Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

For the three and six months ended March 31, 2019 and 2018

Contents

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 interim 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 as issued by the International Accounting Standards Board ("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 unaudited condensed consolidated interim financial statements.

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENTS OF FINANCIAL POSITION (UNAUDITED)

Expressed in Canadian Dollars

	March 31, 2019	September 30, 2018
Assets		
Current assets		
Cash and cash equivalents	**$1,811,732**	$5,483,087
Accounts receivable	**8,800,407**	5,132,693
Inventories (Note 5)	**10,231,519**	5,564,539
Prepaid expenses	**504,815**	959,915
Total current assets	**21,348,473**	17,140,234
Non-current assets		
Restricted cash	**37,425**	36,052
Property, plant and equipment (Note 8)	**1,967,385**	1,161,201
Intangible assets (Note 4)	**2,508,734**	1,370,346
Goodwill (Note 4)	**12,576,988**	-
Total non-current assets	**17,090,532**	2,567,599
Total assets	**$38,439,005**	$19,707,833
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable and accrued liabilities	**$6,294,447**	$4,721,381
Short-term debt (Note 11)	**4,652,673**	1,526,928
Acquisition note payable (Note 3)	**3,325,277**	-
Deferred revenue	**235,273**	206,811
Total current liabilities	**14,507,670**	6,455,120
Non-current liabilities		
Deferred revenue	**240,534**	-
Deferred rent	**134,090**	127,937
Long-term debt (Note 11)	**4,022,308**	-
Acquisition note payable (Note 3)	**6,192,275**	-
Total non-current liabilities	**10,589,207**	127,937
Total liabilities	**25,096,877**	6,583,057
Shareholders' equity		
Share capital (Note 6)	**40,697,574**	39,257,032
Contributed surplus (Note 6)	**6,311,096**	5,572,839
Foreign exchange translation reserve	**104,077**	(76,114)
Accumulated deficit	**(33,770,619)**	(31,628,981)
Total shareholders' equity	**13,342,128**	13,124,776
Total liabilities and shareholders' equity	**$38,439,005**	$19,707,833

On behalf of the Board:

(signed) "Abe Schwartz" *Director*

(signed) "Brian Pedlar" *Director*

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

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENTS OF OPERATIONS AND COMPREHENSIVE (LOSS) (UNAUDITED)

Expressed in Canadian Dollars

	Three months ended March 31,		Six months ended March 31,	
	2019	2018	**2019**	2018
Revenue				
Product	**$12,109,456**	$5,079,373	**$18,464,994**	$11,054,013
Development and consulting services	**821,018**	326,664	**1,651,915**	726,953
Licensing and royalty fees	**382,069**	321,238	**457,120**	351,014
Total revenue	**13,312,543**	5,727,275	**20,574,029**	12,131,980
Cost of product sales	**4,068,587**	1,392,459	**6,725,899**	3,257,944
Gross profit before operating expenses	**9,243,956**	4,334,816	**13,848,130**	8,874,036
Operating expenses				
Operations	**598,373**	518,219	**907,787**	907,098
Research and development activities	**395,109**	384,277	**770,099**	743,812
Sales, marketing and agency fees	**5,659,328**	2,489,083	**8,920,379**	4,645,025
General and administrative	**2,705,733**	1,422,319	**4,935,605**	2,533,838
	9,358,543	4,813,898	**15,533,870**	8,829,773
Financing expenses				
Finance cost	**117,640**	-	**455,898**	-
Net (loss) income	**$(232,227)**	$(479,082)	**$(2,141,638)**	$44,263
Other comprehensive (loss) income				
Foreign currency translation adjustment	**(821,675)**	292,504	**180,191**	337,959
Other comprehensive (loss) income	**$(1,053,902)**	$(186,578)	**$(1,961,447)**	$382,222
Basic (loss) earnings per share (Note 14)	**$(0.01)**	$(0.02)	**$(0.10)**	$0.00
Diluted (loss) earnings per share (Note 14)	**$(0.01)**	$(0.02)	**$(0.10)**	$0.00

