Covalon Technologies Ltd.

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

December 31, 2013

MANAGEMENT'S DISCUSSION & ANALYSIS
For the three months ended December 31, 2013

February 28, 2014

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

In this MD&A, financial information for the three months ended December 31, 2013 and 2012 is based on unaudited condensed consolidated interim financial statements of the Company, which was prepared in accordance with International Financial Reporting Standards ("IFRS"), and is presented in Canadian dollars unless otherwise specified. In accordance with its terms of reference, the Audit Committee of the Company's Board of Directors reviews the contents of the MD&A and recommends its approval to the Board of Directors. The Board of Directors has approved this MD&A, on February 28, 2014. Disclosure contained in this document is current to that date, unless otherwise noted.

On January 1, 2011, as issued by the International Accounting Standards Board ("IASB"), IFRS became the basis of preparation of financial statements for publicly accountable enterprises in Canada. The information presented in this MD&A, is presented in accordance with IFRS unless otherwise noted as being presented under Canadian generally accepted accounting principles ("Canadian GAAP") and not IFRS.

Management's Responsibility for Financial Reporting

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

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

Non-IFRS Financial Measures

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

Forward-looking Statements

This MD&A contains forward-looking statements, which reflect the Company's current expectations regarding future events. The forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "estimate", "expect", "intend" and statements that an event or result "may", "will", "should", "could" or "might" occur or be achieved and other similar expressions. These

forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance of and demands for new products, the impact of the products and pricing strategies of competitors, delays in developing and launching new products, the regulatory environment, fluctuations in operating results and other risks, any of which could cause results, performance, or achievements to differ materially from the results discussed or implied in the forward-looking statements. Many risks are inherent in the industry; others are more specific to the Company. Investors should consult the "Risks & Uncertainties" section of this MD&A as well as the Company's ongoing quarterly filings for additional information on risks and uncertainties relating to these forward-looking statements. Investors should not place undue reliance on any forward-looking statements. Management assumes no obligation to update or alter any forward-looking statements whether as a result of new information, further events or otherwise.

Nature of Our Business

Covalon Technologies Ltd. is a researcher, developer, manufacturer and marketer of patent-protected medical products that improve patient outcomes and save lives in the areas of advanced wound care and infection management. Our offices and laboratories are located in Mississauga, Ontario, Canada.

Covalon leverages its patented medical technology platforms and expertise in two ways; (i) we develop products that we sell under Covalon's name; and (ii) we develop and commercialize medical products for other medical companies under development and license contracts.

The majority of Covalon-branded products are sold through independent distributors to various health care providers such as hospitals, wound care centers, burn centers, extended/alternate care facilities, acute care facilities, home health care agencies and physicians' offices. Our products require regulatory clearances and are sold on a prescription basis in the United States, Canada, and a number of international countries.

We also license our technologies and products to large medical device companies as well as work with niche start-ups to create novel technology to advance their product offerings in various medical device markets. Covalon has worked with over twenty medical companies including leaders in vascular access devices, I.V. infusion, orthopedics, device and patient care distributors, wound care product companies, specialty medical device manufacturers and major contract manufacturers.

Covalon currently has three proprietary platform technologies that have the potential to be developed into dozens of medical devices: (i) Collagen matrix; (ii) Antimicrobial silicone adhesive; and (iii) Medical coating technology. These platform technologies are protected by patents, patent applications and patents pending, patented and proprietary manufacturing processes and trade secrets, brands, trademarks and trade names.

Our Products

We have obtained regulatory clearance on four families of medical device products derived from our platform technologies:

ColActive and **ColActive Plus**: Collagen Matrix Dressings. The ColActive family of products is based on our patented collagen matrix and is used to treat chronic and infected wounds including diabetic ulcers (including diabetic foot ulcers), pressure ulcers, venous ulcers (including venous leg ulcers), donor and graft sites, traumatic wounds healing by secondary intention, dehisced surgical wounds, first and second degree burns. These dressings begin from a collagen base, which is generally biocompatible with the human body, and enable the release of beneficial materials, such as antimicrobials, into the wound site and/or enhance the removal of undesirable materials, such as wound exudate from the wound. Covalon's patented manufacturing process for ColActive has certain clinical advantages over other dressings, such as open binding sites for destructive enzymes, effective antimicrobial activity and exudate management properties that help chronic wounds heal.

