Covalon Technologies Ltd.
CONSOLIDATED FINANCIAL STATEMENTS

For the years ended September 30, 2018, and 2017

Contents

Tel: 416 865 0200
Fax: 416 865 0887
www.bdo.ca

BDO Canada LLP
TD Bank Tower
222 Bay Street
Suite 2200, P.O. Box 131
Toronto ON M5K 1H1 Canada

Independent Auditor's Report

To the Shareholders of
Covalon Technologies Ltd.

We have audited the accompanying consolidated financial statements of Covalon Technologies Ltd., which comprise the consolidated statements of financial position as at September 30, 2018 and September 30, 2017 and the consolidated statements of operations and comprehensive income, changes in equity and cash flows for the years ended September 30, 2018 and September 30, 2017, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Covalon Technologies Ltd. as at September 30, 2018 and September 30, 2017 and its financial performance and its cash flows for the years ended September 30, 2018 and September 30, 2017 in accordance with International Financial Reporting Standards.

BDO Canada LLP

Chartered Professional Accountants, Licensed Public Accountants

Toronto, Ontario
December 17, 2018

BDO Canada LLP, a Canadian limited liability partnership, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms.

Covalon Technologies Ltd.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

Expressed in Canadian Dollars

	September 30, 2018	September 30, 2017
Assets		
Current assets		
Cash and cash equivalents	**$5,483,087**	$4,155,883
Accounts receivable, net (Note 9)	**5,132,693**	2,749,161
Inventories (Note 5)	**5,564,539**	2,477,573
Prepaid expenses	**959,915**	397,448
Total current assets	**17,140,234**	9,780,065
Non-current assets		
Restricted cash (Note 20)	**36,052**	35,795
Property, plant and equipment (Note 8)	**1,161,201**	615,753
Intangible assets (Note 4)	**1,370,346**	1,535,378
Total non-current assets	**2,567,599**	2,186,926
Total assets	**$19,707,833**	$11,966,991
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable and accrued liabilities	**$4,721,381**	$2,341,474
Short-term debt (Note 11)	**1,526,928**	-
Deferred revenue (Note 3)	**206,811**	463,258
Total current liabilities	**6,455,120**	2,804,732
Non-current liabilities		
Deferred revenue (Note 3)	**-**	61,627
Deferred rent	**127,937**	119,545
Total non-current liabilities	**127,937**	181,172
Total liabilities	**6,583,057**	2,985,904
Shareholders' equity		
Share capital (Note 6 (a))	**39,257,032**	37,879,335
Contributed surplus (Notes 6 (b)(c))	**3,538,358**	3,422,406
Stock options (Note 7)	**2,034,481**	1,378,410
Foreign exchange translation reserve	**(76,114)**	(452,435)
Accumulated deficit	**(31,628,981)**	(33,246,629)
Total shareholders' equity	**13,124,776**	8,981,087
Total liabilities and shareholders' equity	**$19,707,833**	$11,966,991

Subsequent events (Note 23)

On behalf of the Board:

(*signed) "Abe Schwartz"* — *Director*

(signed) "Brian Pedlar" — *Director*

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

Covalon Technologies Ltd.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

Expressed in Canadian Dollars

	Year ended September 30, **2018**	2017
Revenue (Note 3)		
Product	**$19,990,663**	$24,681,335
Development and consulting services	**1,782,368**	866,139
Licensing and royalty fees	**4,950,311**	1,762,283
Total revenue	**26,723,342**	27,309,757
Cost of product sales	**7,058,506**	6,297,098
Gross profit before operating expenses	**19,664,836**	21,012,659
Operating expenses		
Operations	**1,990,549**	1,433,900
Research and development activities	**1,416,640**	1,125,848
Sales, marketing, and agency fees	**8,186,811**	11,484,990
General and administrative	**6,453,188**	5,156,227
	18,047,188	19,200,965
Net income	**$1,617,648**	$1,811,694
Other comprehensive income (loss)		
Foreign currency translation adjustment (Note 2(d))	**376,321**	(452,435)
Total comprehensive income	**$1,993,969**	$1,359,259
Basic earnings per share (Note 15)	**$0.08**	$0.09
Diluted earnings per share (Note 15)	**$0.07**	$0.09

