

**Covalon Technologies Ltd.**  
**CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**For the three months ended December 31, 2014**

---

**Contents**

<b>Condensed Consolidated Interim Statement of Financial Position</b>	<b>3</b>
<b>Condensed Consolidated Interim Statement of Comprehensive Earnings</b>	<b>4</b>
<b>Condensed Consolidated Interim Statement of Changes in Equity</b>	<b>5</b>
<b>Condensed Consolidated Interim Statement of Cash Flows</b>	<b>6</b>
<b>Notes to Condensed Consolidated Interim Financial Statements</b>	<b>7-24</b>

**MANAGEMENT’S COMMENTS ON**  
**UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS**

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

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

# Covalon Technologies Ltd.

## CONDENSED CONSOLIDATED INTERIM STATEMENT OF FINANCIAL POSITION (UNAUDITED)

Expressed in Canadian Dollars

	December 31, 2014	September 30, 2014
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$3,609,666	\$3,574,836
Short-term investments	542,918	541,000
Accounts receivable, net (Note 5)	528,839	644,903
Prepaid expenses	123,228	91,893
Inventories (Note 8)	683,359	545,259
<b>Total current assets</b>	<b>5,488,010</b>	<b>5,397,891</b>
<b>Non-current assets</b>		
Restricted cash (Note 9)	155,853	152,509
Other receivables (Note 17)	30,000	30,000
Property, plant and equipment (Note 10)	434,577	457,449
Intangible assets (Note 11)	1,908,011	1,923,544
<b>Total non-current assets</b>	<b>2,528,441</b>	<b>2,563,502</b>
<b>Total Assets</b>	<b>\$8,016,451</b>	<b>\$7,961,393</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current Liabilities</b>		
Accounts payable and accrued liabilities	\$985,775	\$777,024
Deferred revenue (Note 12)	728,910	596,363
<b>Total current liabilities</b>	<b>1,714,685</b>	<b>1,373,387</b>
<b>Non-current Liabilities</b>		
Convertible debenture (Note 13)	703,591	660,517
Deferred revenue (Note 12)	262,736	399,883
<b>Total non-current liabilities</b>	<b>966,327</b>	<b>1,060,400</b>
<b>Total Liabilities</b>	<b>2,681,012</b>	<b>2,433,787</b>
<b>Shareholders' Equity</b>		
Share capital (Note 14 a)	32,423,095	32,423,095
Contributed surplus (Note 14 b and c)	2,683,072	2,679,565
Stock Options (Note 15)	1,254,925	1,220,779
Equity component of convertible debentures	225,352	225,352
Accumulated deficit (Note 14 d)	(31,251,005)	(31,021,185)
<b>Total shareholders' Equity</b>	<b>5,335,439</b>	<b>5,527,606</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$8,016,451</b>	<b>\$7,961,393</b>

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 financial statements.

## Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF COMPREHENSIVE LOSS (UNAUDITED)

Expressed in Canadian Dollars

	<b>Three months ended:</b>	
	<b>December 31,</b>	December 31,
	<b>2014</b>	2013
<b>Revenue</b>		
Product and Services		
Advanced wound care	\$767,091	\$733,590
Specialized medical device coatings	454,607	-
Licensing and royalty fees	114,987	3,788,611
<b>Total Revenue</b>	<b>1,336,685</b>	<b>4,522,201</b>
<b>Cost of sales</b>	<b>473,860</b>	<b>384,989</b>
<b>Gross Profit</b>	<b>862,825</b>	<b>4,137,212</b>
<b>Operating Expenses</b>		
Operations	169,485	126,362
Research and development activities	169,337	115,972
Sales and marketing	232,579	190,942
General and administrative	491,992	560,136
	<b>1,063,393</b>	<b>993,412</b>
<b>(Loss) earnings before undernoted</b>	<b>(200,568)</b>	<b>3,143,800</b>
Interest (expense)	(29,252)	(23,381)
<b>Net (loss) earnings and comprehensive (loss) income for the year</b>	<b>\$(229,820)</b>	<b>\$3,120,419</b>
Basic (loss) earnings per share (Note 22)	\$(0.02)	\$ 0.34
Diluted (loss) earnings per share (Note 22)	\$(0.02)	\$ 0.17

