

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

For the three and nine months ended June 30, 2019 and 2018

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

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

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

	June 30, 2019	September 30, 2018
Assets		
Current assets		
Cash and cash equivalents	\$1,144,489	\$5,483,087
Accounts receivable	6,915,192	5,132,693
Inventories (Note 5)	8,818,151	5,564,539
Prepaid expenses	463,426	959,915
Total current assets	17,341,258	17,140,234
Non-current assets		
Restricted cash	36,789	36,052
Property, plant and equipment (Note 8)	2,016,581	1,161,201
Intangible assets (Note 4)	2,404,731	1,370,346
Goodwill (Note 4)	12,317,223	-
Total non-current assets	16,775,324	2,567,599
Total assets	\$34,116,582	\$19,707,833
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable and accrued liabilities	\$5,371,330	\$4,721,381
Short-term debt (Note 11)	8,367,436	1,526,928
Acquisition note payable (Note 3)	3,298,131	-
Deferred revenue	437,180	206,811
Total current liabilities	17,474,077	6,455,120
Non-current liabilities		
Deferred revenue	196,305	-
Deferred rent	131,321	127,937
Acquisition note payable (Note 3)	6,141,724	-
Total non-current liabilities	6,469,350	127,937
Total liabilities	23,943,427	6,583,057
Shareholders' equity		
Share capital (Note 6)	40,806,217	39,257,032
Contributed surplus (Note 6)	6,785,353	5,572,839
Foreign exchange translation reserve	(166,661)	(76,114)
Accumulated deficit	(37,251,754)	(31,628,981)
Total shareholders' equity	10,173,155	13,124,776
Total liabilities and shareholders' equity	\$34,116,582	\$19,707,833

On behalf of the Board:

(signed) "Abe Schwartz"

(signed) "Brian Pedlar"

Director

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 INCOME
(LOSS) (UNAUDITED)

Expressed in Canadian Dollars

	Three months ended		Nine months ended	
	2019	June 30, 2018	2019	June 30, 2018
Revenue				
Product	\$6,360,385	\$3,074,374	\$24,825,379	\$14,128,387
Development and consulting services	411,740	295,089	2,063,655	1,022,042
Licensing and royalty fees	81,867	4,564,213	538,987	4,915,227
Total revenue	6,853,992	7,933,676	27,428,021	20,065,656
Cost of product sales	2,815,107	1,426,748	9,541,006	4,684,692
Gross profit before operating expenses	4,038,885	6,506,928	17,887,015	15,380,964
Operating expenses				
Operations	474,607	584,364	1,382,394	1,491,462
Research and development activities	364,919	366,033	1,135,018	1,109,845
Sales, marketing and agency fees	3,451,188	1,511,262	12,371,567	6,156,287
General and administrative	3,027,164	1,846,802	7,962,769	4,380,640
	7,317,878	4,308,461	22,851,748	13,138,234
Financing expenses				
Finance cost	202,142	-	658,040	-
Net income (loss)	\$(3,481,135)	\$2,198,467	\$(5,622,773)	\$2,242,730
Other comprehensive income (loss)				
Foreign currency translation adjustment	(270,738)	264,201	(90,547)	602,160
Other comprehensive income (loss)	\$(3,751,873)	\$2,462,688	\$(5,713,320)	\$2,844,890
Basic earnings (loss) per share (Note 14)	\$(0.16)	\$0.10	\$(0.25)	\$0.10
Diluted earnings (loss) per share (Note 14)	\$(0.16)	\$0.09	\$(0.25)	\$0.10

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	-	982,870	-	-	982,870
Exercise of stock options	358,605	(171,351)	-	-	187,254
Issue common shares (Note 6)	205,330	-	-	-	205,330
Net income for the period	-	-	2,242,730	-	2,242,730
Foreign currency translation adjustment	-	-	-	602,160	602,160
Balance at June 30, 2018	\$38,443,270	\$5,612,335	\$(31,003,899)	\$149,725	\$13,201,431
Balance at October 1, 2018	\$39,257,032	\$5,572,839	\$(31,628,981)	\$(76,114)	\$13,124,776
Share based payment expense	-	1,333,258	-	-	1,333,258
Exercise of stock options and warrants	277,284	(120,744)	-	-	156,540
Issuance of common shares on acquisition (Note 3)	1,271,901	-	-	-	1,271,901
Net loss for the period	-	-	(5,622,773)	-	(5,622,773)
Foreign currency translation adjustment	-	-	-	(90,547)	(90,547)
Balance at June 30, 2019	\$40,806,217	\$6,785,353	\$(37,251,754)	\$(166,661)	\$10,173,155