The accompanying notes are an integral part of these 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	Accumulated deficit	Foreign exchange translation reserve	Total
Balance at October 1, 2017	$37,879,335	$4,800,816	$(33,246,629)	$(452,435)	$8,981,087
Share based payment expense	-	651,822	-	-	651,822
Exercise of stock options	228,238	(109,256)	-	-	118,982
Issue common shares (Note 6)	190,150	-	-	-	190,150
Net income for the period	-	-	44,263	-	44,263
Foreign currency translation adjustment	-	-	-	337,959	337,959
Balance at March 31, 2018	**$38,297,723**	**$5,343,382**	**$(33,202,366)**	**$(114,476)**	**$10,324,264**
Balance at October 1, 2018	$39,257,032	$5,572,839	$(31,628,981)	$(76,114)	$13,124,776
Share based payment expense	-	819,110	-	-	819,110
Exercise of stock options	168,641	(80,853)	-	-	87,788
Issuance of common shares on acquisition (Note 3)	1,271,901	-	-	-	1,271,901
Net loss for the period	-	-	(2,141,638)	-	(2,141,638)
Foreign currency translation adjustment	-	-	-	180,191	180,191
Balance at March 31, 2019	**$40,697,574**	**$6,311,096**	**$(33,770,619)**	**$104,077**	**$13,342,128**

The accompanying notes are an integral part of these 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,	
	2019	2018
Cash flows from operating activities		
Net income (loss) for the period	**$(2,141,638)**	$44,263
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation - property, plant and equipment	**156,718**	73,924
Amortization - intangible assets	**95,815**	77,394
Share-based payments	**819,110**	651,822
Interest expense and accretion	**455,898**	-
Foreign exchange gain (loss) on cash held	**34,593**	(22,934)
Cash generated by operating activities before change in non-cash working capital balances	**(579,504)**	824,469
Change in non-cash working capital (Note 18)	**(3,180,149)**	(3,171,515)
Total cash flows from operating activities	**(3,759,653)**	(2,347,046)
Cash flows from investing activities		
Purchase of property, plant and equipment	**(898,118)**	(471,046)
Purchase of intangible assets	**(19,943)**	(13,610)
Acquisition of AquaGuard	**(5,506,652)**	-
Restricted cash	**(194)**	150
Total cash flows from investing activities	**(6,424,907)**	(484,506)
Cash flows from financing activities		
Exercise of stock options (Note 6)	**87,788**	309,132
Interest paid	**(175,369)**	-
Repayment of debt	**(806,928)**	-
Proceeds from debt	**7,510,972**	-
Total cash flows from financing activities	**6,616,463**	309,132
Foreign exchange rate changes on cash	**(103,258)**	200,308
Total cash flows during the period	**(3,671,355)**	(2,322,112)
Cash and cash equivalents, beginning of the period	**$5,483,087**	$4,155,883
Cash and cash equivalents, end of the period	**$1,811,732**	$1,833,771

The accompanying notes are an integral part of these 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 three and six months ended March 31, 2019 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 predominantly 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.

On October 1, 2018 the Company completed the acquisition of AquaGuard, a division of a Seattle-based medical company (Note 3). The Company acquired all of the assets of AquaGuard, to allow the Company to carry on the operations of the business, including the AquaGuard family of moisture barrier products as well as their specialised salesforce in the United States.

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 unaudited condensed consolidated interim financial statements have been prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS") applicable to the preparation of interim financial statements, including IAS 34, Interim Financial Reporting. These condensed consolidated interim financial statements are presented in Canadian dollars and should be read in conjunction with the Company's annual financial statements for the year ended September 30, 2018, which were prepared in accordance with IFRS.

The condensed consolidated interim financial statements were prepared on a going concern basis under the historical cost convention, except for contingent consideration which is measured at fair value through profit or loss.

The accounting policies adopted are consistent with those of the previous financial year except for additional accounting policies added as a result of the AquaGuard acquisition outlined in section c and updated accounting policies as a result of the adoption of new accounting standards outlined in section d.

The unaudited condensed consolidated interim financial statements were authorized for issue by the Board of Directors on May 28, 2019.

b) Basis of consolidation

These unaudited condensed consolidated interim financial statements include the accounts of the Company and its wholly owned subsidiaries over which the Company has control: Covalon Technologies Inc.; Covalon Technologies (USA) Ltd. (formally COV Healthcare Innovations Corp.); Covalon Medical Device Shanghai Co., Ltd.; Covalon Technologies (Israel) Ltd.; Covalon Technologies (Europe) Limited; and, Covalon Technologies AG Ltd. The Company controls an entity when it is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The wholly owned subsidiaries of the Company are consolidated from the date control is obtained. All intercompany transactions, balances, income and expenses have been eliminated upon consolidation.

c) Accounting policies applied in relation to the business acquisition (Note 3)