IV Clear: Antimicrobial Clear Silicone Adhesive Dressings with Chlorhexidine and Silver. IV Clear is intended to cover and protect insertion sites and to secure intravenous devices to skin, including IV catheters, central venous lines, peripherally inserted central catheters (PICCs), hemodialysis catheters, other intravascular catheter and percutaneous devices. IV Clear is the only antimicrobial clear silicone vascular access dressing that combines silver and chlorhexidine to provide broad-spectrum antimicrobial activity for 7 days. IV Clear meets the current FDA "greater than 4 log reduction" standard for an antimicrobial claim against bacteria and yeast most commonly associated with healthcare acquired infections. The soft silicone adhesive provides greater patient comfort, does not macerate or damage the skin, and was shown to be up to 10 times less painful upon removal when compared to acrylic adhesives.

SurgiClear: Antimicrobial Clear Silicone Adhesive Dressings with Chlorhexidine and Silver. Covalon developed SurgiClear based on the same technology as IV Clear to address the shortcomings of other surgical site cover dressings in the market. SurgiClear is intended to cover and protect wound sites against external contamination, including post-operative, debrided or partial thickness wounds such as skin graft donor sites, abrasions, lacerations, skin tears, first and second degree burns. SurgiClear can be used to cover and protect wound closure devices (i.e. sutures, staples, clips), orthopedic pins, fixtures & wires as well as drains. SurgiClear may also be used to cover and secure primary dressings. SurgiClear inhibits microbial colonization and suppresses microbial regrowth under the dressing. SurgiClear is gentle on the skin for maximum patient comfort. Its removal will not tear or damage fragile skin, and the novel adhesive film provides excellent tissue contact and infection management. The use of silicone materials on wounds is known to help reduce excessive scarring during the healing process.

SilverCoat: Antimicrobial Silicone Foley Catheters: Covalon's SilverCoat urinary Foley catheter is coated with Covalon's patented antimicrobial silver polymer coating which is lubricious and elutes silver from the surface to kill bacteria and yeast over a seven day period. SilverCoat Foley's are used via prescription in hospitals, extended care facilities, acute care facilities, and home health care situations to catheterize patients for extended periods of time. Among urinary tract infections (UTI) acquired in the hospital, approximately 75% are associated with a urinary catheter, which is a tube inserted into the bladder through the urethra to drain urine. Between 15-25% of hospitalized patients receive urinary catheters during their hospital stay. The most important risk factor for developing a catheter-associated UTI (CAUTI) is prolonged use of the urinary catheter, according to the United States Center for Disease Control.

Our Services

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

Analysis of Operating and Financial Results

Covalon is transitioning from solely a research lab to a successful market focused technology business with a broad platform of patented technologies and products. The Company currently uses a combination of distribution under the Covalon brand name and an OEM business model to realize value in the marketplace.

Over the past 24 months the Company has set up distribution relationships with a number of companies in North America and in the Middle East and Asia and is in the process of expanding into other important global markets. The Company's attendance at selected medical products trade shows has led to increased awareness of the Covalon brand and end user interest in its products.

Covalon continues to also utilize an OEM revenue model based on selling our technologies to large medical companies. OEM models do not produce consistent revenues on a quarterly basis. Consequently, any one quarter's results are not particularly indicative of the Company's prospects. Most OEM sales models involve a long sales cycle – from initial discussion, product evaluation, regulatory filings, contract negotiation, performance of services and then to market roll-out. This process generally takes twelve to eighteen months – although there are exceptions for both shorter and longer times for the completion of a project. The start and finish of projects is dependent on many factors, many of which are outside the control of Covalon.

On November 4, 2013, Covalon licensed its antimicrobial silicone adhesive technology to Molnlycke Heath Care ("Molnlycke"). Under the license agreement, Covalon granted Molnlycke the exclusive rights to exploit Covalon's patent-pending antimicrobial silicone adhesive technology in the field of single-use surgical, wound care and vascular access medical dressings. Covalon received $3.5 million in upfront fees and will receive additional ongoing minimum royalties, milestone payments and other fees. Covalon retained the rights to exploit the antimicrobial silicone adhesive technology in other fields and commercialize new life-saving products in its development pipeline while continuing to distribute its other products. The parties simultaneously signed a supply and distribution agreement under which Covalon will provide to Molnlycke its United States Food and Drug Administration cleared products, SurgiClear™ and IV Clear™, for distribution under the Molnlycke brand.

