

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

For the three and six months ended March 31, 2018, and 2017

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

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

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

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

Expressed in Canadian Dollars

	March 31, 2018	September 30, 2017
Assets		
Current Assets		
Cash and cash equivalents	\$1,833,771	\$4,155,883
Accounts receivable, net (Note 9)	4,660,053	2,749,161
Inventories (Note 5)	3,389,171	2,477,573
Prepaid expenses	747,244	397,448
Total current assets	10,630,239	9,780,065
Non-current assets		
Restricted cash (Note 19)	35,645	35,795
Property, plant and equipment (Note 8)	1,040,974	615,753
Intangible assets (Note 4)	1,521,415	1,535,378
Total non-current assets	2,598,034	2,186,926
Total Assets	\$13,228,273	\$11,966,991
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable and accrued liabilities	\$2,464,150	\$2,341,474
Deferred revenue (Note 3)	288,744	463,258
Total current liabilities	2,752,894	2,804,732
Non-current Liabilities		
Deferred revenue (Note 3)	26,357	61,627
Deferred rent	124,759	119,545
Total non-current liabilities	151,116	181,172
Total Liabilities	2,904,010	2,985,904
Shareholders' Equity		
Share capital (Note 6 a)	38,297,723	37,879,335
Contributed surplus (Note 6 b and c)	3,428,235	3,422,406
Stock options (Note 7)	1,915,147	1,378,410
Foreign exchange translation reserve	(114,476)	(452,435)
Accumulated deficit	(33,202,366)	(33,246,629)
Total shareholders' equity	10,324,264	8,981,087
Total Liabilities and Shareholders' Equity	\$13,228,273	\$11,966,991

On behalf of the Board
(signed) "Abe Schwartz"
(signed) "Brian Pedlar"

Director
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

	Three months ended March 31,		Six months ended March 31,	
	2018	2017	2018	2017
Revenue (Note 3)				
Product	\$5,079,373	\$5,625,575	\$11,054,013	\$11,107,120
Development and consulting services	326,664	109,192	726,953	116,538
Licensing and royalty fees	321,238	270,614	351,014	347,457
Total revenue	5,727,275	6,005,381	12,131,980	11,571,115
Cost of product sales	1,392,459	1,304,702	3,257,944	2,443,589
Gross profit before operating expenses	4,334,816	4,700,679	8,874,036	9,127,526
Operating Expenses				
Operations	518,219	313,870	907,098	584,822
Research and development activities	384,277	270,909	743,812	463,340
Sales, marketing, and agency fees	2,489,083	2,588,441	4,645,025	5,334,533
General and administrative	1,422,319	1,053,935	2,533,838	1,733,643
	4,813,898	4,227,155	8,829,773	8,116,338
Net income (loss)	\$(479,082)	\$473,524	\$44,263	\$1,011,188
Other comprehensive income (loss)				
Foreign currency translation adjustment (Note 2d)	292,504	(17,947)	337,959	63,002
Total comprehensive income (loss)	\$(186,578)	\$455,577	\$382,222	1,074,190
Basic earnings (loss) per share (Note 14)	\$(0.02)	\$0.02	\$0.00	\$0.05
Diluted earnings (loss) per share (Note 14)	\$(0.02)	\$0.02	\$0.00	\$0.05

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	Accumulated Deficit	Foreign Exchange Translation Reserve	Total
Balance at October 1, 2016	\$34,646,983	\$3,327,883	\$891,433	\$(35,058,323)	-	\$3,807,976
Share based payments	-	-	201,874	-	-	201,874
Exercise of options	221	-	(221)	-	-	-
Options naturally expired	-	53,706	(53,706)	-	-	-
Comprehensive income for the period	-	-	-	1,011,188	-	1,011,188
Foreign currency translation adjustment	-	-	-	-	63,002	63,002
Balance at March 31, 2017	\$34,647,204	\$3,381,589	\$1,039,380	\$(34,047,135)	\$63,002	\$5,084,040
Balance at October 1, 2017	\$37,879,335	\$3,422,406	\$1,378,410	\$(33,246,629)	\$(452,435)	\$8,981,087
Share based payments	-	-	651,822	-	-	651,822
Exercise of options	228,238	-	(109,256)	-	-	118,982
Options forfeited	-	5,829	(5,829)	-	-	-
Issue common shares (Note 6)	190,150	-	-	-	-	190,150
Comprehensive income for the period	-	-	-	44,263	-	44,263
Foreign currency translation adjustment	-	-	-	-	337,959	337,959
Balance at March 31, 2018	\$38,297,723	\$3,428,235	\$1,915,147	\$(33,202,366)	\$(114,476)	\$10,324,264