Business Combinations

The acquisition method of accounting is used to account for business combinations. The consideration transferred in a business combination is measured at fair value at the date of acquisition. Acquisition-related transaction costs are recognized in the condensed consolidated interim statements of operations (loss) and comprehensive income (loss) as incurred. At the acquisition date, the identifiable assets acquired and the liabilities assumed are initially recognized at their fair value. Goodwill is measured as the excess of the sum of the consideration transferred and the fair value of the acquirer’s previously held equity interest in the acquiree (if any) over the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed. When the consideration transferred by the Company in a business combination includes assets or liabilities resulting from a contingent consideration arrangement, the contingent consideration is measured at its acquisition date fair value and is included as part of the consideration transferred in a business combination. Changes in the acquisition date fair values of the identifiable assets, liabilities and contingent consideration that qualify as measurement period adjustments are adjusted retrospectively, with corresponding adjustments against goodwill. Measurement period adjustments are adjustments that arise from additional information obtained during the measurement period (which cannot exceed one year from the acquisition date) about facts and circumstances that existed at the acquisition date.

Other than measurement period adjustments, contingent consideration that is classified as a financial liability is remeasured at subsequent reporting dates, with the corresponding gain or loss recognized in the condensed consolidated interim statements of operations and comprehensive income (loss).

Goodwill

Goodwill represents the excess fair value of the consideration transferred over the fair value of the underlying net assets in a business combination and is measured at cost less accumulated impairment losses. Goodwill is not amortized but is tested for impairment on an annual basis or more frequently if there are indications the goodwill may be impaired. For the purposes of impairment testing, goodwill is allocated to each of the Company’s cash generating units (CGUs) or group of CGUs that are expected to benefit from the synergies of the acquisition. If the recoverable amount of the CGU or group of CGUs is less than the carrying amount, the impairment loss is allocated first to reduce the carrying amount of any goodwill and then to other assets of the CGU or group of CGUs.

d) Accounting standards adopted

IFRS 15 – Revenue from Contracts with Customers

IFRS 15, Revenue from Contracts with Customers (“IFRS 15”) – replaces IAS 18, Revenue. IFRS 15 clarifies the principles for recognizing revenue and cash flows arising from contracts with customers. The standard became effective for annual periods beginning on or after January 1, 2018, and the Company adopted IFRS 15 as of October 1, 2018.

The Company has adopted IFRS 15 without practical expedients on a full retrospective basis. The effect of initially applying this standard as of the date of initial application has no impact on the comparative information presented. Note disclosures to the condensed consolidated interim financial statements have been updated to reflect the requirements of this standard.

The Company generates revenue from product sales, development and consulting services, as well as licensing, and royalty fees.

Product revenue is recognized when control over products has been transferred to the customer and this either occurs when products are shipped or delivered based upon the contractual agreements in place. The amount of revenue is recorded as the amount that the Company expects to be entitled to in exchange for transferring the promised goods net of estimated returns, chargebacks, or discounts.

Development, and consulting revenue is recognized over the period in which the services are performed.

The Company may enter into product development, consulting, licensing, and royalty agreements with customers. The terms of the agreements may include non-refundable signing fees, milestone payments, hourly rates, or royalty fees. These multiple element arrangements are analysed to determine whether the deliverables can be separated or whether they must be accounted for as a single unit of accounting. Upfront fees are recognized as revenue when persuasive evidence of an arrangement exists, the fee is fixed or determinable, delivery or performance has been substantially completed and collection is reasonably assured. If there are no substantive performance obligations over the life of the contract, the upfront non-refundable payment is recognized when the underlying performance obligation is satisfied. If substantive contractual obligations are satisfied over time or over the life of the contract, revenue may be deferred and recognized over the performance period. The term over which upfront fees are recognized is revised if the period over which the Company maintains substantive contractual obligations changes. Service revenue is recognized over the period in which the services are performed.

In some instances, cash is received before the Company has satisfied the performance obligations and this amount is recorded as deferred revenue.

<u>IFRS 9 – Financial Instruments</u>

IFRS 9, Financial Instruments ("IFRS 9") – replaces IAS 39, Financial Instruments: Recognition and Measurement ("IAS 39"). IFRS 9 simplifies the classification and measurement requirements for financial instruments, which replaces the multiple classification and measurement models in IAS 39. The standard became effective for annual periods beginning on or after January 1, 2018, and the Company adopted this standard on October 1, 2018. The adoption of this standard has no impact on the measurement of the Company's financial instruments in the condensed consolidated interim financial statements, however additional disclosures have been provided. The following are new accounting policies for financial instruments under IFRS 9.

<u>FINANCIAL ASSETS</u>

The Company classifies its financial assets in the following categories: at Fair Value Through Profit or Loss ("FVTPL"); or, at Amortized Cost. The classification depends on the purpose for which the financial assets were acquired. Management determines the classification of its financial assets at initial recognition. Measurement and classification of financial assets is dependent on the Company's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset.

