

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

For the three months ended December 31, 2016, and 2015

Contents

Condensed Consolidated Interim Statements of Financial Position	3
Condensed Consolidated Interim Statements of Operations and Comprehensive Income	4
Condensed Consolidated Interim Statements of Changes in Equity	5
Condensed Consolidated Interim Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7-29

**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

	December 31, 2016	September 30, 2016
Assets		
Current Assets		
Cash and cash equivalents	\$1,221,893	\$1,454,389
Accounts receivable, net (Note 5)	1,369,684	614,620
Prepaid expenses	332,982	175,866
Inventories (Note 8)	1,852,763	2,036,227
Total current assets	4,777,322	4,281,102
Non-current assets		
Restricted cash (Note 9)	36,402	35,550
Other receivables (Note 17)	10,440	10,000
Property, plant and equipment (Note 10)	476,800	454,026
Intangible assets (Note 11)	1,723,362	1,708,039
Total non-current assets	2,247,004	2,207,615
Total Assets	\$7,024,326	\$6,488,717
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable and accrued liabilities	\$1,624,974	\$1,689,576
Deferred revenue (Note 12)	530,377	426,086
Total current liabilities	2,155,351	2,115,662
Non-current Liabilities		
Deferred revenue (Note 12)	202,299	433,629
Deferred rent	133,153	131,450
Total non-current liabilities	335,452	565,079
Total Liabilities	2,490,803	2,680,741
Shareholders' Equity		
Share capital (Note 14 a)	34,646,983	34,646,983
Contributed surplus (Note 14 b and c)	3,327,883	3,327,883
Stock Options (Note 15)	992,921	891,433
Foreign exchange reserve	80,949	-
Accumulated deficit (Note 14 d)	(34,515,213)	(35,058,323)
Total shareholders' equity	4,533,523	3,807,976
Total Liabilities and Shareholders' Equity	\$7,024,326	\$6,488,717
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 INCOME (UNAUDITED)

Expressed in Canadian Dollars

	For the three months ended December 31,	
	2016	2015
Revenue		
Product	\$5,524,149	\$1,943,231
Services	7,338	72,000
Licensing and royalty fees	77,440	425,402
Total revenue	5,608,927	2,440,633
Cost of sales	1,147,428	819,330
Gross Profit	4,461,499	1,621,303
Operating Expenses		
Operations	273,046	223,479
Research and development activities	193,902	150,215
Sales and marketing	2,766,538	304,059
General and administrative	684,970	621,835
	3,918,456	1,299,588
Earnings before undernoted	543,043	321,715
Interest income (expense)	67	(54,405)
Net income	543,110	267,310
Other comprehensive income		
Foreign currency translation adjustment	80,949	-
Total comprehensive income	624,059	267,310
Basic earnings (loss) per share (Note 22)	\$ 0.03	\$ 0.03
Diluted earnings (loss) per share (Note 22)	\$ 0.03	\$ 0.02

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

Covalon Technologies Ltd.

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	Foreign Exchange Reserve	Total
Balance at October 1, 2015	\$32,423,095	\$3,159,125	\$941,593	\$225,352	\$(31,963,175)	-	\$4,785,990
Share based payments	-	-	244,357	-	-	-	244,357
Conversion of debt (Note 13)	1,204,627	-	-	(225,352)	-	-	979,275
Conversion of options	269,332	-	(125,759)	-	-	-	143,573
Options naturally expired	-	168,758	(168,758)	-	-	-	-
Issue common shares (Note 14)	749,929	-	-	-	-	-	749,929
Comprehensive (loss) for the year	-	-	-	-	(3,095,148)	-	(3,095,148)
Balance at September 30, 2016	\$34,646,983	\$3,327,883	\$891,433	-	\$(35,058,323)	-	\$3,807,976
Balance at October 1, 2016	\$34,646,983	\$3,327,883	\$891,433	-	\$(35,058,323)	-	\$3,807,976
Share based payments	-	-	101,488	-	-	-	101,488
Net income	-	-	-	-	543,110	-	543,110
Foreign exchange reserve	-	-	-	-	-	80,949	80,949
Balance at December 31, 2016	\$34,646,983	\$3,327,883	\$992,921	-	\$(34,515,213)	\$80,949	\$4,533,523