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

	For the six months ended March 31,	
	2018	2017
Cash flows from operating activities		
Net income for the period	\$44,263	\$1,011,188
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation - property, plant and equipment	73,924	47,987
Amortization - intangible assets	77,394	79,570
Share based payments	651,822	201,874
Foreign exchange (gain) on cash held	(22,934)	(881)
Cash (used) generated by operating activities before change in non-cash working capital balances	824,469	1,339,738
Change in non-cash working capital (Note 20)	(3,171,515)	(2,216,013)
Total cash flows from operating activities	(2,347,046)	(876,275)
Cash flows from investing activities		
Purchase of property, plant and equipment	(471,046)	(52,038)
Purchase of intangible assets	(13,610)	(63,090)
Other receivables	-	(151)
Restricted cash	150	(111)
Total cash flows from investing activities	(484,506)	(115,390)
Cash flows from financing activities		
Net proceeds on issuance of share capital (Note 6)	309,132	-
Total cash flows from financing activities	309,132	-
Foreign exchange rate changes on cash	200,308	31,393
Total cash flows during the period	(2,322,112)	(960,272)
Cash and cash equivalents, beginning of the period	\$4,155,883	\$1,454,389
Cash and cash equivalents, end of the period	\$1,833,771	\$494,117
Represented by		
Cash	\$1,833,771	\$494,117
Cash equivalents	-	-
	\$1,833,771	\$494,117

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

1. CORPORATE INFORMATION

Covalon Technologies Ltd. (“the Company”) is incorporated under the laws of Ontario and is engaged in the business of developing, licensing, and selling medical technologies and products. The unaudited condensed consolidated interim financial statements of Covalon Technologies Ltd. for the six months ended March 31, 2018 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 of products. The Company is listed on the TSX Venture Exchange, having the symbol COV. The Company also trades on the OTCQX Best Market, having the symbol of CVALF.

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 unaudited condensed consolidated interim financial statements were authorized for issue by the Board of Directors on May 28, 2018.

b) Basis of Consolidation

These unaudited condensed consolidated interim financial statements include the accounts of the Company and its wholly owned subsidiaries, Covalon Technologies Inc., Covalon Technologies (USA) Ltd. (formally COV Healthcare Innovations Corp.), Covalon Medical Device Shanghai Co., Ltd., Covalon, Covalon Technologies (Israel) 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.

c) Basis of Measurement

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

d) Functional and Presentation Currency

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 predominantly United States 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. The parent company, Covalon Technologies Limited's, functional currency is Canadian dollars, and the Company's subsidiary Covalon Technologies (Europe) Limited maintains a functional current of the Pound Sterling dollar.

Effective October 1, 2016, the Company's subsidiaries Covalon Technologies Inc., and Covalon Technologies (USA) Ltd. (formally COV Healthcare Innovations Corp.) changed their functional currency to United States dollars given the increasing prevalence of United States dollar-denominated activities. The change in functional currency from Canadian dollars to United States dollars is accounted for prospectively from October 1, 2016.

The results and financial position of the Company are translated into the Canadian dollar as follows:

- i) Assets and liabilities are translated at the closing rate at the date of the statement of financial position;
- 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 rounded to the nearest Canadian dollar (CAD \$), unless otherwise indicated.

e) 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 could be material.

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. Areas involving the most critical judgments and estimates are:

- i) Impairment of non-financial assets – Note 4
- ii) Inventory allowance – Note 5
- iii) Allowance for doubtful accounts – Note 9
- iv) Foreign currency translation – Note 2(d)
- v) Revenue recognition – Note 3

Covalon Technologies Ltd.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)
Expressed in Canadian Dollars
For the three and six months ended March 31, 2018, and 2017

3. REVENUE

Revenue is recognized on an accrual basis as follows:

- i) Revenue arising from product sales is recognized once the risks and rewards of ownership have passed to the customer. This occurs once the customer has received the product or once the product has been shipped to the customer if the Company arranges product shipment at the customers' request;
- ii) 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; and
- iii) Revenue arising from long-term development and consulting contracts is recognized using the percentage of completion method based on milestones achieved.