Financial assets at FVTPL: Financial assets carried at FVTPL are initially recorded at fair value and transaction costs are expensed in the condensed consolidated interim statements of operations and comprehensive income (loss). Changes in the fair value of a financial asset held at FVTPL are included in the condensed consolidated interim statements of operations and comprehensive income (loss) in the period in which they arise.

Financial assets at amortized cost: Financial assets at amortized cost are initially recognized at fair value and subsequently carried at amortized cost less any impairment. They are classified as current assets or non-current assets based on their maturity date. Financial assets are derecognized when they mature or are sold, and substantially all the risks and rewards of ownership have been transferred. Gains and losses on derecognition of financial assets classified as FVTPL or amortized cost are recognized in the condensed consolidated interim statements of operations and comprehensive income (loss).

FINANCIAL LIABILITIES

Financial liabilities are recognized initially at fair value, net of transaction costs incurred and are subsequently measured at amortized cost. Any difference between the amounts originally received, net of transaction costs, and the redemption value is recognized in profit and loss over the period to maturity using the effective interest rate method. The effective interest rate method is a method of calculating the amortized cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments through the expected life of the financial liability, or, where appropriate, a shorter period.

The Company completed an assessment of its financial instruments at October 1, 2018. The following table shows the original classification under IAS 39 and the new classification under IFRS 9:

Instrument	Classification under IAS 39	Classification under IFRS 9
Cash and cash equivalents	Amortized cost	Amortized cost
Accounts receivable	Amortized cost	Amortized cost
Restricted cash	Amortized cost	Amortized cost
Bank debt	Amortized cost	Amortized cost
Contingent consideration	Fair value through profit or loss	Fair value through profit or loss
Trade and other payables	Amortized cost	Amortized cost

IMPAIRMENT OF FINANCIAL ASSETS AT AMORTIZED COST

The Company recognizes a loss allowance for expected credit losses on financial assets that are measured at amortized cost. At each reporting date, the loss allowance for the financial asset is measured at an amount equal to the lifetime expected credit losses if the credit risk on the financial asset has increased significantly since initial recognition. If at the reporting date, the financial asset has not increased significantly since initial recognition, the loss allowance is measured for the financial asset at an amount equal to twelve month expected credit losses. For trade receivables, the Company applies the simplified approach to providing for expected credit losses, which allows the use of a lifetime expected loss provision. Impairment losses on financial assets carried at amortized cost are reversed in subsequent periods if the amount of the loss decreases and the decrease can be objectively related to an event occurring after the impairment was recognized. Given the nature and balances of the Company's receivables, the Company has no material loss allowance at adoption or as at March 31, 2019.

e) Critical accounting estimates and judgements

Accounting for Acquisitions

The Company asses whether an acquisition should be account for as an asset acquisition or a business combination under IFRS 3. This assessment requires management to asses whether the assets acquired and liabilities assumed constitute a business as defined in IFRS 3 and if the integrated set of activities, including input and processes acquired, is capable of being conducted and managed as a business and the Company obtains control of the business. The Company's acquisition has been accounted for as a business combination. Areas of estimation include the determination and fair value measurement of the contingent consideration, the probability of the contingency being achieved, and the discount rate. Management is also required to make estimates of the fair value of assets acquired and liabilities assumed.

f) Standards, Amendments and Interpretations Not Yet Effective

Certain pronouncements were issued by the IASB or the IFRS Interpretations Committee that are mandatory for adoption by the Company for the accounting period beginning on October 1, 2019, or later periods. None of these are expected to have a significant effect on the consolidated financial statements, except for the following standard that has been issued but is not yet effective:

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, and the Company intends to adopt in its consolidated financial statements for the annual period beginning October 1, 2019. The Company will recognize assets and liabilities for all leases, except for its low value leases, on the consolidated balance sheet upon adoption.

3. ACQUISITION

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 employed all staff dedicated to the AquaGuard business from Cenorin, LLC. The consideration of approximately $15.5 million (USD $12 million) also includes a contingent payment of $1.2 million (USD $0.9m) which required certain revenue targets to be completed during the calendar year 2018. The contingent consideration was classified as a Level 3 financial liability within the fair value hierarchy given its fair value was estimated using the discounted value of the estimated future payment. The key assumptions in valuing the contingent consideration included: estimated projected net sales; the likelihood of the contingent milestone being achieved and a discount rate of 5.2%. During the period the change in fair value of the contingent consideration was $30,370. The revenue target for the twelve month period ended December 31, 2018 was achieved and the full contingent amount of $1.2 million (USD $0.9m) was paid.