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 nine months ended June 30,	
	2019	2018
Cash flows from operating activities		
Net (loss) income for the period	\$(5,622,773)	\$2,242,730
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation - property, plant and equipment	291,107	157,991
Amortization - intangible assets	148,827	116,970
Share-based payments	1,333,258	982,870
Interest expense and accretion	658,040	-
Foreign exchange gain (loss) on cash held	59,865	(20,714)
Cash generated by operating activities before change in non-cash working capital balances	(3,131,676)	3,479,847
Change in non-cash working capital (Note 18)	(855,445)	(5,948,889)
Total cash flows from operating activities	(3,987,121)	(2,469,042)
Cash flows from investing activities		
Purchase of property, plant and equipment	(1,103,757)	(616,904)
Purchase of intangible assets	(19,943)	(13,610)
Acquisition of AquaGuard	(5,506,652)	-
Restricted cash	(334)	(20)
Total cash flows from investing activities	(6,630,686)	(630,534)
Cash flows from financing activities		
Exercise of stock options and warrants (Note 6)	156,540	392,584
Interest paid	(279,208)	-
Repayment of debt	(1,106,928)	-
Proceeds from debt	7,510,972	-
Total cash flows from financing activities	6,281,376	392,584
Foreign exchange rate changes on cash	(2,167)	272,536
Total cash flows during the period	(4,338,598)	(2,434,456)
Cash and cash equivalents, beginning of the period	\$5,483,087	\$4,155,883
Cash and cash equivalents, end of the period	\$1,144,489	\$1,721,427

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

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NOTES TO THE CONDENSED CONSOLIDATED INTERIM STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three and nine months ended June 30, 2019 and 2018

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 nine months ended June 30, 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 August 26, 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

Covalon Technologies Ltd.

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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.

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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.

IFRS 9 – Financial Instruments

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.

FINANCIAL ASSETS

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.

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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:

<u>Instrument</u>	<u>Classification under IAS 39</u>	<u>Classification under IFRS 9</u>
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 June 30, 2019.

e) **Critical accounting estimates and judgements**

Accounting for Acquisitions

The Company assesses whether an acquisition should be accounted for as an asset acquisition or a business combination under IFRS 3. This assessment requires management to assess 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

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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.

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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:

<u>Assets acquired and liabilities assumed</u>	
Accounts receivable	\$1,385,029
Prepays	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.

<u>Consideration paid or payable</u>	
<i>At closing</i>	
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
<i>Post closing</i>	
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	356,484
Foreign exchange	192,890
Balance at June 30, 2019	9,439,855

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

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During the nine month period from October 1, 2018 to June 30, 2019, there was revenue of \$9,872,772 and a net loss and comprehensive loss of \$(1,244,946) 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 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	267,296
Balance at June 30, 2019	12,317,223

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	23,360	24,140	10,624	929	1,434	60,487
Balance at June 30, 2019	2,182,618	1,112,395	953,281	82,123	174,631	4,505,048
Accumulated amortization						
Balance at September 30, 2018	1,453,216	-	333,075	-	145,038	1,931,329
Amortization	83,143	21,185	40,630	-	3,869	148,827
Foreign exchange	14,657	(326)	4,310	-	1,520	20,161
Balance at June 30, 2019	1,551,016	20,859	378,015	-	150,427	2,100,317
Carrying amounts						
At September 30, 2018	706,042	-	584,187	77,783	2,334	1,370,346
At June 30, 2019	631,602	1,091,536	575,266	82,123	24,204	2,404,731

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5. INVENTORIES

Inventories consist of the following:

	June 30, 2019	September 30, 2018
Raw materials	\$2,360,556	\$1,546,489
Finished goods	6,457,595	4,018,050
	<u>\$8,818,151</u>	<u>\$5,564,539</u>

Cost of product sales for the three and nine-month periods ended June 30, 2019 include \$2,215,876 (2018 - \$1,339,423) and \$8,630,288 (2018 - \$4,443,863), 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 June 30, 2019:

	Number of Shares (#)	Amount (\$)
Balance at September 30, 2018	22,009,130	39,257,032
Options exercised	77,669	247,844
Warrants exercised	12,800	29,440
Shares issued as consideration for acquisition	178,028	1,271,901
Balance at June 30, 2019	<u>22,277,627</u>	<u>40,806,217</u>

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.