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

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.

Deferred Revenue

	March 31, 2018	September 30, 2017
Balance, beginning of period	\$524,885	\$859,715
<u>Add:</u>		
Deferred licensing fees	-	-
Deferred product and services revenue	2,196,293	517,426
<u>Less:</u>		
Recognition of deferred product and services revenue	(2,381,441)	(742,056)
Recognition of deferred licensing fees	(36,696)	(72,512)
Foreign exchange	12,060	(37,688)
Balance, end of period	315,101	524,885
 Amount to be recognized within one year	 (288,744)	 (463,258)
Long-term balance	\$26,357	\$61,627

4. INTANGIBLE ASSETS

Recognition and Amortization

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. 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. Development expenditures are capitalized only if the relevant IFRS criteria are met. 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). Development expenditures not satisfying the above criteria are recognized in operations as incurred.

Impairment

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, deferred development, and other definite life assets 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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

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	Deferred Development Costs (\$)	Patents (\$)	Trademarks (\$)	Computer Software (\$)	Total (\$)
Cost					
Balance at October 1, 2016	2,120,395	939,176	78,729	149,163	3,287,463
Additions	-	59,705	-	-	59,705
Foreign exchange	(83,686)	(44,840)	(3,740)	(7,085)	(139,351)
Balance at September 30, 2017	2,036,709	954,041	74,989	142,078	3,207,817
Additions	-	13,610	-	-	13,610
Foreign exchange	48,927	31,842	2,488	4,713	87,970
Balance at March 31, 2018	2,085,636	999,493	77,477	146,791	3,309,397
Accumulated amortization and impairment losses					
Balance at October 1, 2016	1,252,332	246,736	-	145,464	1,644,532
Amortization	104,485	46,393	-	706	151,584
Foreign exchange	(104,874)	(11,898)	-	(6,905)	(123,677)
Balance at September 30, 2017	1,251,943	281,231	-	139,265	1,672,439
Amortization	52,876	24,232	-	286	77,394
Foreign exchange	23,786	9,738	-	4,625	38,149
Balance at March 31, 2018	1,328,605	315,201	-	144,176	1,787,982
Carrying amounts					
At September 30, 2017	784,766	672,810	74,989	2,813	1,535,378
At March 31, 2018	757,031	684,292	77,477	2,615	1,521,415

5. INVENTORIES

Raw materials are stated at the lower of weighted average cost and net realizable value. 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.

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.

Inventories consist of the following:

	March 31, 2018	September 30, 2017
Raw materials	\$777,872	\$884,560
Finished Goods	2,611,299	1,593,013
	\$3,389,171	\$2,477,573

Cost of sales include \$3,104,440 (2017 - \$1,015,076) in inventoried materials.

6. SHARE CAPITAL AND RESERVES

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 and warrants 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.

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 six months ended March 31, 2018, 150,500 warrants were exercised for common shares of the Company for aggregate proceeds of \$190,150.

During the six months ended March 31, 2018, 66,666 options were exercised for proceeds of \$118,983.

On June 1, 2017, the Company completed a non-brokered private placement offering comprised of 1,190,671 units (each, a "Unit") of the Corporation at a price of \$1.96 per unit for aggregate gross proceeds of \$2,333,716 (the "Offering"). Each Unit is comprised of one common share of the Company (a "Common Share") and one Common Share purchase warrant (a "Warrant"). Each Warrant entitles the holder to acquire an additional Common Share at a price of \$2.30 per share for a period of three years from the closing date. Directors and investors who owned more than 10% of the issued and outstanding shares, at the time, participated in the Offering for an aggregate of 765,351 Units for gross proceeds of \$1,500,088. All securities issued pursuant to the Offering were subject to a hold period that expired October 2, 2017.

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 principal and \$278,577 related to 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.

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, 2017, 805,000 warrants were exercised for aggregate proceeds of \$805,000.