Expressed in Canadian Dollars

The Company accounted for this transaction as a business combination and has applied the acquisition method of accounting. The purchase price allocation of assets acquired and liabilities assumed and the fair value of the consideration is as follows:

Assets acquired and liabilities assumed	
Accounts receivable	$1,385,029
Prepaids	41,113
Inventories	889,808
Property, plant and equipment	20,040
Brand	1,088,255
Other intangibles	34,688
Goodwill	12,049,927
Total assets acquired and liabilities assumed	**$15,508,860**

Goodwill of $12,049,927 arising from the acquisition is attributable to the acquired workforce and synergies expected from combining the acquired assets with the Company.

Consideration paid or payable	
At closing	
Cash	$4,657,731
Common shares issued (not held in escrow) 102,892	859,891
Common shares issued (held in escrow) 75,136	412,010
Post closing	
Fair value of contingent consideration	1,123,431
Fair value of future cash payments	8,890,481
Working capital adjustment	(434,684)
Total consideration paid or payable	**$15,508,860**

The shares held in escrow will be released evenly at 12 months; 18 months; and, 24 months from the closing date subject to certain acceleration clauses and restrictions.

Fair value of future cash payments is comprised of two payments. The first payment of $3,325,277 is due 12 months from the acquisition date; and the second payment of $6,192,275 is due 24 months after the acquisition date. Areas of estimation include the determination and fair value measurement of the future payments, which includes a discount rate of 5.2%. The following is a summary of the changes during the period:

	Fair value ($)
Balance at acquisition	8,890,481
Accretion	236,991
Foreign exchange	390,080
Balance at March 31, 2019	**9,517,552**

Acquisition related costs of $473,015 have been charged to general and administrative expense during the period.

Expressed in Canadian Dollars

During the six month period from October 1, 2018 to March 31, 2019, there was revenue of $6,612,660 and a net loss and comprehensive loss of $(51,108) recorded in the condensed consolidated interim statements of operations and comprehensive income (loss) related to the former AquaGuard business.

4. INTANGIBLE ASSETS AND GOODWILL

During fiscal 2019, the Company updated its policy to include Brand Names which will have a straight-line amortization period of 20 years as a result of the acquisition outlined in Note 3. The policy update is related to the AquaGuard brand purchased, as described in Note 3.

Goodwill is comprised of the following amounts:

	Goodwill ($)
Balance at September 30, 2018	-
Acquisition	12,049,927
Foreign exchange	527,061
Balance at March 31, 2019	**12,576,988**

Intangible assets are comprised of the following amounts:

	Deferred Development Costs ($)	**Brand ($)**	**Patents ($)**	**Trademarks ($)**	**Computer Software ($)**	**Total ($)**
Cost						
Balance at September 30, 2018	2,159,258	-	917,262	77,783	147,372	3,301,675
Acquisition		1,088,255	25,395	3,411	5,882	1,122,943
Additions	-	-	-	-	19,943	19,943
Foreign exchange	69,721	47,600	30,729	2,661	5,117	155,828
Balance at March 31, 2019	2,228,979	1,135,855	973,386	83,855	178,314	4,600,389
Accumulated amortization						
Balance at September 30, 2018	1,453,216	-	333,075	-	145,038	1,931,329
Amortization	55,251	14,078	24,997	-	1,489	95,815
Foreign exchange	47,397	121	12,298	-	4,695	64,511
Balance at March 31, 2019	1,555,864	14,199	370,370	-	151,222	2,091,655
Carrying amounts						
At September 30, 2018	706,042	-	584,187	77,783	2,334	1,370,346
At March 31, 2019	**673,115**	**1,121,656**	**603,016**	**83,855**	**27,092**	**2,508,734**

Expressed in Canadian Dollars

5. INVENTORIES

Inventories consist of the following:

	March 31, 2019	September 30, 2018
Raw materials	**$2,250,170**	$1,546,489
Finished goods	**7,981,349**	4,018,050
	$10,231,519	$5,564,539

Cost of product sales for the three and six-month periods ended March 31, 2019 include $3,925,711 (2018 - $1,340,761) and $6,414,412 (2018 - $3,104,440), respectively in inventoried materials.

6. SHARE CAPITAL AND RESERVES

Common shares

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

Covalon acquired AquaGuard, a division of Cenorin LLC., and issued 178,028 common shares as a closing share payment on October 1, 2018 (see Note 3). These shares were valued at $1,271,901 based on the Company's closing share price at the acquisition date. Included in this amount is 75,136 common shares ($647,250) of Covalon Technologies Ltd. which were issued in escrow. For shares issues in escrow, the Black Sholes model was used to determine the average fair value as of $5.48/share across the three escrow release points (12 months, 18 months, and 24 months).