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The following is a summary of changes in options from October 1, 2018 to June 30, 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	-	(30,000)	(5,001)	-	-	-
26-Mar-15	26-Mar-20	\$1.40	100,666	-	(21,667)	(5,000)	73,999	73,999	-
7-Mar-16	7-Mar-21	\$1.13	124,997	-	(12,498)	(10,000)	102,499	102,499	-
23-Jun-16	23-Jun-21	\$1.29	143,332	-	(6,668)	(14,998)	121,666	121,666	-
14-Sep-16	14-Sep-21	\$2.29	30,000	-	-	-	30,000	20,000	10,000
8-Feb-17	8-Feb-22	\$2.20	231,667	-	(3,334)	(10,000)	218,333	151,110	67,223
20-Jun-17	20-Jun-22	\$2.47	383,500	-	(3,500)	(10,000)	370,000	252,166	117,834
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	-	-	(7,500)	147,500	-	147,500
22-Dec-18	22-Dec-23	\$4.28	-	425,000	-	(35,000)	390,000	-	390,000
15-Mar-19	15-Mar-24	\$5.03	-	182,500	-	-	182,500	-	182,500
			1,511,663	607,500	(77,667)	(114,999)	1,926,497	823,940	1,102,557
Weighted Average Exercise Price			\$3.20	\$4.51	\$1.66	\$3.39	\$3.66	\$2.26	\$4.71

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 nine month periods ended June 30, 2019, as part of employee benefit expense were \$514,148 (2018 - \$331,048) and \$1,333,258 (2018 - \$982,870), respectively.

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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	293,824	526,596	283,337	1,103,757
Acquisition	3,290	16,750	-	20,040
Foreign exchange	15,524	(10,216)	2,288	7,596
Balance at June 30, 2019	835,222	2,393,461	482,069	3,710,752
Accumulated depreciation				
Balance at September 30, 2018	343,868	961,285	113,005	1,418,158
Depreciation	65,985	190,232	34,890	291,107
Foreign exchange	(7,711)	(6,705)	(678)	(15,094)
Balance at June 30, 2019	402,142	1,144,812	147,217	1,694,171
Carrying amounts				
At September 30, 2018	178,716	899,046	83,439	1,161,201
At June 30, 2019	433,080	1,248,649	334,852	2,016,581

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 June 30, 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 June 30, 2019, three customers accounted for 62% (2018 – three customers for 87%) 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.

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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	5,371,330	5,371,330	5,371,330	-	-
Short-term debt	8,367,436	8,367,436	8,367,436	-	-
Acquisition note payable	9,439,855	9,699,631	3,298,131	6,401,500	-
Total	23,178,621	23,438,397	17,036,897	6,401,500	-

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 June 30, 2019, if interest rates had been 1% higher or lower then the interest expense would have been \$62,756 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:

<u>Account</u>	<u>June 30, 2019</u>				<u>September 30, 2018</u>			
	<u>Canadian</u>	<u>USD</u>	<u>GBP</u>	<u>Total</u>	<u>Canadian</u>	<u>USD</u>	<u>GBP</u>	<u>Total</u>
Cash	\$298,601	\$726,979	\$118,909	\$1,144,489	\$1,859,740	\$3,169,309	\$454,038	\$5,483,087
Accounts Receivable	-	\$6,878,629	\$36,563	\$6,915,192	-	\$5,115,641	\$17,052	\$5,132,693
Acquisition notes payable	-	\$9,439,855	-	\$9,439,855	-	-	-	-
Accounts Payable	\$1,550,566	\$3,344,953	\$475,811	\$5,371,330	\$802,501	\$3,454,104	\$464,776	\$4,721,381

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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 June 30, 2019 is \$18,540,591 (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 ratio; and, 3) current ratio. As of June 30, 2019, the Company was not able to fulfill all financial covenants as stipulated under the Facility, for the acquisition line, which constituted an event of default. Since the Company did not have an unconditional right to defer the settlement of the debt for at least 12 months, IFRS requires the liability to be classified as current as at June 30, 2019. The carrying amount of the debt is \$5,167,346 as of June 30, 2019.

A reconciliation of the operating line is as follows:

	June 30, 2019 (\$)
Balance – October 1, 2018	1,526,928
Proceeds received	2,000,000
Interest during the period	91,576
Interest paid during the period	(91,576)
Repayment of principal	(326,928)
Balance – Ending	3,200,000
Less: Current portion	3,200,000
Non-current portion	-

As of June 30, 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 nine month period ended June 30, 2019, the Company recognized \$91,576 of interest expense on this loan.

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A reconciliation of the acquisition line is as follows:

	<u>June 30, 2019 (\$)</u>
Balance – October 1, 2018	-
Proceeds received	5,941,005
Repayments of principal	(780,000)
Interest during the period	187,632
Interest paid during the period	(201,608)
Accretion	20,407
Balance – Ending	<u>5,167,346</u>
Less: Current portion	5,167,346
Non-current portion	<u>-</u>

To facilitate the AquaGuard acquisition (discussed in Note 3) the Company drew funds against the acquisition facility. As of June 30, 2019, the Company has \$5,220,000 drawn and outstanding on the acquisition line. During the nine month period ended June 30, 2019, the Company recognized \$208,039 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		Nine months ended	
	2019	June 30, 2018	2019	June 30, 2018
Compensation and short term employee benefits	<u>\$628,048</u>	\$537,078	<u>\$1,739,765</u>	\$1,081,508
Share-based payments	<u>202,250</u>	179,971	<u>500,058</u>	485,144
	<u>\$830,298</u>	<u>\$717,049</u>	<u>\$2,239,823</u>	<u>\$1,566,652</u>