In fiscal 2006, Covalon acquired technology from Perfusion Therapeutics Inc. for 110,000 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 then valued at \$213,875 had been released from trust. During the year ended September 30, 2017 the remaining

balance of 95,000 shares, previously held in trust, have been cancelled as the milestones have not been reached.

The following is a summary of common share capital from September 30, 2016 to March 31, 2018:

	Number of Shares (#)	Effective Price (\$)	Amount (\$)
Balance at September 30, 2016	19,370,915		34,646,983
Shares issued in private placement	1,190,671	\$1.96	2,233,716
Options exercised	54,001	\$1.73	93,636
Warrants exercised	805,000	\$1.00	805,000
Shares cancelled	(95,000)		
Balance at September 30, 2017	21,325,587		37,879,335
Options exercised	66,666	\$3.42	228,238
Warrants exercised	150,500	\$1.26	190,150
Balance at March 31, 2018	21,542,753		38,297,723

b) Contributed Surplus

The following is a summary of changes in contributed surplus from September 30, 2016 to March 31, 2018:

Balance September 30, 2016	\$3,327,883
Options naturally expired	94,523
Balance September 30, 2017	\$3,422,406
Options naturally expired or forfeited	5,829
Balance at March 31, 2018	\$3,428,235

c) Share Purchase Warrants

The Company has previously issued 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.

The following is a summary of warrants from September 30, 2016 to March 31, 2018:

	Number of Warrants	Exercise Price	Expiry Date
Balance at September 30, 2016	925,000		
Exercised during the period	805,000	\$1.00	26-Oct-17
Issued during the period	1,190,671	\$2.30	1-Jun-20
Balance at September 30, 2017	1,310,671	\$2.18	
Exercised during the period	120,000	\$1.00	26-Oct-17
Exercised during the period	30,500	\$2.30	1-Jun-20
Balance at March 31, 2018	1,160,171	\$2.30	1-Jun-20

7. SHARE-BASED PAYMENTS

Equity instruments granted to employees, and directors 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.

a) Option Plan Details

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

The following is a summary of changes in options from October 1, 2016 to March 31, 2017:

Grant Date	Expiry Date	Exercise Price	Opening Balance	Granted	Exercised	Expired	Closing Balance	Vested	Unvested
16-Aug-13	16-Aug-18	\$0.16	56,500	-	(1,500)	-	55,000	55,000	-
26-Sep-13	26-Sep-18	\$0.85	235,000	-	-	-	235,000	235,000	-
13-Jun-14	13-Jun-19	\$2.00	95,000	-	-	(2,500)	92,500	61,667	30,833
26-Mar-15	26-Mar-20	\$1.40	148,833	-	-	(5,000)	143,833	95,889	47,944
07-Mar-16	07-Mar-21	\$1.13	192,500	-	-	(15,000)	177,500	59,167	118,333
23-Jun-16	23-Jun-21	\$1.29	200,000	-	-	(15,000)	185,000	-	185,000
14-Sep-16	14-Sep-21	\$2.29	70,000	-	-	(5,000)	65,000	-	65,000
08-Feb-17	08-Feb-22	\$2.20	-	265,000	-	-	265,000	-	265,000
			997,833	265,000	(1,500)	(42,500)	1,218,833	506,722	712,111
Weighted Average Exercise Price			\$1.25	\$2.20	(\$0.16)	\$1.41	\$1.45	\$1.05	\$1.73

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

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The following is a summary of changes in options from October 1, 2017 to March 31, 2018:

Grant Date	Expiry Date	Exercise Price	Opening Balance	Granted	Exercised	Expired	Forfeited	Closing Balance	Vested	Unvested
16-Aug-13	16-Aug-18	\$0.16	40,000	-	-	-	-	40,000	40,000	-
26-Sep-13	26-Sep-18	\$0.85	230,000	-	-	-	-	230,000	230,000	-
13-Jun-14	13-Jun-19	\$2.00	85,001	-	(29,999)	-	-	55,002	55,002	-
26-Mar-15	26-Mar-20	\$1.40	134,666	-	(11,667)	-	-	122,999	122,999	-
7-Mar-16	7-Mar-21	\$1.13	164,166	-	(6,667)	-	-	157,499	102,777	54,722
23-Jun-16	23-Jun-21	\$1.29	174,999	-	(1,667)	-	-	173,332	56,666	116,666
14-Sep-16	14-Sep-21	\$2.29	65,000	-	-	-	-	65,000	21,667	43,333
8-Feb-17	8-Feb-22	\$2.20	260,000	-	(16,666)	-	(5,000)	238,334	65,001	173,333
20-Jun-17	20-Jun-22	\$2.47	422,500	-	-	-	(7,500)	415,000	-	415,000
25-Oct-17	25-Oct-22	\$3.80	-	60,000	-	-	-	60,000	-	60,000
21-Dec-17	21-Dec-22	\$4.65	-	187,500	-	-	-	187,500	-	187,500
18-Jan-18	24-Jan-23	\$6.02	-	60,000	-	-	-	60,000	-	60,000
			1,576,332	307,500	(66,666)	-	(12,500)	1,804,666	694,111	1,110,555
Weighted Average Exercise Price			\$1.74	\$4.75	\$1.84	\$0.00	\$2.36	\$2.24	\$1.25	\$2.86

b) Fair Value of Options Issued During the Period

During the six months ended March 31, 2018, the Company issued three new tranches of options:

- On January 18, 2018, 60,000 options with a weighted average fair value of \$4.44 were granted. Trading price of the stock at the time of the grant was \$6.02. 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 – 1.77%, dividend rate NIL, average volatility – 103.31% and an average term of 5 years. The estimated forfeiture rate is 6.07%.
- On December 21, 2017, 187,500 options with a weighted average fair value of \$3.51 were granted. Trading price of the stock at the time of the grant was \$4.65. 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 – 107.36% and an average term of 5 years. The estimated forfeiture rate is 5.87%.
- On October 25, 2017, 60,000 options with a weighted average fair value of \$3.05 were granted. Trading price of the stock at the time of the grant was \$3.80. 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 – 1.73%, dividend rate NIL, average volatility – 119.81% and an average term of 5 years. The estimated forfeiture rate is 6.23%.

During the year ended September 30, 2017, the Company issued two new tranches of options:

- On June 20, 2017, 422,500 options with a weighted average fair value of \$2.14 were granted. Trading price of the stock at the time of the grant was \$2.47. 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 – 0.85%, dividend rate NIL, average volatility – 140.54% and an average term of 5 years. The estimated forfeiture rate is 6.1%.

- On February 9, 2017, the Company issued 265,000 options with a weighted average fair value of \$1.96. Trading price of the stock at the time of the grant was \$2.20. 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 – 1.08%, dividend rate NIL, average volatility – 150.22% and an average term of 5 years. The estimated forfeiture rate is 5.65%.

c) Expenses Arising from Share-based Payment Transactions

Total expenses arising from share-based payment transactions recognized during the six months ended March 31, 2018, as part of employee benefit expense were \$651,822 (2017 - \$201,091).

8. PROPERTY, PLANT AND EQUIPMENT

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. 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. Property, plant and equipment is subsequently measured at cost less accumulated depreciation, and any accumulated impairment losses. See Note 4 for policy regarding impairment.

Depreciation

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

	Furniture and Fixtures (\$)	Lab Equipment (\$)	Leasehold Improvements (\$)	Total (\$)
Cost				
Balance at October 1, 2016	396,152	1,025,085	135,056	1,556,293
Additions	29,725	270,270	-	299,995
Foreign exchange	(18,931)	(49,728)	(6,416)	(75,075)
Balance at September 30, 2017	406,946	1,245,627	128,640	1,781,213
Additions	58,753	374,396	37,897	471,046
Foreign exchange	14,547	48,537	4,932	68,016
Balance at March 31, 2018	480,246	1,668,560	171,469	2,320,275
Accumulated depreciation				
Balance at October 1, 2016	290,342	726,596	85,328	1,102,266
Depreciation	24,019	84,107	9,510	117,636
Foreign exchange	(13,883)	(36,468)	(4,091)	(54,442)
Balance at September 30, 2017	300,478	774,235	90,747	1,165,460
Depreciation	13,232	55,162	5,530	73,924
Foreign exchange	10,189	26,624	3,104	39,917
Balance at March 31, 2018	323,899	856,021	99,381	1,279,301
Carrying amounts				
At September 30, 2017	106,468	471,392	37,893	615,753
At March 31, 2018	156,347	812,539	72,088	1,040,974

9. FINANCIAL RISK MANAGEMENT

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 is exposed to credit risk associated with its trade receivables. The risk is reduced by having trade receivables insured or obtaining letters of credit 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.