Financial Highlights for the Three Months Ended December 31, 2013

- Total revenue for the three months ended December 31, 2013 was $4,522,201 a significant increase of $572,005 over the same period of the prior year. This increase was due to the recognition of the US$3,500,000 received by the Company as a result of the licensing of the Company's two new products IV Clear and SurgiClear to Molnlycke Health Care AB in November 2013.
- Revenue from advanced wound care for the three months ended December 31, 2013 increased $213,067 or 41% over the same period of the prior year.
- Medical device coating revenues for the three months ended December 31, 2013 were included in licensing fees as royalties as the Company transitioned to a royalty-based model of outsourced production of the medical coating devices sold in the market. For the same period of the previous year, medical device coating revenue was $Nil.
- Revenue from licensing fees increased to $3,788,611 for the three months ended December 31, 2013 compared to $51,482 for the same period last year. This increase is primarily a result of the recognition of US$3,500,000 received for the licensing of the Company's two new products IV Clear and SurgiClear to Molnlycke Health Care AB in November 2013

- Gross margin on product sales and services (excluding licensing fees) for the three months increased to 48% compared to 32% for the same period of the prior year as a result of product mix.
- Operating expenses for the year ended September 30, 2013 decreased 2.5% to $993,412 compared to $1,018,751 for the prior year. This decrease reflects continued effort to reduce ongoing operating expenses.
- Net income per share for the period ended December 31, 2013 was $0.34 ($0.17 diluted) compared to a loss per share of $0.10 for the period ended December 31, 2012.

Consolidated Statement of Comprehensive Gain (Loss)

	Three months ended December 31,	
(Canadian $)	**2013**	2012
Revenue		
Product and Services		
Advanced wound care	**$ 733,590**	$ 520,523
Licensing fees	**3,788,611**	51,482
Total revenue	**4,522,201**	572,005
Cost of sales	**384,989**	353,997
Gross Profit	**4,137,212**	218,008
Operating Expenses	**993,412**	1,018,751
Earnings (loss) before undernoted	**3,143,800**	(800,743)
Interest income (expense)	**(23,381)**	6,262
Net earnings (loss) and comprehensive gain (loss) for the period	**$ 3,120,419**	$ (794,481)
Earnings (loss) per share	**$ 0.34**	$ (0.10)

Product and Service Revenue, Licensing and Gross Profit

Product and services revenue is comprised of (i) Advanced wound care product sales, which includes ColActive Plus, IV Clear, SurgiClear and other wound care products sold under Covalon brands or sold by third parties under private label brands; and (ii) Specialized medical device coatings, which includes coating services revenue and royalties, development services contract fees and consulting services fees. Quarter-to-quarter revenue continues to be inherently unpredictable due to our OEM business model and fluctuates from quarter to quarter depending on the composition of contractual arrangements entered into in each quarter, the timing of product shipments and completion of services in any period.

Sales of advanced wound care products increased 41% over the same period last year primarily due to the launch of IV Clear and SurgiClear products and increased global distribution of ColActive Plus. The Company is encouraged by revenues being delivered by new distributors resulting from sales and marketing investments made by the Company over the past year. In future quarters, all sales of IV Clear and SurgiClear will be to Molnlycke who will distribute the products into the market. Revenue growth

continues to be unpredictable as the Company is early stage in its execution of its Covalon branded distribution business model.

During late 2012 and throughout most of 2013, the Company transitioned its specialized medical device coating services from an in-house manufacturing business model to a third party outsourced manufacturing model.

Revenue from licensing fees increased to $3,788,611 for the three months ended December 31, 2013 compared to $51,482 for the same period last year. This increase is primarily a result of the recognition of US$3,500,000 received for the licensing of the Company's two new products IV Clear and SurgiClear to Molnlycke Health Care AB in November 2013.

Gross margin on product sales and services, which does not include licensing fees, fluctuates as a result of the mix of products sold in any given quarter or year by product type and geography. Gross margin was 48% in the three months ended December 31, 2013 compared to 32% in the prior year. Gross margin is highly influenced by product mix between advanced wound care and specialized medical device coatings; the mix of silicone-based wound dressings and collagen dressings sold in the periods; and the amount of funded coating services included in revenue and costs. The absence of low-margin coating services and the increased sales of IV Clear and SurgiClear contributed to the increase in gross margin.