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CASH FLOWS (UNAUDITED)

Expressed in Canadian Dollars

	Three months ended December 31,	
	2016	2015
Cash flows from operating activities		
Net (loss) earnings and comprehensive (loss) income for the period	\$543,110	\$267,310
Adjustments to reconcile net earnings and comprehensive income to net cash used in operating activities:		
Depreciation - property, plant and equipment	24,997	23,620
Amortization - intangible assets	36,952	40,969
Non-cash interest (Note 13)	-	54,472
Share based payments	101,488	44,388
Foreign exchange (gain) on cash held	(4,461)	(37,055)
Cash (used) generated by operating activities before change in non-cash working capital balances	702,086	393,704
Change in non-cash working capital (Note 20)	(918,654)	(669,401)
Total cash flows from operating activities	(216,568)	(275,697)
Cash flows from investing activities		
Purchase of property, plant and equipment	(36,473)	(46,493)
Purchase of intangible assets	(13,255)	(77,390)
Short term investments	-	(1,023)
Other receivables	(440)	-
Restricted cash	(852)	(65)
Total cash flows from investing activities	(51,020)	(124,971)
Total cash flows from investing activities	-	-
Foreign exchange rate changes on cash	35,092	37,055
Total cash flows during the period	(232,496)	(363,613)
Cash and cash equivalents, beginning of the period	1,454,389	1,304,550
Cash and cash equivalents, end of the period	\$ 1,221,893	\$940,937
Represented by		
Cash	\$1,221,893	\$ 640,410
Cash equivalents	-	300,527
	\$1,221,893	\$940,937

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

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

1. CORPORATE INFORMATION

Covalon Technologies Ltd. (“the Company”) is incorporated under the laws of Ontario and is engaged in the business of developing, licensing, and selling medical technologies. The unaudited condensed consolidated interim financial statements of Covalon Technologies Ltd. for three months ended December 31, 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 unaudited condensed consolidated interim 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 January 26, 2016.

b) Basis of Measurement

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

c) Functional and Presentation Currency

Effective October 1, 2016, the Company changed the functional currency to U.S. dollars given the increasing prevalence of U.S. dollar-denominated activities. The change in functional currency from Canadian dollars to U.S. dollars is accounted for prospectively from October 1, 2016. The results and financial position of the Company are translated into the presentation currency as follows:

- I. Assets and liabilities are translated at the closing rate at the date of the balance sheet;
- II. Income and expenses are translated at average exchange rates. The Company uses monthly average exchange rates due to the volume of transactions each month; and
- III. All resulting exchange differences are recognized in other comprehensive income.

These unaudited condensed consolidated interim financial statements are presented in Canadian dollars, and are rounded to the nearest dollar (CAD \$), unless otherwise indicated.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

There have been no changes in the accounting policies since the Company's 2016 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., Covalon Medical Device Shanghai Co., Ltd., and Covalon Technologies (Europe) Limited 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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

c) Cash and Cash Equivalents

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

d) Inventories

Raw materials 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) 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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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.

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).

g) Impairment of Non-Financial Assets

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

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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 substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations for the year in which the change occurs.