The following is a summary of the movements in share capital from October 1, 2018 to March 31, 2019:

	Number of Shares (#)	**Amount ($)**
Balance at September 30, 2018	22,009,130	39,257,032
Options exercised	51,001	168,641
Shares issued as consideration for acquisition	178,028	1,271,901
Balance at March 31, 2019	22,238,159	40,697,574

7. SHARE-BASED PAYMENTS

a) Option plan details

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

Expressed in Canadian Dollars

The following is a summary of changes in options from October 1, 2018 to March 31, 2019:

Grant Date	Expiry Date	Exercise Price	Opening Balance	Granted	Exercised	Forfeited	Closing Balance	Vested	Unvested
13-Jun-14	13-Jun-19	$2.00	35,001	-	(20,000)	(5,000)	10,001	10,001	-
26-Mar-15	26-Mar-20	$1.40	100,666	-	(16,667)	(5,000)	78,999	78,999	-
07-Mar-16	07-Mar-21	$1.13	124,997	-	(7,500)	(9,999)	107,498	107,498	-
23-Jun-16	23-Jun-21	$1.29	143,332	-	-	(13,332)	130,000	95,555	34,445
14-Sep-16	14-Sep-21	$2.29	30,000	-	-	-	30,000	20,000	10,000
08-Feb-17	08-Feb-22	$2.20	231,667	-	(3,334)	(10,000)	218,333	151,111	67,222
20-Jun-17	20-Jun-22	$2.47	383,500	-	(3,500)	(10,000)	370,000	124,333	245,667
25-Oct-17	25-Oct-22	$3.80	60,000	-	-	-	60,000	20,000	40,000
21-Dec-17	21-Dec-22	$4.65	187,500	-	-	(17,500)	170,000	62,500	107,500
18-Jan-18	24-Jan-23	$6.02	60,000	-	-	-	60,000	20,000	40,000
27-Sep-18	27-Sep-23	$8.50	155,000	-	-	(2,500)	152,500	-	152,500
22-Dec-18	22-Dec-23	$4.28	-	425,000	-	(5,000)	420,000	-	420,000
15-Mar-19	15-Mar-24	$5.03	-	182,500	-	-	182,500	-	182,500
			1,511,663	607,500	(51,001)	(78,331)	1,989,831	689,997	1,299,834
Weighted Average Exercise Price			$3.20	$4.51	$1.72	$2.76	$3.66	$2.24	$4.41

b) Fair value of options issued during the period

On March 15, 2019, 182,500 options with a weighted average fair value of $3.37 were granted. Trading price of the stock at the time of the grant was $5.03. 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 – 1.79%, dividend rate – NIL, volatility – 89.15% and an expected life of 5 years. The estimated forfeiture rate is 7.47%.

On December 22, 2018, 425,000 options with a weighted average fair value of $2.93 were granted. Trading price of the stock at the time of the grant was $4.28. 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 – 2.26%, dividend rate – NIL, volatility – 91.6% and an expected life of 5 years. The estimated forfeiture rate is 7.52%.

c) Share based payment expense

Total expense arising from share based payment transactions recognized during the three and six month periods ended March 31, 2019, as part of employee benefit expense was $491,694 (2018 - $394,262) and $819,110 (2018 - $651,822), respectively.

Expressed in Canadian Dollars

8. PROPERTY, PLANT AND EQUIPMENT

	Furniture and Fixtures ($)	Lab Equipment ($)	Leasehold Improvements ($)	Total ($)
Cost				
Balance at September 30, 2018	522,584	1,860,331	196,444	2,579,359
Additions	189,495	514,153	194,470	898,118
Acquisition	3,290	16,750	-	20,040
Foreign exchange	18,506	63,167	7,875	89,548
Balance at March 31, 2019	733,875	2,454,401	398,789	3,587,065
Accumulated depreciation				
Balance at September 30, 2018	343,868	961,285	113,005	1,418,158
Amortization	33,884	100,309	22,525	156,718
Foreign exchange	9,754	31,226	3,824	44,804
Balance at March 31, 2019	387,506	1,092,820	139,354	1,619,680
Carrying amounts				
At September 30, 2018	178,716	899,046	83,439	1,161,201
At March 31, 2019	**346,369**	**1,361,581**	**259,435**	**1,967,385**

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. The Company applies the simplified approach to providing for expected credit losses, which allows the use of a lifetime expected loss for all receivables. Receivables have been grouped based on shared credit risk characteristics and the days outstanding to measure the expected credit loss. On this basis the loss allowance at March 31, 2019, and September 30, 2018, is nominal.