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

## Covalon Technologies Ltd.

### CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY (UNAUDITED)

Expressed in Canadian Dollars

	Share Capital	Contributed Surplus	Stock Options	Equity Component of Convertible Debentures	Accumulated Deficit	Total
<b>Balance at October 1, 2013</b>	\$32,393,095	\$2,224,645	\$1,526,210	\$225,352	\$(33,422,954)	\$2,946,348
Share based payments	-	-	31,691	-	-	31,691
Comprehensive gain	-	-	-	-	3,120,419	3,120,419
<b>Balance at December 31, 2013</b>	<u>\$32,393,095</u>	<u>\$2,224,645</u>	<u>\$1,557,901</u>	<u>\$225,352</u>	<u>\$(30,302,535)</u>	<u>\$6,098,458</u>
<b>Balance at October 1, 2014</b>	\$32,423,095	\$2,679,565	\$1,220,779	\$225,352	\$(31,021,185)	\$5,527,606
Share based payments	-	-	37,653	-	-	37,653
Options naturally expired	-	3,507	(3,507)	-	-	-
Comprehensive (loss)	-	-	-	-	(229,820)	(229,820)
<b>Balance at December 31, 2014</b>	<u>\$32,423,095</u>	<u>\$2,683,072</u>	<u>\$1,254,925</u>	<u>\$225,352</u>	<u>\$(31,251,005)</u>	<u>\$5,335,439</u>

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

# Covalon Technologies Ltd.

## CONDENSED CONSOLIDATED INTERIM STATEMENT OF CASH FLOWS (UNAUDITED)

Expressed in Canadian Dollars

	Three months ended:	
	December 31, 2014	December 31, 2013
<b>Cash flows from operating activities</b>		
Net (loss) earnings and comprehensive (loss) income for the period	\$(229,820)	\$3,120,419
Adjustments to reconcile net earnings and comprehensive gain to net cash used in operating activities:		
Depreciation - property, plant and equipment	22,871	28,174
Amortization - intangible assets	39,899	52,324
Non-cash interest (Note 13)	43,075	33,307
Share based payments	37,653	31,691
Foreign exchange (gain) on cash held	(33,142)	(23,803)
Cash used by operating activities before change in non-cash working capital balances	(119,464)	3,242,112
Change in non-cash working capital (Note 20)	150,780	855,165
<b>Total cash inflows from operating activities</b>	<b>31,316</b>	<b>4,097,277</b>
<b>Cash flows from investing activities</b>		
Purchase of property, plant and equipment	-	(10,437)
Purchase of intangible assets	(24,366)	(25,697)
<b>Total cash outflows from investing activities</b>	<b>(24,366)</b>	<b>(36,134)</b>
<b>Cash flows from financing activities</b>		
Restricted cash	(3,344)	-
Short term investments	(1,918)	-
<b>Total cash outflows from financing activities</b>	<b>(5,262)</b>	<b>-</b>
Foreign exchange gain on cash held	33,142	23,803
<b>Total net increase in cash and cash equivalents during the period</b>	<b>34,830</b>	<b>4,084,946</b>
<b>Cash and cash equivalents, beginning of the period</b>	<b>\$3,574,836</b>	<b>\$4,718,049</b>
<b>Cash and cash equivalents, end of the period</b>	<b>\$3,609,666</b>	<b>\$4,718,049</b>
<b>Represented by</b>		
Cash	\$382,267	\$1,352,115
Cash equivalents	3,227,399	3,365,934
	<b>\$3,609,666</b>	<b>\$4,718,049</b>

The accompanying notes are an integral part of these unaudited condensed consolidated 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, 2014

---

## 1. CORPORATE INFORMATION

Covalon Technologies Ltd. (“the Company”) is incorporated under the laws of Ontario and is engaged in the business of developing, licensing and selling medical technologies. The unaudited consolidated financial statements of Covalon Technologies Ltd. for the three months ended December 31, 2014 comprise the results of the Company and its subsidiaries. The Company has now received regulatory approval on numerous products and is currently generating revenue. The Company has adopted a business model that contracts the manufacturing and distribution of its commercialized products through partners. The Company generates its revenues through development contracts, licensing agreements and distribution contracts and sales. The Company is listed on the TSX Venture Exchange, having the symbol COV.