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

Interest Expense and Income

Interest expense was $23,381 in the period ended December 31, 2013 compared to interest income of $6,262 in the same period of the previous year. Interest expense includes interest earned on investments, interest expense associated with the face value of convertible debentures and the accretion of interest on convertible debentures to bring the interest expense up to an estimated fair market value. All investments are made in accordance with the Company's Audit Committee investment guidelines of investing cash of the Company in low-risk interest-bearing instruments.

Operating Expenses

(Canadian $)	Three months ended December 31, 2013	2012
Operations		
Wages, benefits and consulting fees	**$ 98,322**	$ 127,925
Depreciation and amortization	**2,215**	3,460
Other	**25,825**	24,803
	126,362	166,188
Research and development activities		
Wages, benefits and consulting fees	**101,274**	112,598
Depreciation and amortization	**6,159**	11,399
Other	**8,539**	6,912
	115,972	130,909
Sales and marketing		
Wages, benefits and consulting fees	**127,620**	270,400
Travel	**35,408**	36,268
Other	**27,914**	49,256
	190,942	355,924
General and administrative		
Wages, benefits and consulting fees	**414,361**	175,010
Directors compensation	**8,000**	62,400
Professional fees	**26,128**	30,881
Facility	**39,936**	39,863
Depreciation and amortization	**26,567**	19,520
Other	**45,144**	38,056
	560,136	365,730
Total Operating Expenses	**$ 993,412**	$ 1,018,751

Total operating expenses for the period ended December 31, 2013 decreased 2.5% or $25,339 from the prior year.

Related Party Transactions

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

	Three months ended December 31, 2013	2012
Short term employee benefits	**$ 276,681**	$ 177,589
Share-based payments	**27,379**	4,671
	$ 304,060	$ 182,260

Critical Accounting Estimates and Judgements

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

ESTIMATES

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

i) **Share-based Payment Transactions**

The Company measures the cost of equity-settled transactions with directors, officers and employees by reference to the fair value of the equity instruments at the date at which they are granted. Estimating fair value for share-based payment transactions requires determining the most appropriate valuation model, which is dependent on the terms and conditions of the grant. This estimate also requires determining the most appropriate inputs to the valuation model including the expected life of the share option, volatility and dividend yield and making assumptions about them. The assumptions and models used for estimating fair value for share-based payment transactions are disclosed in Note 14 of the Consolidated Financial Statements.

ii) **Intangible Assets**

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

iii) **Impairment of non-financial assets**

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

iv) **Income taxes**

The Company recognizes deferred tax assets, related tax-loss 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.

Summary of Quarterly Results and Financial Position

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

(in Canadian $)	2014 First Quarter	2013 Fourth Quarter	2013 Third Quarter	2013 Second Quarter	2013 First Quarter	2012 Fourth Quarter	2012 Third Quarter	2012 Second Quarter	2012 First Quarter	2011 Fourth Quarter
Revenue (1)	4,532,121	$ 1,547,398	$ 1,482,132	$ 535,224	$ 578,267	$ 951,134	$ 1,085,791	$ 1,100,222	$ 704,706	$ 581,599
Operating income (loss) before amortization	3,224,298	346,228	323,742	(479,448)	(712,591)	$ (1,406,202)	$ (650,181)	$ (528,710)	$ (730,388)	$ (1,212,961)
Net income (loss)	3,120,419	121,300	238,837	(558,831)	(794,481)	$ (1,854,874)	$ (732,308)	$ (604,146)	$ (800,054)	$ (1,294,531)
Net income (loss) per share (2)	0.34	0.01	0.03	(0.06)	(0.10)	$ (0.22)	$ (0.09)	$ (0.07)	$ (0.10)	$ (0.10)
Cash and cash equivalents	4,718,049	633,103	$ 439,366	$ 416,038	$ 727,024	$ 1,142,667	$ 1,594,075	$ 2,851,504	$ 3,926,152	$ 4,763,152
Net working capital	4,319,614	1,069,858	$ 261,121	$ (2,815)	$ 584,019	$ 928,220	$ 2,338,111	$ 3,069,155	$ 3,732,626	$ 4,456,098
Current Ratio	2.9	1.6	1.1	1.0	1.3	1.4	2.5	2.6	3.1	3.6