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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		Nine months ended	
	June 30,		June 30,	
	2019	2018	2019	2018
Short-term wages & benefits, commissions, contract and director fees	\$4,147,889	\$2,172,805	\$12,031,588	\$5,565,682
Share based payments	514,148	331,048	1,333,258	982,870
Total employee costs	\$4,662,037	2,503,853	\$13,364,846	6,548,552
Included in				
Cost of product sales	111,587	250,408	861,732	627,703
Operations	296,715	295,363	690,669	789,312
Research and development activities	280,960	233,149	825,842	758,335
Sales, marketing and agency fees	2,302,710	666,064	6,616,014	1,838,831
General and administrative	1,670,065	1,058,869	4,370,589	2,534,371
Total employee costs	\$4,662,037	\$2,503,853	\$13,364,846	\$6,548,552

b) Depreciation and amortization

	For the three months ended		For the nine months ended	
	June 30,		June 30,	
	2019	2018	2019	2018
Cost of product sales	\$108,271	\$87,324	\$242,314	\$187,796
Operations	1,087	1,259	3,156	3,733
Research and development activities	8,456	3,464	27,250	8,557
General and administrative	69,586	31,594	167,214	74,874
Total depreciation and amortization	\$187,400	\$123,641	\$439,934	\$274,960

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.

Shares issued and outstanding at June 30, 2019 were 22,277,627 (September 30, 2018 – 22,009,130). The weighted average number of shares outstanding during the nine month period was 22,214,537 (June 30,

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2018– 21,516,767). The weighted average number of shares outstanding during the three month period was 22,244,276 (June 30, 2018 – 21,549,487)

For the nine months ended June 30, 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	June 30, 2019	June 30, 2018
Common shares potentially dilutive		
- under stock options	722,954	1,002,969
- under warrants	612,564	637,538
Total dilutive shares	1,335,518	1,640,507

15. COMMITMENTS

The Company has signed lease agreements for three locations in Mississauga, Ontario and one in each of: Shanghai, China; Leicestershire, United Kingdom; and, Seattle Washington. 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:

<u>Year</u>	<u>Annual Commitment</u>
2019	174,130
2020	584,069
2021	600,402
2022	591,304
2023	579,742
Thereafter	\$1,227,670

16. OPERATING SEGMENTS

During the three months ended June 30, 2019, there was one customer who individually accounted for approximately 14% 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 \$5,631,610 (2018 – \$6,422,438) in the US, \$793,855 (2018 – \$1,269,724) in the Middle East, \$7,076 (2018 – \$4,382) in Canada, and \$421,451 (2018 – \$237,132) in the rest of the world.

During the nine months ended June 30, 2019, there was one customer who individually accounted for approximately 31% of revenue (2018 – approximately 37%). The Company generated revenue of \$18,035,344 (2018 – \$10,119,716) in the US, \$8,571,317 (2018 – \$9,311,690) in the Middle East, \$24,706 (2018 – \$13,972) in Canada, and \$769,654 (2018 – \$620,278) in the rest of the world.

As of June 30, 2019, the Company had \$2,957,796 (67%) of its property, plant, and equipment, and intangible assets located in Canada and the remainder in the rest of the world. Goodwill for the amount of \$12,317,223 is attributed to the acquired business operated in the US.

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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:

	Nine months ended June 30,	
	<u>2019</u>	<u>2018</u>
Accounts receivable	\$(11,677)	\$(4,385,580)
Prepaid expenses	548,744	(12,414)
Inventories	(2,483,827)	(1,378,156)
Accounts payable and accrued liabilities	659,828	78,179
Deferred revenue	429,436	(253,522)
Deferred rent	2,051	2,605
	<u>\$(855,445)</u>	<u>\$(5,948,889)</u>

19. SUBSEQUENT EVENTS

Subsequent to June 30, 2019, 791,051 warrants were exercised for common shares of the Company for aggregate proceeds of \$1,819,417. Included in this amount, related parties exercised 625,000 warrants for common shares of the Company for aggregate proceeds of \$1,437,500.

On August 1, 2019, Covalon announced that the Company intends to raise up to an aggregate of \$6,275,000 in one or more closings of a private placement. The raise will consist of units comprised of one share at \$2.51 and one warrant which will entitle the holder to acquire an additional common share at a price of \$2.95 per share for a period of five years from the applicable closing date. Proceeds of the Offering will be used by Covalon for general working capital, to expand international distribution channels, and develop and commercialize new products. The raise is subject to TSX-V final approval and will comply with applicable rules and guidelines.