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

## 2. BASIS OF PRESENTATION

### a) Statement of Compliance

These consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”).

The interim consolidated financial statements were authorized for issue by the Board of Directors on February 25, 2015

### b) Basis of Measurement

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

### c) Functional Currency

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

### d) Critical accounting estimates and judgments

The preparation of financial statements in compliance with IFRS requires management to make certain critical accounting estimates. It also requires management to exercise judgment in applying the Company’s accounting policies. The areas involving a higher degree of judgment, complexity, or areas where assumptions and estimates are significant to the 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 2014 annual 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, 2014

---

## 4. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

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

### ESTIMATES

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

#### i) Share-based Payment Transactions

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

#### ii) Intangible Assets

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 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



# Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

---

necessitate future adjustments to taxable income and deductions already recorded. The Company established provisions, based on reasonable estimates, for possible consequences of audits by the tax authorities of the restive countries in which it operates. The amount of such provision is based on various factors, such as experience of previous tax audits and differing interpretations of tax regulations by the taxable entity and the responsible tax authority. Such differences of interpretation may arise on a wide variety of issues depending on the conditions prevailing in the respective Company domicile.

## 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; and

### ii) Provisions

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

## 5. FINANCIAL RISK MANAGEMENT

### Risk factors

The following is a discussion of market, credit, and liquidity risks and related mitigation strategies that have been identified. This is not an exhaustive list of all risks, nor will the mitigation strategies eliminate all risks listed.

### Credit risk

The Company's cash and cash equivalents, and short-term investments do not subject the Company to significant credit risk. The Company has guaranteed investment certificates and provincial bonds, as per its practice of

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

protecting its capital rather than maximizing investment yield, of \$3,926,170 invested with two issuers; however, this risk is mitigated as the issuers are two major Canadian banks and the Province of Ontario.

The Company, in the normal course of business, is exposed to credit risk from its global customers in the medical device industry. The accounts and other 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, 2014, ten customers accounted for 92% (2013 – ten customers for 98%) 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 \$Nil (2013 – \$1,121) resulting in a provision for doubtful accounts expense of \$Nil (2013 - \$1,121). 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:

	<b>December 31, 2014</b>	September 30, 2014
Current	<b>\$348,755</b>	\$553,506
30-60 days past due	<b>157,045</b>	21,762
Over 60 days past due, (net of allowance for doubtful accounts of \$379,118; Sep 2014 - \$379,118)	<b>23,038</b>	69,635
	<b>\$528,839</b>	\$644,903

### Liquidity risk

The Company continually monitors working capital to ensure sufficient cash is available to meet operational and capital expenditure requirements.

The Company has contractual obligations related to accounts payable and accrued liabilities that are due within a year. The Company has contractual obligations related to its signed offer to lease for its premises at 405 Britannia Rd. Mississauga, and for its operating leases which are payable from 2015 to 2019 in the amounts of \$94,354 and \$104,934 respectively.

On November 17, 2014 the Company signed an offer to lease for its premises at 1660 Tech Avenue, Mississauga which will commence June 1, 2015. The lease agreement is for a period of 10 years and will expire May 31, 2025. The minimum lease payments for the first five years will be \$159,250 annually and increase to \$202,125 for years six to ten.

### Interest rate risk

The Company is subject to interest rate risk on its cash and cash equivalents. The Company believes that interest rate risk is low as its cash and cash equivalents consists of low risks money market and fixed income securities with maturity dates of less than one year. This risk has not changed from the prior year.

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

---

### Currency risk

The Company has suppliers and customers that are not based in Canada which gives rise to a risk that earnings and cash flows may be adversely affected by fluctuations in foreign currency exchange rates. The Company is primarily exposed to the US dollar. Part of the currency risk is mitigated by the fact that the company has both purchases and sales in US dollars, creating a natural hedge. The Company believes the remaining risk is acceptable and does not use financial instruments to hedge these risks. This risk has not changed from the prior year.

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

	December 31, 2014	September 30, 2014
Accounts receivable, net	510,614	494,350
Accounts payable	(449,199)	(222,555)
Deferred Revenue	(270,501)	(125,723)
Cash	238,482	94,577
Exchange rate (\$USD / \$CAD)	1.14	1.12
	<u>\$29,396</u>	<u>\$240,649</u>

An increase of 5% and 10% in the US dollar exchange rate would result in an increase in net income by approximately \$1,470 (2013 – \$12,032) and \$2,940 (2013 - \$24,064) respectively.

