useful to the users of our consolidated financial statements. The presentation of operating segments as previously disclosed (with a distinction between Advanced Wound Care and Medical Device Coatings) is not being shown as management does not view the business this way. The management team of Covalon does not make decisions, review performance, or have separate staff between Advanced Wound Care and Medical Device Coatings. These two areas are

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strongly aligned as the majority of customers will purchase products from both categories on the same order, through the same channel, and expect delivery at the same time; as such, management has determined that the Company has one operating segment. As management continues to review the performance, and forecasts, operational segments may be a meaningful requirement in the future.

During the three months ended, June 30, 2016 there was 1 customer who individually accounted for more than 10% of revenue (2015 – 2 customers). The Company generated revenue of \$592,379 (2015 – \$772,273) in the US, \$5,737 (2015 – \$1,653) in Canada, and \$2,001,886 (2015 – \$1,200,411) internationally.

During the nine months ended, June 30, 2016 there was 1 customer who individually accounted for more than 10% of revenue (2015 – 3 customers). The Company generated revenue of \$2,259,323 (2015 – \$2,555,722) in the US, \$123,339 (2015 – \$665,841) in Canada, and \$3,455,722 (2015 – \$2,269,737) internationally.

22. EARNINGS (LOSS) PER SHARE

Earnings per share is calculated using the weighted average number of shares outstanding during the period. There were 5,116,827 shares issued during the nine months ended, June 30, 2016 (2015 – nil). The weighted average number of shares outstanding during the nine months ended June 30, 2016 were 10,353,277 (September 30, 2015 - 9,306,171).

Details of anti-dilutive securities outstanding would be included in diluted EPS calculations as follows:

Potentially dilutive securities	June 30, 2016	September 30, 2015
Common shares potentially assumable		
- under stock options	87,606	111,727
- under warrants	4,108,823	4,300,928
- under terms of convertible debenture	4,069,721	4,183,958
Total potentially dilutive shares	4,196,429	8,596,613

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three and nine months ended June 30, 2016

23. EXPENSES BY NATURE

The consolidated statements of operations and comprehensive loss include the following expenses by nature:

a) Employee costs

	Nine months ended June 30,	
	2016	2015
Short-term wages & benefits, commissions, contract and director fees	2,585,754	2,171,068
Share based payments	153,824	115,176
Total employee costs	2,739,578	2,286,244
Included in		
Cost of goods sold	116,550	98,283
Operations	371,655	397,773
Research and development activities	439,187	341,669
Sales and marketing	823,391	551,300
General and administrative	988,795	897,219
Total employee costs	2,739,578	2,286,244

b) Depreciation and amortization

	Nine months ended June 30,	
	2016	2015
Cost of sales	\$ 118,266	\$ 129,731
Operations	5,332	4,999
Research and development activities	12,276	14,322
General and administrative	60,592	43,619
Total depreciation and amortization	\$ 196,466	\$ 192,671