Accounts receivable, and other receivables, are written off when there is no reasonable expectation of recovery which may be supported by failure to make contractual payments for more than 180 days as well as other factors.

The accounts receivable is 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, 2019, three customers accounted for 79% (2018 – 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.

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.

	Carrying amount ($)	**Future cash flows ($)**	**Less than 1 year ($)**	**Between 1 and 5 years ($)**	**Greater than 5 years ($)**
Accounts payable and accrued liabilities	6,294,447	6,294,447	6,294,447	-	-
Short-term debt	4,652,673	4,652,673	4,652,673	-	-
Long-term debt	4,022,308	4,022,308	-	4,022,308	-
Acquisition note payable	9,517,552	10,092,138	3,410,638	6,681,500	-
Total	**24,486,980**	**25,061,566**	**14,357,758**	**10,703,808**	-

Interest rate risk

The Company is subject to interest rate risk on its cash, cash equivalents and debt. The Company believes that interest rate risk is low due to market based variable interest rate. During fiscal 2019, the Company took on floating rate debt to fund the acquisition described in Note 3 and to fund working capital. At March 31, 2019, if interest rates had been 1% higher or lower then the interest expense would have been $38,112 higher or lower, respectively, during the period.

Currency risk

The Company's exposure to foreign currency risk at the end of the reporting period, expressed in Canadian dollars, was as follows:

	March 31, 2019				**September 30, 2018**			
Account	Canadian	USD	GBP	**Total**	Canadian	USD	GBP	**Total**
Cash	$189,761	$1,368,330	$253,641	**$1,811,732**	$1,859,740	$3,169,309	$454,038	**$5,483,087**
Accounts Receivable	-	$8,748,473	$51,934	**$8,800,407**	-	$5,115,641	$17,052	**$5,132,693**
Acquisition notes payable	-	$9,517,552	-	**$9,517,552**	-	-	-	**-**
Accounts Payable	$1,480,552	$4,080,798	$733,097	**$6,294,447**	$802,501	$3,454,104	$464,776	**$4,721,381**

Expressed in Canadian Dollars

10. CAPITAL MANAGEMENT

The Company defines capital that it manages as its shareholders' equity comprising share capital, contributed surplus, foreign exchange translation reserve, accumulated deficit, and debt. 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, 2019 is $22,017,109 (September 30, 2018 – $14,651,704).

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.

During the period this definition was updated to include debt in the definition above; however, the Company's overall strategy with respect to management of capital remains unchanged.

11. DEBT

During the year ended September 30, 2018, the Company 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 certain reporting requirements. These covenants include: 1) funded debt to adjusted EBIDTA; 2) fixed charged coverage ration; and, 3) current ratio. As of March 31, 2019, the Company was in compliance with all of the banking covenants.

A reconciliation of the operating line is as follows:

	March 31, 2019 ($)
Balance – October 1, 2018	1,526,928
Proceeds received	2,000,000
Interest during the period	54,642
Interest paid during the period	(54,642)
Repayment of principal	(326,928)
Balance – Ending	3,200,000
Less: Current portion	3,200,000
Non-current portion	-

As of March 31, 2019, the Company has $3,200,000 drawn and outstanding on the revolving operating line. This facility is repayable on demand by HSBC which could occur if there was a default on the financial covenants. The interest rate associated with the operating line is Prime Rate plus 1.0%. During the six month period ended March 31, 2019, the Company recognized $54,642 of interest expense on this loan.

Expressed in Canadian Dollars

A reconciliation of the acquisition line is as follows:

	March 31, 2019 ($)
Balance – October 1, 2018	-
Proceeds received	5,941,005
Repayments of principal	(480,000)
Interest during the period	120,726
Interest paid during the period	(120,726)
Accretion	13,976
Balance – Ending	5,474,981
Less: Current portion	1,452,673
Non-current portion	4,022,308

To facilitate the AquaGuard acquisition (discussed in Note 3) the Company drew funds against the acquisition facility. As of March 31, 2019, the Company has $5,520,000 drawn and outstanding on the acquisition line. The interest rate associated with this amount is Prime Rate plus 1.5% and the loan is repayable over a five-year period ending September, 2023. During the six month period ended March 31, 2019, the Company recognized $134,702 of interest and accretion expense on this loan.