### Commodity risk

The Company is exposed to commodity risk related to purchases of key raw materials necessary for the manufacture of its bulk product from a limited number of suppliers around the world. The Company attempts to mitigate this risk by entering into long-term supply contracts at fixed pricing with capped annual increases. There is commodity risk for all ingredients in each of the Company's products. The company attempts to mitigate these risks through the use of multiple suppliers and fixed price contracts but due to the nature of some of the chemicals required and the regulatory paths to approving new suppliers, this is not always possible. This risk has not changed from the prior year.

## 6. MANAGEMENT OF CAPITAL

The Company defines capital that it manages as its shareholders' equity comprising of share capital, options, contributed surplus, equity component of convertible debentures, and accumulated deficit. Its objectives when managing capital are to ensure that the Company will continue as a going concern, so that it can provide services to its customers and returns to its shareholders. The capital at December 31, 2014 is \$5,335,440 (September 30, 2014 - \$5,527,606).

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.

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

---

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.

### 7. INVESTMENT TAX CREDITS

The Company is eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% refundable in cash to the Company. The refundable tax credits received by the Company are subject to review by Canada Revenue Agency and the Ontario Ministry of Finance. During the three months ended December 31, 2014, the Company recognized \$Nil (2013 - \$Nil) in credits.

### 8. INVENTORIES

Inventories consist of the following:

	<b>December 31, 2014</b>	September 30, 2014
Raw materials	<b>\$439,468</b>	\$337,008
Finished Goods	<b>243,891</b>	208,252
	<b>\$683,359</b>	\$545,259

Product expenses include \$369,495 (2013 - \$291,092) in inventoried materials.

### 9. RESTRICTED CASH

The Company assigned \$155,853 of its cash equivalents with a major financial institution as collateral to secure its credit cards and a letter of credit available to support bids. 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, 2014

---

### 10. PROPERTY PLANT AND EQUIPMENT

	<b>Furniture and Fixtures</b>	<b>Lab Equipment</b>	<b>Leasehold Improvements</b>	<b>Total</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
<b>Cost</b>				
Balance at October 1, 2013	319,116	1,478,500	71,416	1,869,032
Additions	-	12,055	-	12,055
Balance at September 30, 2014	319,116	1,490,555	71,416	1,881,087
Additions	-	-	-	-
Balance at December 31, 2014	319,116	1,490,555	71,416	1,881,087
<b>Accumulated depreciation</b>				
Balance at October 1, 2013	225,737	1,013,630	71,416	1,310,783
Depreciation	18,676	94,179	-	112,855
Balance at September 30, 2014	244,413	1,107,809	71,416	1,423,638
Depreciation	3,735	19,137	-	22,872
Balance at December 31, 2014	248,148	1,126,946	71,416	1,446,510
<b>Carrying amounts</b>				
At September 30, 2014	74,703	382,746	-	457,449
At December 31, 2014	70,968	363,609	-	434,577

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

### 11. INTANGIBLE ASSETS

	Deferred Development Costs \$	Patents \$	Trademarks \$	Computer Software \$	Total \$
<b>Cost</b>					
Balance at October 1, 2013	4,134,415	621,804	72,782	149,163	4,978,164
Additions	-	100,973	4,855	-	105,828
Balance at September 30, 2014	4,134,415	722,777	77,637	149,163	5,083,992
Additions	-	24,040	326	-	24,366
Balance at December 31, 2014	4,134,415	746,817	77,963	149,163	5,108,358
<b>Accumulated amortization and impairment losses</b>					
Balance at October 1, 2013	2,727,891	133,366	-	115,877	2,977,134
Amortization	121,711	34,093	-	27,510	183,314
Balance at September 30, 2014	2,849,602	167,459	-	143,387	3,160,448
Amortization	30,426	9,185	-	288	39,899
Balance at December 31, 2014	2,880,028	176,644	-	143,675	3,200,347
<b>Carrying amounts</b>					
At September 30, 2014	1,284,813	555,318	77,637	5,776	1,923,544
At December 31, 2014	1,254,387	570,173	77,963	5,488	1,908,011