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

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

k) Foreign Currency Transactions

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

At the transaction date each asset, liability, revenue, and expense denominated in a foreign currency is translated into US 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 US 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 US 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:

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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. 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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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, 2017 or later periods. None of these are expected to have a significant effect on the consolidated financial statements, except for the following standards and interpretations that have been issued but are not yet effective:

i) IFRS 9 - Financial Instruments

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

iii) IFRS 16 - Leases

IFRS 16, Leases specifies how to recognize, measure, present and disclose leases. It also provides a single lessee accounting model, requiring lessees to recognize assets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a small value. Accounting for the lessor will remain substantially unchanged. The standard is effective for periods beginning on or after January 1, 2019, with earlier application permitted for companies that also apply IFRS 15, Revenue from Contracts with Customers. The Company is in the process of evaluating the impact of the new 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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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) Intangible assets and non-financial assets

When the Company assesses the recoverable amount of intangible, and non- financial, assets for impairment the values calculated for these 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.

ii) 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.

iii) Inventory allowance

The Company states its inventories at the lower of cost and net realizable value, and records a provision for obsolete inventories. The Company determines its provision for obsolete inventory based on the quantities on hand at the reporting dates, compared to foreseeable needs over the upcoming periods

iv) 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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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; its other sources and uses of cash flows; 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 is probable and then to estimate the amount; and

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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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 December 31, 2016, ten customers accounted for 97% (2015 – ten customers for 99%) of the accounts receivable balance. These customers, who are distributors and strategic partners of the Company, represent substantially all of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies and due diligence procedures for new customers. The Company has recorded an allowance for bad debts in the amount of \$447,066 (September 2015 – \$442,861) resulting in a bad debt expense \$nil (2015 - \$55,145). 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:

	December 31, 2016	September 30, 2016
Current	\$ 408,725	\$ 591,167
30-60 days past due	936,523	21,093
Over 60 days past due, (net of allowance for doubtful accounts of \$447,066; Sep 2015 - \$442,861)	24,436	2,360
	<u>\$1,369,684</u>	<u>\$614,620</u>

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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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 three months. 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 CDN dollar. Part of the currency risk is mitigated by the fact that the company has both purchases and sales in CDN dollars, creating a natural hedge. The Company believes the remaining risk is acceptable and does not use financial instruments to hedge these risks. This risk has not changed from the prior year.

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

	December 31, 2016	September 30, 2016
Accounts payable	(372,462)	(443,868)
Cash	81,393	483,607
Exchange rate (\$USD / \$CAD)	0.74	0.77
	-\$291,069	\$39,739

An increase of 5% and 10% in the US dollar exchange rate would result in an increase in net income by approximately \$-14,553 (2015 – \$1,987) and \$-29,107 (2015 - \$3,974) respectively.

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 December 31, 2016 is \$4,533,523 (September 2015 - \$3,807,976).

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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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 three months ended December 31, 2016 the Company recognized \$nil (September 2016 – \$34,972) in credits.

8. INVENTORIES

Inventories consist of the following:

	December 31, 2016	September 30, 2016
Raw materials	\$916,194	\$720,923
Finished Goods	936,569	1,315,304
	<u>\$1,852,763</u>	<u>\$2,036,227</u>

Cost of sales include \$1,015,076 (2015 - \$700,369) in inventoried materials.

9. RESTRICTED CASH

The Company assigned \$36,402 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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

10. PROPERTY PLANT AND EQUIPMENT

	Furniture and Fixtures	Lab Equipment	Leasehold Improvements	Total
	\$	\$	\$	\$
Cost				
Balance at October 1, 2015	391,394	969,528	127,898	1,488,820
Disposals	-	(34,279)	-	(34,279)
Additions	4,758	89,835	7,158	101,751
Balance at September 30, 2016	396,152	1,025,085	135,056	1,556,293
Additions	6,601	29,872	-	36,473
Foreign exchange	9,840	25,541	3,340	38,721
Balance at December 31, 2016	412,593	1,080,498	138,396	1,631,487
Accumulated depreciation				
Balance at October 1, 2015	263,229	696,007	74,197	1,033,433
Depreciation	27,113	60,296	11,131	98,540
Disposals	-	(29,707)	-	(29,707)
Balance at September 30, 2016	290,342	726,596	85,328	1,102,266
Depreciation	5,669	16,796	2,532	24,997
Foreign exchange	7,217	18,081	2,126	27,424
Balance at December 31, 2016	303,228	761,473	89,986	1,154,687
Carrying amounts				
At September 30, 2016	105,810	298,488	49,728	454,026
At December 31, 2016	109,365	319,025	48,410	476,800