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 March 31, 2018, ten customers accounted for 95% (2017 – ten customers for 93%) 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, the use of Letters of Credit, and due diligence procedures for new customers. The Company has recorded an allowance

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

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for bad debts in the amount of \$1,221,908 (September 2017 – \$1,221,908) resulting in a bad debt expense of \$NIL (2017 - \$1,215,216). 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:

	March 31, 2018	September 30, 2017
Current	\$3,997,908	\$1,998,400
30-60 days past due	121,374	422,990
Over 60 days past due	540,771	327,771
Total (net of allowance for doubtful accounts of \$1,221,908; Sep 2017 - \$1,221,908)	\$4,660,053	\$2,749,161

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 15.

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's US functional currency subsidiaries have suppliers and customers that do not transact in United States dollars, which gives rise to a risk that earnings and cash flows may be adversely affected by fluctuations in foreign currency exchange rates. Part of the currency risk is mitigated by the fact that the company has both purchases and sales in Canadian 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 recorded in Canadian dollars consist of the following:

	March 31, 2018	September 30, 2017
Accounts payable	\$(507,123)	\$(611,664)
Cash	281,345	209,819
Exchange rate (\$CAD / \$USD)	0.78	0.80
	\$(225,778)	\$(401,845)

An increase of 5% and 10% in the United States dollar exchange rate would result in an increase in net income by approximately \$(11,289) (2017 – \$(14,553)) and \$(22,578) (2017– \$(29,107)) respectively.

10. MANAGEMENT OF CAPITAL

The Company defines capital that it manages as its shareholders' equity comprising of share capital, options, contributed surplus, foreign currency translation adjustment, and accumulated deficit. Its objectives when managing capital are to ensure that the Company will continue as a going concern, so that it can provide services to its customers and returns to its shareholders. The capital at March 31, 2018 is \$10,324,264 (September 30, 2017 – \$8,981,087).

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.

11. INCOME TAXES

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in net income except to the extent that it relates to a business combination, or items recognized directly in equity or in other comprehensive income.

The Company computes an income tax provision in each of the jurisdictions in which it operates. The operations in Canada and the United States are subject to income tax at average rates of 26.5% - 39.5% for the year ended September 30, 2017 (2016 – 26.5% - 39.5%).

a) Reconciliation between statutory rate and actual rate

	September 30,	
	2017	2016
Income tax computed at statutory tax rates	\$536,100	(\$858,200)
Permanent differences	166,100	59,800
Provision to return adjustment	-	-
Other	(15,200)	18,000
Change in deferred tax assets not recognized	(687,000)	780,400
	\$ -	\$ -

b) Deferred tax assets

The tax effect of the temporary differences that gives rise to deferred tax assets (liabilities) as of September 30, 2017, and 2016 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,	
	2017	2016
Non-capital loss carry forwards	\$4,609,000	\$5,237,800
Capital loss carry forwards	127,600	127,600
Capital and other assets	(6,300)	29,200
Deferred development costs	1,793,800	1,722,500
Deferred revenue and other liabilities	170,500	264,300
Deferred tax assets not recognized	(6,694,400)	(7,381,400)
	\$ -	\$ -

The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2017 of approximately \$17,108,000 which are available to reduce taxable incomes of future years. These losses expire as follows:

<u>Year</u>	<u>Canada Amount</u>	<u>US Amount</u>	<u>UK Amount</u>
2029	3,339,000	-	
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	246,000	
2036	2,183,000	113,000	
2037	23,000	209,000	1,108,000
	\$14,760,000	\$1,240,000	\$1,108,000

c) Other income tax items

The Company has capital losses carry forward for income tax purposes as at September 30, 2017 of approximately \$962,883 (2016 - \$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.

Covalon Technologies Ltd.