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

### 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.

	<b>December 31 2014</b>	September 30, 2014
Balance, beginning of period	\$ 996,246	\$ 1,225,107
Add:		
Deferred licensing fees	-	207,638
Deferred product and services revenue	250,459	49,532
Less:		
Recognition of deferred product and services revenue	(188,121)	(235,584)
Recognition of deferred licensing fees	(66,938)	(250,447)
Balance, end of period	991,646	996,246
Amount to be recognized within one year	(728,910)	(596,363)
	<b>\$ 262,736</b>	<b>\$ 399,883</b>

### 13. CONVERTIBLE DEBENTURE UNITS

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

The debenture is secured, ranking senior to all indebtedness of the Company.

	<b>December 31, 2014</b>	September 30, 2014
Face value of convertible debenture at maturity August 31, 2016	\$ 750,000	\$ 750,000
Fair value of the convertible debenture at date of issue, net	524,648	524,648
Less transaction costs	(19,733)	(19,733)
Interest at 12% accrued and compounded annually	122,781	97,500
Accretion	75,895	58,102
	<b>703,591</b>	660,517
Fair value of Equity component	<b>225,352</b>	225,352

# Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

---

## 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.

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 hold period expiring 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, 2014, 15,000 (2013 – 15,000) shares valued at \$213,875 (2013 - \$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 changes in common share capital from September 30, 2013 to December 31, 2014:

	Number of Shares (#)	Issue Price (\$)	Amount (\$)
<b>Balance at September 30, 2013</b>	9,276,171		32,393,095
Shares issued from exercise of warrants	30,000	1.00	30,000
<b>Balance at September 30, 2014, and December 31, 2014</b>	9,306,171		32,423,095



## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

---

### b) Contributed Surplus

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

<b>Balance September 30, 2014</b>	\$ 2,679,565
Options naturally expired	3,507
<b>Balance December 31, 2014</b>	<b>\$ 2,683,072</b>

### c) Share Purchase Warrants

The following is a summary of changes in warrants from September 30, 2013 to December 31, 2014:

	<b>Number of Warrants</b>	<b>Exercise Price</b>	<b>Expiry Date</b>
<b>Balance at September 30, 2013</b>	<b>5,793,250</b>		
Warrants exercised	30,000	\$ 1.00	October 26, 2017
<b>Balance at September 30, 2014, and December 31, 2014</b>	<b>5,763,250</b>		

### d) Nature and Purpose of Equity and Reserves

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

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

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

## 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, 2014

The following is a summary of changes in options from September 30, 2014 to December 31, 2014:

Grant Date	Expiry Date	Exercise Price	Opening Balance	During the period				Closing Balance	Vested	Unvested
				Granted	Exercised	Expired	Forfeited			
11-Dec-09	11-Dec-14	\$ 2.90	1,007	-	-	(1,007)	-	-	-	-
27-Jan-10	27-Jan-15	\$ 3.10	85,500	-	-	-	-	85,500	85,500	-
01-Sep-10	01-Sep-15	\$ 2.00	120,000	-	-	-	-	120,000	120,000	-
02-Sep-10	02-Sep-15	\$ 2.00	26,996	-	-	-	-	26,996	26,996	-
10-Jun-11	10-Jun-16	\$ 2.00	26,995	-	-	-	-	26,995	26,995	-
13-Jun-11	13-Jun-16	\$ 2.00	71,000	-	-	-	-	71,000	71,000	-
27-Sep-11	27-Sep-16	\$ 1.40	100,000	-	-	-	-	100,000	100,000	-
16-Aug-13	16-Aug-18	\$ 0.16	64,500	-	-	-	-	64,500	21,500	43,000
26-Sep-13	26-Sep-18	\$ 0.85	235,000	-	-	-	-	235,000	78,333	156,667
13-Jun-14	13-Jun-19	\$ 2.00	97,500	-	-	-	(2,500)	95,000	-	95,000
			828,498	-	-	(1,007)	(2,500)	824,991	530,324	294,667
		Weighted Average Exercise Price	\$ 1.57	\$ -	\$ -	\$(4.97)	\$2.00	\$1.57	\$1.82	\$1.12