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

11. INTANGIBLE ASSETS

	Deferred Development	Patents	Trademarks	Computer Software	Total
	Costs			\$	
Cost					
Balance at October 1, 2015	4,134,415	789,981	77,963	149,163	5,151,522
Additions	-	149,195	766	-	149,961
Impairment	(248,556)	-	-	-	(248,556)
Balance at September 30, 2016	3,885,859	939,176	78,729	149,163	5,052,927
Additions	-	13,255	-	-	13,255
Foreign exchange	96,103	23,313	1,947	3,689	125,052
Balance at December 31, 2016	3,981,962	975,744	80,676	152,852	5,191,234
Accumulated amortization and impairment losses					
Balance at October 1, 2015	2,971,305	204,678	-	144,537	3,320,520
Amortization	121,703	42,058	-	927	164,688
Impairment	(140,320)	-	-	-	(140,320)
Balance at September 30, 2016	2,952,688	246,736	-	145,464	3,344,888
Amortization	27,817	8,994	-	141	36,952
Foreign exchange	73,194	9,184	-	3,654	86,032
Balance at December 31, 2016	3,053,699	264,914	-	149,259	3,467,872
Carrying amounts					
At September 30, 2016	933,171	692,440	78,729	3,699	1,708,039
At December 31, 2016	928,263	710,830	80,676	3,593	1,723,362

During the year ended September 30, 2016, it was determined that some of the Deferred Development Costs, which had previously been capitalized, no longer met the Company's internal policy for capitalization (outlined in paragraph 3). The identified projects are no longer expected to result in commercial products. As a result, an impairment loss was recorded during the 2016 year.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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.

	December 31, 2016	September 30 2016
Balance, beginning of period	\$ 859,715	\$ 595,253
<u>Add:</u>		
Deferred licensing fees	-	-
Deferred product and services revenue	188,066	621,178
<u>Less:</u>		
Recognition of deferred product and services revenue	(318,271)	(294,896)
Recognition of deferred licensing fees	(19,305)	(61,820)
Foreign exchange	22,471	-
Balance, end of period	732,676	859,715
Amount to be recognized within one year	(530,377)	(426,086)
Long term balance	\$ 202,299	\$ 433,629

13. CONVERTIBLE DEBENTURE

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.

During the year ended September 30, 2016, all 750 units of the convertible debt instrument were converted into 5,116,827 shares of the Company. The converted amount was comprised of \$750,000 related to the principal and \$278,577 related to the interest which converted into 4,838,250 and 278,577 common shares respectively.

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.

During the year ended September 30, 2016, warrants were exercised for 4,838,250 common shares of the Company at a price of \$0.155 with total proceeds of \$749,929.

During the year ended September 30, 2016, all 750 units of the convertible debt instrument were converted into 5,116,827 shares of the Company. The converted amount was comprised of \$750,000

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

related to the principal and \$278,577 related to the interest which converted into 4,838,250 and 278,577 common shares respectively. In addition, all of the warrants issued in connection with the convertible debentures were exercised for gross proceeds of \$749,929.

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.

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, 2015 to December 31, 2016:

	Number of Shares (#)	Effective Price (\$)	Amount (\$)
Balance at September 30, 2015	9,306,171		32,423,095
Conversion of debt	5,116,827	0.24	1,204,627
Options exercised	109,667	2.46	269,332
Warrants exercised	4,838,250	0.155	749,929
Balance at September 30, 2016	19,370,915		34,646,983
Balance at and December 31, 2016	19,370,915		34,646,983

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

b) Contributed Surplus

The following is a summary of changes in contributed surplus from September 30, 2015 to December 31, 2016:

Balance September 30, 2015	\$ 3,159,125
Options naturally expired	168,758
Balance September 30, 2016	\$ 3,327,883
Options naturally expired	-
Balance December 31, 2016	\$ 3,327,883

c) Share Purchase Warrants

The following is a summary of warrants from September 30, 2015 to December 31, 2016:

	Number of Warrants	Exercise Price	Expiry Date
Balance at September 30, 2015	5,763,250	-	-
Exercised during the period	4,838,250	.155	30-Aug-2016
Balance at September 30, 2016	925,000	1.00	26-Oct-2017
Balance at December 31, 2016	925,000	1.00	26-Oct-2017

d) Nature and Purpose of Equity and Reserves

The reserves recorded in equity on the Company's consolidated 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.