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

Covalon Technologies Ltd.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

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	-	-	623,312	-	-	623,312
Exercise of options	93,636	-	(41,812)	-	-	51,824
Options naturally expired	-	94,523	(94,523)	-	-	-
Issue common shares (Note 6)	3,138,716	-	-	-	-	3,138,716
Net income for the year	-	-	-	1,811,694	-	1,811,694
Foreign currency translation adjustment	-	-	-	-	(452,435)	(452,435)
Balance at September 30, 2017	**$37,879,335**	**$3,422,406**	**$1,378,410**	**$(33,246,629)**	**$(452,435)**	**$8,981,087**
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	**-**	**-**	**1,252,577**	**-**	**-**	**1,252,577**
Exercise of options	**1,001,539**	**-**	**(480,554)**	**-**	**-**	**520,985**
Options forfeited	**-**	**115,952**	**(115,952)**	**-**	**-**	**-**
Issue common shares (Note 6)	**376,158**	**-**	**-**	**-**	**-**	**376,158**
Net income for the year	**-**	**-**	**-**	**1,617,648**	**-**	**1,617,648**
Foreign currency translation adjustment	**-**	**-**	**-**	**-**	**376,321**	**376,321**
Balance at September 30, 2018	**$39,257,032**	**$3,538,358**	**$2,034,481**	**$(31,628,981)**	**$(76,114)**	**$13,124,776**

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

Covalon Technologies Ltd.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Expressed in Canadian Dollars

	Year ended September 30,	
	2018	2017
Cash flows from operating activities		
Net income for the period	**$1,617,648**	$1,811,694
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation - property, plant and equipment	**207,931**	117,636
Amortization - intangible assets	**148,464**	151,584
Impairment of intangible assets	**63,371**	-
Share based payments	**1,252,577**	623,312
Foreign exchange (gain) loss on cash held	**(51,946)**	5,591
Cash generated by operating activities before change in non-cash working capital balances	**3,238,045**	2,709,817
Change in non-cash working capital (Note 21)	**(3,893,515)**	(2,694,670)
Total cash flows from operating activities	**(655,470)**	15,147
Cash flows from investing activities		
Purchase of property, plant and equipment	**(726,483)**	(299,995)
Purchase of intangible assets	**(13,610)**	(59,705)
Other receivables	**-**	10,000
Restricted cash	**(120)**	(245)
Total cash flows from investing activities	**(740,213)**	(349,945)
Cash flows from financing activities		
Net proceeds on issuance of share capital (Note 6)	**897,144**	3,190,540
Net proceeds from bank indebtedness	**1,521,470**	-
Total cash flows from financing activities	**2,418,614**	3,190,540
Foreign exchange rate changes on cash	**304,273**	(154,248)
Total cash flows during the period	**1,327,204**	2,701,494
Cash and cash equivalents, beginning of the period	**$4,155,883**	$1,454,389
Cash and cash equivalents, end of the period	**5,483,087**	$4,155,883
Represented by		
Cash	**$5,483,087**	$4,155,883
Cash equivalents	**-**	-
	5,483,087	$4,155,883

The accompanying notes are an integral part of these consolidated 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 consolidated financial statements of Covalon Technologies Ltd. for the year ended September 30, 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.

2. BASIS OF PRESENTATION

a) Statement of compliance

The Company's consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

The consolidated financial statements were authorized for issue by the Board of Directors on December 17, 2018.

b) Basis of consolidation

These consolidated 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 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 upon consolidation.

c) Basis of measurement

The consolidated 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 Ltd.'s functional currency is Canadian dollars, and the Company's subsidiary Covalon

Technologies (Europe) Limited maintains a functional currency of the Pound Sterling. The functional currency for all other subsidiaries is United States dollar.

The results and financial position of the Company and its entities are translated into the Canadian dollar presentation currency 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 consolidated 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 management to make certain 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) Functional currency – Note 2(d)
ii) Revenue recognition – Note 3
iii) Impairment of non-financial assets – Note 4
iv) Inventory allowance – Note 5
v) Share based payments – Note 7
vi) Allowance for doubtful accounts – Note 9

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 when the terms of sale are based on the shipping point;

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.

Expressed in Canadian Dollars

Deferred Revenue

	September 30, 2018	September 30, 2017
Balance, beginning of period	**$524,885**	$859,715
Add:		
Deferred product and services revenue	**2,936,275**	517,426
Less:		
Recognition of deferred product and services revenue	**(3,194,460)**	(742,056)
Recognition of deferred licensing fees	**(74,274)**	(72,512)
Foreign exchange	**14,385**	(37,688)
Balance, end of period	**206,811**	524,885
Amount to be recognized within one year	**(206,811)**	(463,258)
Long-term balance	**$ -**	$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 on a 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 costs, 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.