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

The following is a summary of changes from October 1, 2013 to September 30, 2014

Grant Date	Expiry Date	Exercise Price	Opening Balance	During the period				Closing Balance	Vested	Unvested
				Granted	Exercised	Expired	Forfeited			
15-Oct-08	15-Oct-13	\$ 7.50	6,000	-	-	(6,000)	-	-	-	
22-May-09	22-May-14	\$ 4.00	120,000	-	-	(120,000)	-	-	-	
11-Dec-09	11-Dec-14	\$ 2.90	1,007	-	-	-	1,007	1,007	-	
27-Jan-10	27-Jan-15	\$ 3.10	85,500	-	-	-	85,500	85,500	-	
01-Sep-10	01-Sep-15	\$ 2.00	120,000	-	-	-	120,000	120,000	-	
02-Sep-10	02-Sep-15	\$ 2.00	28,496	-	-	-	(1,500)	26,996	26,996	
10-Jun-11	10-Jun-16	\$ 2.00	26,995	-	-	-	-	26,995	26,995	
13-Jun-11	13-Jun-16	\$ 2.00	71,000	-	-	-	-	71,000	71,000	
27-Sep-11	27-Sep-16	\$ 1.40	100,000	-	-	-	-	100,000	100,000	
16-Aug-13	16-Aug-18	\$ 0.16	74,500	-	-	-	(10,000)	64,500	21,500	43,000
26-Sep-13	26-Sep-18	\$ 0.85	235,000	-	-	-	-	235,000	78,333	156,667
13-Jun-14	13-Jun-19	\$ 2.00	-	102,500	-	-	(5,000)	97,500	-	97,500
			868,498	102,500	-	(126,000)	(16,500)	828,498	531,331	297,167
		Weighted Average Exercise Price	\$ 1.89	\$ 2.00	\$ -	\$ 4.13	\$ 0.88	\$ 1.57	\$ 1.82	\$ 1.13

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

During the three months ended December 31, 2014 the Company issued no new options.

During the year ended September 30, 2014, the Company issued one tranche of options:

- i) 102,500 options with a weighted average fair value of \$1.89 were granted. Trading price of the stock at the time of the grant was \$2.00. The fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 1.31%, dividend rate NIL, average volatility – 169.38% and an average term of 5 years. The estimated annualized forfeiture rate is 8.01%.

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

- i) 74,500 options with a weighted average fair value of \$0.1466 were granted. Trading price of the stock at the time of the grant was \$0.155. The fair market value of options granted was determined using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 1.57%, dividend rate NIL, average volatility – 179.9% and an average term of 5 years. The estimated annualized forfeiture rate is 8.01%.
- ii) 235,000 options with a weighted average fair value of \$0.8035 were granted. Trading price of the stock at the time of the grant was \$0.85. The fair market value of options granted was determined

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

---

using the Black-Scholes valuation model with the following implicit assumptions: average risk-free rate of interest – 1.72%, dividend rate NIL, average volatility – 179.5% and an average term of 5 years. The estimated annualized forfeiture rate is 8.01%.

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

Total expenses arising from share-based payment transactions recognized during the year as part of employee benefit expense were \$37,653 (2014 - \$31,691).

## 16. INCOME TAXES

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

<u>Year</u>	Canada Amount	US Amount
2015	242,000	
2026	1,499,000	
2027	-	
2028	2,132,000	
2029	3,309,000	
2030	601,000	
2031	3,874,000	68,200
2032	3,267,000	140,000
2033	859,000	127,000
2034	89,000	161,800
	<u>\$ 15,872,000</u>	<u>\$ 497,000</u>

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

The Company is eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10% on its research and development expenditures and refundable in cash to the Company. The Company is also eligible for a 20% federal research and development investment tax credit and a 4.5% Ontario Research and Development Tax Credit ("ORDTC") which are available to offset federal income taxes payable and Ontario income taxes payable, respectively, in the future. The tax credits ultimately received by the Company are subject to review by Canada Revenue Agency and the Ontario Ministry of Finance.

At September 30, 2013, the Company had \$1,414,446 (2012 - \$1,414,446) of unclaimed investment tax credits available to reduce federal income taxes payable in future years. If not utilized, these investment tax credits will start expiring in 2023. These unclaimed investment tax credits have not been recognized as receivables.