'Stock Options' is used to record the expenses related to Company's currently outstanding stock options.

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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

The following is a summary of changes from October 1, 2015 to September 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	26,995	-	-	(26,995)	-	-	-	-
13-Jun-11	13-Jun-16	\$ 2.00	71,000	-	-	(71,000)	-	-	-	-
27-Sep-11	27-Sep-16	\$ 1.40	100,000	-	(100,000)	-	-	-	-	-
16-Aug-13	16-Aug-18	\$ 0.16	64,500	-	(8,000)	-	-	56,500	56,500	-
26-Sep-13	26-Sep-18	\$ 0.85	235,000	-	-	-	-	235,000	235,000	-
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	-	(1,667)	-	-	148,833	49,611	99,222
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
14-Sep-16	14-Sep-21	\$ 2.29	-	70,000	-	-	-	70,000	-	70,000
			742,995	462,500	(109,667)	(97,995)	-	997,833	404,444	593,389
Weighted Average Exercise Price			\$ 1.27	\$ 1.37	\$ (1.31)	\$ 2.00	\$ -	\$ 1.25	\$ 1.00	\$ 1.41

The following is a summary of changes in options from October 1, 2016 to December 31, 2016:

Grant Date	Expiry Date	Exercise Price	Opening Balance	During the period				Closing Balance	Vested	Unvested
				Granted	Exercised	Expired	Forfeited			
16-Aug-13	16-Aug-18	\$ 0.16	56,500	-	-	-	-	56,500	56,500	-
26-Sep-13	26-Sep-18	\$ 0.85	235,000	-	-	-	-	235,000	235,000	-
13-Jun-14	13-Jun-19	\$ 2.00	95,000	-	-	-	-	95,000	63,333	31,667
26-Mar-15	26-Mar-20	\$ 1.40	148,833	-	-	-	-	148,833	49,611	99,222
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
14-Sep-16	14-Sep-21	\$ 2.29	70,000	-	-	-	-	70,000	-	70,000
			997,833	-	-	-	-	997,833	404,444	593,389
Weighted Average Exercise Price			\$ 1.25	\$ -	\$ -	\$ -	\$ -	\$ 1.25	\$ 1.00	\$ 1.41

b) Fair Value of Options Issued During the Period

During three months ended December 31, 2016, the Company issued no new options.

During the year ended September 30, 2016, the Company issued three tranches of options:

- On September 14, 2016, 70,000 options with a weighted average fair value of \$2.07 were granted. Trading price of the stock at the time of the grant was \$2.29. 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 – 0.6%, dividend rate NIL, average volatility – 155.68% and an average term of 5 years. The estimated forfeiture rate is 6.49%.
- On June 23, 2016, 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

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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, 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 three months ended December 31, 2016, as part of employee benefit expense were \$101,488 (2015 - \$44,388).

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% - 39.28% for the year ended September 30, 2016 (2015 – 26.5% - 39.28%).

a) Reconciliation between statutory rate and actual rate

	September 30,	
	2016	2015
Income tax expense computed at statutory combined tax rates	\$(858,200)	\$(281,200)
Permanent differences	59,800	55,500
Provision to return adjustment	-	1,000
Other	18,000	2,000
Change in deferred tax assets not recognized	780,400	222,700
	\$ -	\$ -

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

b) Deferred tax assets

The tax effect of the temporary differences that gives rise to deferred tax assets (liabilities) as of September 30, 2016, and 2015 is presented below. No benefit has been recorded in these financial statements as there is no assurance that the Company will generate taxable income to utilize these differences.