12. RELATED PARTY TRANSACTIONS

Key management personnel includes the company’s directors and senior management team. These individuals are responsible for planning, directing and controlling the activities of an entity. Key management personnel compensation comprised:

	Three months ended March 31,		**Six months ended March 31,**	
	2019	2018	**2019**	2018
Compensation and short-term employee benefits	**$469,758**	$252,839	**$1,111,717**	$544,271
Share-based payments	**140,549**	184,706	**308,825**	305,174
	$610,307	$437,545	**$1,420,542**	$849,445

Expressed in Canadian Dollars

13. EXPENSES BY NATURE

The condensed consolidated interim statements of operations and comprehensive income (loss) include the following expenses by nature:

a) Employee costs

	Three months ended March 31,		Six months ended March 31,	
	2019	2018	**2019**	2018
Short-term wages & benefits, commissions, contract and director fees	**$4,204,951**	1,724,456	**$7,883,699**	$3,392,877
Share based payments	**491,694**	394,262	**819,110**	651,822
Total employee costs	**$4,696,645**	2,118,718	**$8,702,809**	$4,044,699
Included in				
Cost of product sales	**186,940**	189,917	**750,145**	377,295
Operations	**253,147**	235,468	**393,954**	493,949
Research and development activities	**264,186**	294,207	**544,882**	525,186
Sales, marketing and agency fees	**2,535,951**	575,669	**4,313,304**	1,172,767
General and administrative	**1,456,421**	823,457	**2,700,524**	1,475,502
Total employee costs	**$4,696,645**	2,118,718	**$8,702,809**	$4,044,699

b) Depreciation and amortization

	For the three months ended March 31,		For the six months ended March 31,	
	2019	2018	**2019**	2018
Cost of product sales	**$61,732**	$51,698	**$134,043**	$100,472
Operations	**588**	1,234	**2,069**	2,474
Research and development activities	**9,820**	2,540	**18,794**	5,093
General and administrative	**62,860**	21,437	**97,627**	43,280
Total depreciation and amortization	**$135,000**	$76,909	**$252,533**	$151,319

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 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.

Expressed in Canadian Dollars

Shares issued and outstanding at March 31, 2019 were 22,238,159 (September 30, 2018 – 22,009,130). The weighted average number of shares outstanding during the period were 22,193,467 (March 31, 2018– 21,493,584).

For the six months ended March 31, 2019, the computation of diluted loss per share is equal to the basic loss per share due to the anti-dilutive effect of the stock options and warrants.

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

Potentially dilutive securities	**March 31, 2019**	March 31, 2018
Common shares potentially dilutive		
- under stock options	**757,461**	996,356
- under warrants	**625,499**	604,126
Total dilutive shares	**1,382,960**	1,600,482

15. 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 payments for the next five years are as follows:

Year	Annual Commitment
2019	347,421
2020	584,069
2021	600,402
2022	591,304
2023	579,742
Thereafter	$1,227,670

16. OPERATING SEGMENTS

During the three months ended March 31, 2019, there was one customer who individually accounted for approximately 46% of revenue (2018 – approximately 61%). As the Company has historically operated with distribution partners in geographic areas, the revenue by geography is regularly reviewed by management. The Company generated revenue of $6,900,139 (2018 – $1,475,980) in the US, $6,187,052 (2018 – $4,102,509) in the Middle East, $6,898 (2018 – $4,098) in Canada, and $218,454 (2018 – $144,688) in the rest of the world.

During the six months ended March 31, 2019, there was one customer who individually accounted for approximately 38% of revenue (2018 – approximately 53%). The Company generated revenue of $12,403,731 (2018 – $3,716,180) in the US, $7,777,462 (2018 – $8,041,966) in the Middle East, $17,630 (2018 – $9,590) in Canada, and $375,206 (2018 – $364,244) in the rest of the world.

As of March 31, 2019, the Company had $2,961,446 (66%) of its property, plant, and equipment, and intangible assets located in Canada and the remainder in the rest of the world. Goodwill in the amount of $12,576,988 is attributed to the acquired business operated in the US.

Expressed in Canadian Dollars

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. CHANGES IN NON-CASH WORKING CAPITAL ITEMS

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

	Six months ended March 31,	
	2019	2018
Accounts receivable	**$(1,713,834)**	$(1,811,687)
Prepaid expenses	**518,961**	(329,479)
Inventories	**(3,683,919)**	(817,135)
Accounts payable and accrued liabilities	**1,434,662**	49,962
Deferred revenue	**261,930**	(264,407)
Deferred rent	**2,051**	1,231
	$(3,180,149)	$(3,171,515)