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

---

At September 30, 2013, the Company had \$90,115 (2012 – \$90,115) of unclaimed ORDTC available to reduce Ontario income taxes payable in future years. If not utilized, these ORDTC will start expiring in 2029. These unclaimed ORDTC have not been recognized as receivables.

### 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,	
	2014	2013
Short term employee benefits	\$ 336,044	\$ 276,681
Share-based payments	10,970	27,379
	<u>\$ 347,014</u>	<u>\$ 304,060</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.

A portion of the Convertible Debenture Units (Note 13) were issued to related parties.

### 18. COMMITMENTS

The Company signed an offer to lease for its premises at 405 Britannia Rd, Mississauga which commenced December 1, 2009 and expires November 30, 2014 when the rent becomes payable on a month-to-month basis. The annual rental payment for fiscal 2014 through termination is \$91,627. On December 5, 2014 the Company negotiated a lease renewal for this location. The revised lease has a term of five years commencing January 1, 2015 and expires December 31, 2019. The annual rent will be: \$94,354 (2015); \$96,863 (2016); \$99,481 (2017); \$102,208 (2018); and \$104,935 (2019).

On November 17, 2014 the Company signed an offer to lease for its premises at 1660 Tech Avenue, Mississauga which will commence June 1, 2015. The lease agreement is for a period of 10 years and will expire May 31, 2025. The minimum lease payments for the first five years will be \$159,250 annually and increase to \$202,125 for years six to ten.

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

### 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.

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

---

### 20. CHANGE IN NON-CASH WORKING CAPITAL ITEMS

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

	For the three months ended December 31,	
	2014	2013
Accounts receivable, net	\$ 116,064	\$ 606,718
Prepaid expenses	(31,336)	4,971
Inventories	(138,100)	(97,535)
Accounts payable and accrued liabilities	208,751	(15,640)
Deferred revenue	(4,600)	356,651
	<u>\$ 150,779</u>	<u>\$ 855,165</u>

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

### 21. OPERATING SEGMENTS

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

For the three months ended December 31,

	2014			2013		
	Advanced Wound Care	Specialized Medical Device Coatings	Total	Advanced Wound Care	Specialized Medical Device Coatings	Total
	\$	\$	\$	\$	\$	\$
Product and Services	767,091	454,607	1,221,698	733,590	-	733,590
Licensing Fee	3,581	111,406	114,987	3,699,466	89,145	3,788,611
	<b>770,672</b>	<b>566,013</b>	<b>1,336,685</b>	4,433,056	89,145	4,522,201
Segment earnings before the following:	<b>296,812</b>	<b>566,013</b>	<b>862,825</b>	4,048,067	89,145	4,137,212
Operations			169,485			126,362
Research and development activities			169,337			115,972
Sales and marketing			232,579			190,942
General and administrative			491,992			560,136
Interest income (expense)			(29,252)			(23,381)
			<b>(229,820)</b>			<b>3,120,419</b>

During the period ended December 31, 2014, there were 3 customer who individually accounted for more than 10% of revenue (2014 – 1 customer); \$541,936 (2013 - \$3,964,463) relates to advanced wound care; \$400,000 relates to device coating (2013-\$Nil).

The Company generated product and services sales and licensing fees of \$767,586 (2013 - \$4,458,250) in the US; \$401,688 (2013 - \$8,160) in Canada; and \$158,826 (2013 - \$55,791) internationally.

### 22. (LOSS) EARNINGS PER SHARE

Loss per share is calculated using the weighted average number of shares outstanding during the period. There were Nil shares issued during the period ended December 31, 2014 (December 31, 2013 – nil). Shares issued and outstanding at December 31, 2014 were 9,306,171 (December 31, 2013 - 9,276,171). The Company experienced

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three months ended December 31, 2014

---

losses for the period ended December 31, 2014; all potential common shares outstanding from dilutive securities are considered anti-dilutive and are excluded from the calculation of loss per share for those periods.

Details of anti-dilutive potential securities outstanding not included in diluted EPS calculations are as follows:

	<b>December 31, 2014</b>	September 30, 2014
Potentially dilutive securities		
Common shares potentially assumable		
- under stock options	<b>739,491</b>	828,498
- under warrants	<b>4,450,619</b>	5,763,250
- under terms of convertible debenture	<b>4,247,625</b>	4,838,710
	<b>9,437,735</b>	11,430,458