Expressed in Canadian Dollars

	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
Impairment	-	(66,578)	-	-	(66,578)
Foreign exchange	122,549	16,189	2,794	5,294	146,826
Balance at September 30, 2018	2,159,258	917,262	77,783	147,372	3,301,675
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	107,023	40,862	-	579	148,464
Impairment	-	(3,207)	-	-	(3,207)
Foreign exchange	94,250	14,189	-	5,194	113,633
Balance at September 30, 2018	1,453,216	333,075	-	145,038	1,931,329
Carrying amounts					
At September 30, 2017	784,766	672,810	74,989	2,813	1,535,378
At September 30, 2018	706,042	584,187	77,783	2,334	1,370,346

During the year ended September 30, 2018, it was determined that some of the Patent costs, which had previously been capitalized, no longer met the Company's internal policy for capitalization as the identified projects are no longer expected to result in a commercial product. As a result, an impairment loss has been recorded in fiscal 2018.

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, *Inventories*. Cost comprises all costs of purchase and costs of conversion which includes directly attributable production overheads.

Expressed in Canadian Dollars

Inventories consist of the following:

	September 30, 2018	September 30, 2017
Raw materials	**$1,546,489**	$884,560
Finished Goods	**4,018,050**	1,593,013
	$5,564,539	$2,477,573

Cost of product sales include $6,715,698 (2017 - $5,801,680) 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 year ended September 30, 2018, 231,373 warrants were exercised for common shares of the Company for aggregate proceeds of $376,158.

During the year ended September 30, 2018, 452,169 options were exercised for proceeds of $520,985. Additionally, $480,554 of contributed surplus related those stock options was reclassified to share capital.

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.

The following is a summary of common share capital from October 1, 2016 to September 30, 2018:

Expressed in Canadian Dollars

	Number of shares (#)	Effective price ($)	Amount ($)
Balance at October 1, 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	452,170	$2.21	1,001,539
Warrants exercised	231,373	$1.63	376,158
Balance at September 30, 2018	**22,009,130**		**39,257,032**

b) Contributed surplus

The following is a summary of changes in contributed surplus from October 1, 2016 to September 30, 2018:

Balance at October 1, 2016	**$3,327,883**
Options naturally expired	94,523
Balance at September 30, 2017	**$3,422,406**
Options naturally expired or forfeited	115,952
Balance at September 30, 2018	**$3,538,358**

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 October 1, 2016 to September 30, 2018:

	Number of warrants (#)	Exercise price ($)	Expiry date
Balance at October 1, 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	111,373	$2.30	1-Jun-20
Balance at September 30, 2018	**1,079,298**	**$2.30**	**1-Jun-20**

Expressed in Canadian Dollars

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 September 30, 2017:

Grant date	Expiry date	Exercise price	Opening balance	Granted	Exercised	Expired	Forfeited	Closing balance	Vested	Unvested
16-Aug-13	16-Aug-18	$0.16	56,500	-	(16,500)	-	-	40,000	40,000	-
26-Sep-13	26-Sep-18	$0.85	235,000	-	(5,000)	-	-	230,000	230,000	-
13-Jun-14	13-Jun-19	$2.00	95,000	-	(4,999)	-	(5,000)	85,001	85,001	-
26-Mar-15	26-Mar-20	$1.40	148,833	-	(6,667)	-	(7,500)	134,666	87,555	47,111
7-Mar-16	7-Mar-21	$1.13	192,500	-	(10,834)	-	(17,500)	164,166	47,499	116,667
23-Jun-16	23-Jun-21	$1.29	200,000	-	(10,001)	-	(15,000)	174,999	51,666	123,333
14-Sep-16	14-Sep-21	$2.29	70,000	-	-	-	(5,000)	65,000	21,667	43,333
8-Feb-17	8-Feb-22	$2.20	-	265,000	-	-	-	265,000	-	265,000
20-Jun-17	20-Jun-22	$2.47	-	422,500	-	-	-	422,500	-	422,500
			997,833	687,500	(54,001)	-	(50,000)	1,581,332	563,388	1,017,944
Weighted Average Exercise Price			$1.25	$2.37	($0.95)	$0.00	$1.49	$1.74	$1.18	$2.05