(1) includes Product Revenue, Licensing Revenue and interest income for comparative purposes to prior quarters
(2) Reflects 1 for 10 share consolidation which occurred in July 2013

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

The Current Ratio is a model for measuring the liquidity of the Company by calculating the ratio between all current assets and all current liabilities. It is an indicator of our ability to pay short-term obligations. Current assets include cash and cash equivalents, short-term investments, accounts receivable, inventories and prepaid expenses. Current liabilities include accounts payable and accrued liabilities, and the current portion of deferred revenue. Net Working Capital is calculated as current assets minus current liabilities. At December 31, 2013, the Company had 2.9 times the current assets needed to pay its current liabilities (September 30, 2013 – 1.6).

	As at		
(Canadian $)	**December 31, 2013**	September 30, 2013	September 30, 2012
Cash and cash equivalents	**4,718,049**	727,024	1,142,667
Short-term investments	**500,000**	500,000	500,000
Total assets	**6,578,759**	5,304,931	5,963,729
Deferred revenue	**1,581,758**	1,293,236	1,118,057

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

On December 31, 2013 cash, cash equivalents, restricted cash and short-term investments amounted to $5,281,049 as compared to $1,290,024 as at September 30, 2013. During the last nine months, the Company was able to maintain profitable operations and generate positive overall cash flow in each the last three quarters. Revenues have increased significantly during this period and management has reduced operating expenses by 39% year over year. During fiscal 2013, management raised net proceeds of $1,212,918 through two private placements.

On November 4, 2013 the Company announced that it had licensed its antimicrobial silicone adhesive technology to Molnlycke Heath Care and as a result, Covalon received $3.5 million USD in upfront fees and will receive additional ongoing minimum royalties, milestone payments and other fees. After receipt of the upfront fees, the Company had over $5 million in cash, cash equivalents, restricted cash and short-term investments.

Covalon follows a policy of investing its surplus cash resources in high quality, liquid, short-term deposits. Cash equivalents as of December 31, 2013 was $500,000, had less than three months to maturity and were cashable without penalty. At December 31, 2013, the Company had $63,000 assigned as collateral to secure the Company's credit card and automated clearing house (ACH) facilities with a major financial institution. These funds are expected to be restricted for more than one year and are not included in Cash and cash equivalents.

Total assets at December 31, 2013 were $9,196,673 compared to $5,670,246 at September 30, 2013. Cash and cash equivalents and short-term investments comprised 57% of total assets at December 31, 2013. Of the remaining assets, the Company's accounts receivable and inventories are liquid, with collection periods and turnover ratios in the 60 to 180 day range. The balance of our assets is comprised of property, plant and equipment and the Company's intangible assets. These have low liquidity but represent much of the intellectual property assets that are used to generate Covalon's revenue streams.

Deferred revenue increased by $356,651 to $1,581,758 at December 31, 2013 compared to $1,225,107 at September 30, 2013.

Share Capital and Reserves

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

During the three months ended December 31, 2012, the Company raised gross proceeds of $496,600 through a non-brokered private placement comprised of 9.55 million units at a price of $0.052 per unit pre-consolidation. Each unit is comprised of one common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to acquire an additional common share at a pre-consolidation price of $0.10 per share for a period of five years from the closing date. All securities issued pursuant to the Offering were subject to a hold period expiring February 27, 2013. Directors and officers of Covalon participated in the non-brokered private placement for an aggregate of 1.8 million units. The remaining units were subscribed for by an individual who subsequently became a Director of the Company. Proceeds of the private placement will be used by Covalon to develop and commercialize new wound care products, expand international distribution channels and for general working capital. Net proceeds raised from the offering were $481,736.

On August 30, 2013, the Company completed a non-brokered private placement comprised of 750 units at a price of $1,000 per unit for gross proceeds of $750,000. Each unit consisted of $1,000 principal amount of 12% senior secured convertible debenture and 6,452 warrants. Proceeds of the private placement are intended to be used by Covalon to fund the market launch of the Company's new products IV Clear and SurgiClear and for general working capital. Each Debenture is convertible at the holder's option into 6,452 common shares of the Company at a conversion price of $0.155 at any time on or prior to the maturity date. These conversion rights are subject to standard anti-dilution provisions. The debentures bear interest at the rate of 12% per annum and are direct secured obligations of the Company ranking senior to all indebtedness of the Company. Interest accrues and is added to the principal amount outstanding under the debentures. Each warrant entitles the holder thereof to acquire one Common Share at an exercise price of $0.155 at any time for a period of three years from the date of the private placement. Insiders acquired 450 of the 750 units.