	September 30,	
	2016	2015
Non-capital loss carry forwards	\$5,237,800	\$ 4,614,400
Capital loss carry forwards	127,600	127,600
Capital and other assets	29,200	90,200
Deferred development costs	1,722,500	1,609,200
Deferred revenue and other liabilities	264,300	188,700
Convertible debenture	-	(29,100)
Deferred tax assets not recognized	(7,381,400)	(6,601,000)
	\$ -	\$ -

The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2015 of approximately \$18,237,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

<u>Year</u>	Canada Amount	US Amount
2026	1,365,000	-
2028	2,132,000	-
2029	3,342,000	-
2030	601,000	68,000
2031	3,821,000	140,000
2032	3,278,000	127,000
2033	848,000	-
2034	89,000	162,000
2035	578,000	247,000
2036	2,183,000	287,000
	\$ 18,237,000	\$ 1,031,000

- (c) The Company has capital losses carry forward for income tax purposes as at September 30, 2016 of approximately \$962,883 (2015 - \$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 15% 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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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

At September 30, 2016, the Company has \$1,562,770 (2015 - \$1,392,700) 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, 2016, the Company has \$128,594 (2015 – \$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 December 31,	
	2016	2015
Compensation and short term employee benefits	\$300,330	\$434,415
Share-based payments	37,723	17,457
	<u>\$338,052</u>	<u>\$451,872</u>

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.

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>
2017	\$486,874
2018	369,642
2019	368,684
2020	262,518
2021	306,998
Thereafter	1,227,992

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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:

	Three months ended December 31,	
	<u>2016</u>	<u>2015</u>
Accounts receivable, net	\$(755,064)	\$(700,638)
Prepaid expenses	(157,116)	(11,126)
Inventories	183,464	(619,925)
Accounts payable and accrued liabilities	(64,602)	646,984
Deferred revenue	(127,039)	7,782
Deferred Rent	1,703	7,522
	<u>\$(918,654)</u>	<u>\$(669,401)</u>

21. OPERATING SEGMENTS

During three months ended December 31, 2016 there was 1 customer who individually accounted for more than 10% of revenue (2015 – 2 customers). The Company generated revenue of \$620,201 (2015 – \$921,634) in the US, \$7,738 (2015 – \$72,872) in Canada, and \$4,980,988 (2015 – \$1,446,127) internationally.

22. EARNINGS (LOSS) PER SHARE

Earnings per share is calculated using the weighted average number of shares outstanding during the period. The weighted average number of shares outstanding during the period were 19,370,915 (2015 – 9,306,171). There were nil shares issued during three months ended December 31, 2016 (2015 – nil). Shares issued and outstanding at December 31, 2016 were 19,370,915 (September 30, 2015 - 9,306,171).

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2016, and 2015

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

Potentially dilutive securities	December 31, 2016	September 30, 2016
Common shares potentially assumable		
- under stock options	171,613	156,617
- under warrants	393,144	135,381
Total potentially dilutive shares	564,757	291,998

23. EXPENSES BY NATURE

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

a) Employee costs

	Three months ended December 31,	
	2016	2015
Short-term wages & benefits, commissions, contract and director fees	698,321	817,623
Share based payments	101,488	44,386
Total employee costs	799,809	862,009
Included in		
Cost of sales	22,184	38,850
Operations	123,919	150,149
Research and development activities	125,923	131,368
Sales and marketing	267,837	225,004
General and administrative	259,946	316,638
Total employee costs	799,809	862,009

b) Depreciation and amortization

	Three months ended December 31,	
	2016	2015
Cost of sales	\$ 39,831	\$ 38,686
Operations	1,538	1,777
Research and development activities	3,245	4,134
General and administrative	20,388	19,993
Total depreciation and amortization	\$ 65,002	\$ 64,590