Expressed in Canadian Dollars

The following is a summary of changes in options from October 1, 2017 to September 30, 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	-	(35,000)	(5,000)	-	-	-	-
26-Sep-13	26-Sep-18	$0.85	230,000	-	(230,000)	-	-	-	-	-
13-Jun-14	13-Jun-19	$2.00	85,001	-	(50,000)	-	-	35,001	35,001	-
26-Mar-15	26-Mar-20	$1.40	134,666	-	(34,000)	-	-	100,666	100,666	-
7-Mar-16	7-Mar-21	$1.13	164,166	-	(29,169)	-	(10,000)	124,997	80,275	44,722
23-Jun-16	23-Jun-21	$1.29	174,999	-	(31,667)	-	-	143,332	84,999	58,333
14-Sep-16	14-Sep-21	$2.29	65,000	-	-	-	(35,000)	30,000	20,000	10,000
8-Feb-17	8-Feb-22	$2.20	260,000	-	(23,333)	-	(5,000)	231,667	63,334	168,333
20-Jun-17	20-Jun-22	$2.47	422,500	-	(19,000)	-	(20,000)	383,500	121,833	261,667
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
24-Jan-18	24-Jan-23	$6.02	-	60,000	-	-	-	60,000	-	60,000
27-Sep-18	27-Sep-23	$8.50	-	155,000	-	-	-	155,000	-	155,000
			1,576,332	462,500	(452,169)	(5,000)	(70,000)	1,511,663	506,108	1,005,555
Weighted Average Exercise Price			$1.74	$6.01	$1.15	$0.16	$2.17	$3.20	$1.77	$3.92

b) Fair value of options issued during the period

During the year ended September 30, 2018, the Company issued four new tranches of options:

- On September 27, 2018, 155,000 options with a weighted average fair value of $5.86 were granted. Trading price of the stock at the time of the grant was $8.50. 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 – 2.2%, dividend rate – NIL, average volatility – 92.5% and an average term of 5 years. The estimated forfeiture rate is 6.71%.

- On January 24, 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 year ended September 30, 2018, as part of employee benefit expense were $1,252,577 (2017 - $623,312).

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.

Expressed in Canadian Dollars

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	104,098	560,255	62,130	726,483
Foreign exchange	11,540	54,449	5,674	71,663
Balance at September 30, 2018	522,584	1,860,331	196,444	2,579,359
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	31,966	157,187	18,778	207,931
Foreign exchange	11,424	29,863	3,480	44,767
Balance at September 30, 2018	343,868	961,285	113,005	1,418,158
Carrying amounts				
At September 30, 2017	106,468	471,392	37,893	615,753
At September 30, 2018	178,716	899,046	83,439	1,161,201

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

The accounts receivable 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 September 30, 2018, three customers accounted for 80% (2017 – three customers for 85%) 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 for bad debts in the amount of $1,221,908 (September 2017 – $1,215,216) resulting in a bad debt expense of $6,251 (September 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:

	September 30, 2018	September 30, 2017
Current	**$4,972,810**	$1,998,400
30-60 days past due	**159,883**	422,990
Over 60 days past due	**-**	327,771
Total (net of allowance for doubtful accounts of $1,221,908; Sep 2017 - $1,221,908)	**$5,132,693**	$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 short term debt and accounts payable and accrued liabilities that are due within a year. The future contractual commitments that the Company has are outlined in Note 16.

Interest rate risk

The Company is subject to interest rate risk on its cash and cash equivalents and short-term debt. 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. The Company believes that interest rate risk is low due to market based variable interest rate. 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:

	September 30, 2018	September 30, 2017
Accounts payable	**($802,501)**	($611,664)
Cash	**1,865,175**	209,819
Exchange rate ($CAD / $USD)	**0.77**	0.80
	$1,062,674	($401,845)

An increase of 5% and 10% in the United States dollar exchange rate would result in a decrease in net income by approximately $53,134 (2017 – $(20,092)) and $106,267 (2017– $(40,185)) respectively.

10. MANAGEMENT OF CAPITAL

The Company defines capital that it manages as its shareholders' equity comprising share capital, stock options, contributed surplus, foreign exchange translation reserve, 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 September 30, 2018 is $13,124,776 (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. DEBT

During the year ended September 30, 2018, Covalon entered into a banking credit facility agreement (the "Facility") with HSBC Bank Canada ("HSBC"). This multifaceted Facility provides credit of up to approximately $17 million and is comprised of:

- An acquisition line of $9,000,000;
- A revolving operating line of $5,000,000;
- A guarantee facility of $2,000,000 (USD); and,
- Other facilities of $480,000 (USD) and $100,000 for other liabilities.

The Facility is secured by a General Security Agreement which also includes the wholly owned subsidiaries. The Company is also subject to financial covenant and reporting requirements typical with a Facility of this nature.