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.

No options were granted during the three months ended December 31, 2013. Total expenses arising from share-based payment transactions recognized during the period was $31,691, compared to $13,840 in the same period the previous year.

Sources and Uses of Cash

The following is a summary of the cash flows for the periods ending December 31, 2013 and 2012:

	Three months ended December 31,	
	2013	2012
Cash flows from operating activities	$ 4,097,277	$ (813,675)
Cash flows from investing activities	$ (36,134)	$ (75,704)
Cash flows from financing activities	$ -	$ 481,736

Operating Activities

Cash generated by operating activities for the three month period ended December 31, 2013 was $4,097,277 compared to cash used of $813,675 in the same period of the prior year due to the transformative licensing deal with Molnlycke and cost containment activities undertaken. Working capital generated $855,165 of cash during the three months ended December 31, 2013 as a result of growth in revenue and better collection of accounts receivable.

Investing Activities

Investing activities comprised expenditures on general office furniture, lab equipment and expenditures on intangible assets relate to filing and maintaining patents and trademarks.

Financing Activities

During the three months ended December 31, 2012, the Company raised net proceeds of $481,736 through a private placement that comprised of 9.55 million units. Each unit entitled the holder to one common share and one warrant to purchase an additional common share at a pre-consolidation $0.10 per share for a period of 5 years.

Off-Balance Sheet Arrangements

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

Financial Instruments

Unless otherwise noted, it is Management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments. The Company is exposed to currency risk arising from fluctuations in foreign exchange rates and the degree of volatility in those rates. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

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

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

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

Risks and Uncertainties

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

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

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

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

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

Covalon cannot predict if sustained profitability will ever be achieved and, if it is, whether or not it will be sustainable on a quarterly or an annual basis. Even if Covalon is not able to successfully further commercialize its products, Covalon believes that it has sufficient capital to fund its business and operations through at least fiscal 2015. However, Covalon may need to raise additional capital in the future. Additional financing may not be available, and even if available, may not be available on acceptable terms.

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

Covalon's success depends, in part, on its ability to obtain patents, or licenses to patents, maintain trade secret protection, and enforce its rights against others. Covalon has filed and is actively pursuing patent applications in Canada, the United States and other jurisdictions. Covalon may not be able to obtain patent protection for key elements of its technology.
There can be no assurance that:

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

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

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

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

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

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

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

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

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

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

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

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

These laws require, among other things:

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

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

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

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

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

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

- Manufacturing may be prioritized other than as Covalon's customers desires;
- Production quality measures may not be achieved;

- Sales expectations are not achieved;
- New products are not launched expeditiously.

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

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

International Financial Reporting Standards
Standards, Amendments and Interpretations Not Yet Effective

Certain pronouncements were issued by the IASB or the IFRS Interpretations Committee that are mandatory for accounting periods beginning after October 1, 2011 or later periods. None of these is expected to have a significant effect on the consolidated financial statements, except for the following standards and interpretations that have been issued but are not yet effective:

IFRS 9 Financial Instruments

IFRS 9 Financial Instruments is part of the IASB's wider project to replace IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 retains but simplifies the mixed measurement model and establishes two primary measurement categories for financial assets: amortized cost and fair value. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset. The standard is effective for annual periods beginning on or after January 1, 2015. The Company is in the process of evaluating the impact of the new standard.

IFRS 13 Fair Value Measurement

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

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

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

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Effective as of December 15, 2008, the Ontario Securities Commission approved the revised *National Instruments 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings* ("NI 52-109"). The revised NI 52-109 extends the exemption for venture issuers from certifications relating to the establishment and maintenance of disclosure controls and procedures ("DC&P) and internal controls over financial reporting ("ICFR"), as defined in NI 52-109. Additional risks to the quality, reliability, transparency, and timeliness of the Company's interim and annual filings may result from the inherent

limitations on management's ability to design and implement on a cost effective basis DC&P and ICFR. The Company recognizes the importance of DC&P and ICFR, and will endeavour to have sufficient controls in place to ensure financial statements are materially correct and sufficiently disclosed.

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

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