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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, 2017, the Company has \$1,570,619 (2016 - \$1,592,150) 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, 2017, the Company has \$137,108 (2016 – \$137,108) 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.

12. RELATED PARTY TRANSACTIONS

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

	Three months ended March 31,		Six months ended March 31,	
	2018	2017	2018	2017
Compensation and short-term benefits	\$252,839	\$305,980	\$544,271	\$606,309
Share-based payments	184,706	45,134	305,174	81,366
	437,545	351,114	849,445	687,675

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.

13. EXPENSES BY NATURE

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

a) Employee costs

	Six months ended March 31,	
	2018	2017
Short-term wages & benefits, commissions, contract and director fees	\$3,392,877	\$1,900,763
Share based payments	651,822	201,091
Total employee costs	\$4,044,699	\$2,101,854
Included in		
Cost of product sales	377,295	56,129
Operations	493,949	339,270
Research and development activities	525,186	342,316
Sales and marketing	1,172,767	654,133
General and administrative	1,475,502	710,005
Total employee costs	\$4,044,699	\$2,101,854

b) Depreciation and amortization

	For the six months ended March 31,	
	2018	2017
Cost of product sales	\$100,472	\$77,308
Operations	2,474	3,051
Research and development activities	5,093	6,443
General and administrative	43,280	40,756
Total depreciation and amortization	\$151,319	\$127,558

14. 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.

There were 217,166 Shares issued (2017– nil), and no shares cancelled (2017 – nil) for the six months ended March 31, 2018. Shares issued and outstanding at March 31, 2018 were 21,542,753 (September 30, 2017 - 21,325,587). The weighted average number of shares outstanding during the period were 21,493,584 (2017– 19,372,415).

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

	March 31, 2018	September 30, 2017
Potentially dilutive securities		
Common shares potentially assumable		
- under stock options	996,356	412,222
- under warrants	604,126	317,738
Total dilutive shares	1,600,482	729,960

15. COMMITMENTS

The Company has signed lease agreements for two locations in Mississauga, Ontario and one in each of Shanghai, China and Leicestershire, United Kingdom. The leases range from a monthly term 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>
2018	\$565,511
2019	433,742
2020	296,545
2021	312,878
2022	309,938
Thereafter	\$920,994

16. OPERATING SEGMENTS

During the three months ended March 31, 2018 there was one customer who individually accounted for approximately 61% of revenue (2017 – approximately 73%). The Company generated revenue of \$1,469,016 (2017 – \$729,520) in the US, \$4,102,509 (2017 – \$4,943,999) in the Middle East, \$4,098 (2017 – \$17,942) in Canada, and \$144,688 (2017 – \$313,874) in the rest of the world.

During the period ended March 31, 2018 there was 1 customer who individually accounted for approximately 53% of revenue (2017 – approximately 77%). The Company generated revenue of \$3,697,278 (2017 – \$1,347,135) in the US, \$8,041,966 (2017 – \$9,777,786) in the Middle East, \$9,590 (2017 – \$28,266) in Canada, and \$364,244 (2017 – \$461,077) in the rest of the world.

As of September 30, 2017, the company had \$806,892 (78%) of its property, plant, and equipment located in Canada and the remainder in the rest of the world. The company holds all intellectual property in Canada.

17. 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.

18. 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.

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 year ended September 30, 2017 the Company recognized \$21,531 (September 2016 – \$34,972) in credits.

19. RESTRICTED CASH

The Company assigned \$35,645 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.

20. CHANGE IN NON-CASH WORKING CAPITAL ITEMS

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

	Six months ended March 31,	
	<u>2018</u>	<u>2017</u>
Accounts receivable	(\$1,811,687)	(\$2,758,161)
Prepaid expenses	(329,479)	(308,257)
Inventories	(817,135)	416,726
Accounts payable and accrued liabilities	49,962	672,844
Deferred revenue	(264,407)	(238,108)
Deferred rent	1,231	(1,057)
	<u>(\$3,171,515)</u>	<u>(\$2,216,013)</u>

21. 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 expects the changes associated with the adoption of this standard to have a minimal impact on the financial statements.

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 expects the changes associated with the adoption of this standard to have a minimal impact on the financial statements.

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.