As of September 30, 2018, the Company has $1,526,928 drawn and outstanding on the Revolving Operating Facility. The interest rate associated with this amount is Prime Rate plus 1.0%.

Expressed in Canadian Dollars

Debt is measured at the initially recognized amounts less any principal repayments made over the term of the loan.

12. 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 21.0% - 26.5% for the year ended September 30, 2018 (2017 – 21.0% - 26.5%).

a) Reconciliation between statutory rate and actual rate

	September 30,	
	2018	2017
Income tax computed at statutory tax rates	**$428,700**	$536,100
Permanent differences	**344,100**	166,100
Rate differences and other	**114,000**	(15,200)
Change in deferred tax assets not recognized	**(886,800)**	(687,000)
	$ -	$ -

b) Deferred tax assets

The tax effect of the temporary differences that gives rise to deferred tax assets (liabilities) as of September 30, 2018, and 2017 is presented below. No benefit has been recorded in these consolidated financial statements as there is no assurance that the Company will generate taxable income to utilize these differences.

	September 30,	
	2018	2017
Non-capital loss carry forwards	**$3,375,600**	$4,609,000
Capital loss carry forwards	**127,600**	127,600
Capital and other assets	**(220,400)**	(6,300)
Deferred development costs	**2,061,300**	1,793,800
Deferred revenue and other liabilities	**88,700**	170,500
Deferred tax assets not recognized	**(5,807,800)**	(6,694,600)
	$ -	$ -

The Company has non-capital losses carry forward available for income tax purposes as at September 30, 2018 of approximately $14,153,000 (2017 - $17,108,000) which are available to reduce taxable incomes of future years.

Expressed in Canadian Dollars

These losses expire as follows:

Year	Canada Amount	US Amount	UK Amount
2030	-	68,000	-
2031	1,103,000	140,000	-
2032	3,267,000	127,000	-
2033	859,000	-	-
2034	89,000	162,000	-
2035	578,000	247,000	-
2036	2,183,000	287,000	-
2037	23,000	209,000	1,108,000
2038	484,000	1,355,000	1,864,000
	$8,586,000	$2,595,000	$2,972,000

c) Other income tax items

The Company has capital losses carry forward for income tax purposes as at September 30, 2018 of approximately $962,883 (2017 - $962,883), which are available to reduce taxable capital gains in future years. These losses do not expire.

13. 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:

	Year ended September 30,	
	2018	2017
Compensation and short-term employee benefits	**$1,365,291**	$1,319,298
Share-based payments	**603,232**	261,135
	1,968,523	1,580,433

During the year end September 30, 2013, a non-interest bearing loan of $50,000 was made to a key employee. As of September 30, 2018, $10,000 of this loan remained outstanding.

14. EXPENSES BY NATURE

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

a) Employee costs

	Year ended September 30,	
	2018	2017
Short-term wages & benefits, commissions, contract and director fees	**$7,246,434**	$5,046,087
Share based payments	**1,252,577**	623,312
Total employee costs	**$8,499,011**	$5,693,834

Expressed in Canadian Dollars

Included in		
Cost of product sales	**887,792**	401,500
Operations	**1,026,305**	712,789
Research and development activities	**969,757**	750,024
Sales and marketing	**2,360,260**	1,847,289
General and administrative	**3,254,897**	1,982,232
Total employee costs	**$8,499,011**	$5,693,834

b) Depreciation and amortization

	For the year ended September 30,	
	2018	2017
Cost of product sales	**$237,182**	$170,429
Operations	**5,079**	5,775
Research and development activities	**21,950**	12,388
General and administrative	**92,184**	80,627
Total depreciation and amortization	**$356,395**	$269,219

15. EARNINGS PER SHARE

Earnings per share is computed by dividing the net income applicable to common shares of the Company by the weighted average number of common shares outstanding for the relevant period. Diluted earnings per share is computed similar to basic earnings 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 683,543 shares issued (2017– 2,049,672) and no shares cancelled (2017 – 95,000) for the year ended September 30, 2018. Shares issued and outstanding at September 30, 2018 were 22,009,130 (September 30, 2017 - 21,325,587). The weighted average number of shares outstanding during the period were 21,560,162 (2017– 20,027,640).

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

Potentially dilutive securities	**September 30, 2018**	September 30, 2017
Common shares potentially dilutive		
- under stock options	**994,844**	412,222
- under warrants	**667,245**	317,738
Total dilutive shares	**1,662,089**	729,960

16. COMMITMENTS

The Company has signed lease agreements for three 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:

Expressed in Canadian Dollars

Year	Annual Commitment
2019	574,072
2020	439,232
2021	457,250
2022	455,658
2023	411,834
Thereafter	$ 800,759

17. OPERATING SEGMENTS

During the year ended September 30, 2018 there was one customer who individually accounted for approximately 48% of revenue (2017 – approximately 70%). The Company generated revenue of $12,768,225 (2017 – $4,629,623) in the US, $13,044,819 (2017 – $21,848,611) in the Middle East, $18,546 (2017 – $26,435) in Canada, and $891,752 (2017 – $805,088) in the rest of the world.

As of September 30, 2018, the Company had $813,983 (70%) 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.

18. 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.

19. 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, 2018 the Company recognized $NIL (September 2017 – $21,531) in credits.

The Company is eligible for the Ontario Innovation Tax Credit ("OITC") at the rate of 10.0% on its research and development expenditures and refundable in cash to the Company. The Company is also eligible for a 20.0% 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.

Expressed in Canadian Dollars

At September 30, 2018, the Company has $1,679,947 (2017 - $1,627,640) 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, 2018, the Company has $160,043 (2017 – $147,395) 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.

20. RESTRICTED CASH

The Company assigned $36,052 (2017 - $35,795) 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.

21. CHANGE IN NON-CASH WORKING CAPITAL ITEMS

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

	Year ended September 30,	
	2018	2017
Accounts receivable	**$(2,316,843)**	$(2,340,917)
Prepaid expenses	**(537,462)**	(237,069)
Inventories	**(2,998,642)**	(504,559)
Accounts payable and accrued liabilities	**2,329,252**	702,389
Deferred revenue	**(373,759)**	(308,720)
Deferred rent	**3,939**	(5,794)
	$(3,893,515)	$(2,694,670)

During the year ended September 30, 2018 non-cash working capital generated a foreign exchange translation adjustment amount of $147,643 (2017 - $216,868).

22. 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, 2018 or later periods. None of these are expected to have a significant effect on the consolidated financial statements, except for the following standards and interpretations that have been issued but are not yet effective:

i) IFRS 9 - Financial Instruments

IFRS 9, Financial Instruments is part of the IASB's wider project to replace IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 retains but simplifies the mixed measurement model and establishes two primary measurement categories for financial assets: amortized cost and fair value. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset. The standard is effective for annual periods beginning on or after January 1, 2018. The Company is in the process of evaluating the impact of the new standard.

ii) IFRS 15 - Revenue from Contracts with Customers

IFRS 15, Revenue from Contracts with Customers establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer. The standard is effective for annual periods beginning on or after January 1, 2018. The Company is in the process of evaluating the impact of the new standard.

iii) IFRS 16 - Leases

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

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

23. SUBSEQUENT EVENTS

AquaGuard Acquisition

On October 1, 2018, Covalon completed the acquisition of AquaGuard, a Seattle, Washington-based division of medical technologies company Cenorin, LLC. AquaGuard's specialized products provide patients with crucial moisture protection for wound, surgical, and vascular access sites throughout the body while showering.

Covalon acquired all of the assets and staff dedicated to the AquaGuard business from Cenorin, LLC. The consideration of approximately $16 million (USD $12.4 million) was comprised of the following:

- $4.7 million (USD $3.7 million) in cash paid on closing;
- $0.7 million (USD $0.5 million) or 75,136 common shares of shares of Covalon Technologies Ltd. issued on closing, which will be held in escrow for up to 2 years;
- $3.3 million (USD $2.6 million) payable 12 months from the date hereof;
- $6.5 million (USD $5.0 million) payable 24 months from the date hereof;
- $0.9 million (USD $0.7 million) of assumed liabilities payable to management and key staff of AquaGuard by issuance of 102,891 common shares of Covalon Technologies Ltd. on closing;
- In addition, there is potential contingent consideration of up to $1.2 million (USD $0.9 million) payable upon achievement of certain revenue targets by December 31, 2018.

Due to the recent timing of this acquisition, the Company is currently in the process of determining the fair value of the consideration paid and the purchase price allocation related to the transaction.

Debt

To facilitate the acquisition of the AquaGuard division (discussed in Note 23) the Company drew funds against the Acquisition facility described in Note 11. On October 1, 2018, a total of $4,800,000 was drawn to facilitate the closing cash payment. The associated debt is amortized over a 5 year period with a rate that is prime plus 1.5% and repayment is on demand. The acquisition facility is covered 50% by EDC.