

# Covalon Technologies Ltd.

## CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

For the three months ended March 31, 2021 and 2020

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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 FINANCIAL STATEMENTS OF FINANCIAL POSITION (UNAUDITED)  
Expressed in Canadian Dollars

	March 31, 2021	September 30, 2020
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$3,794,509	\$3,506,991
Accounts receivable	4,171,235	3,333,437
Inventories (Note 4)	6,349,545	7,199,774
Prepaid expenses	629,647	809,404
<b>Total current assets</b>	<b>14,944,936</b>	<b>14,849,606</b>
<b>Non-current assets</b>		
Restricted cash	37,027	37,309
Property, plant and equipment (Note 6)	1,619,902	1,824,959
Intangible assets (Note 5)	1,921,518	2,151,274
Right-of-use assets (Note 8)	2,400,432	2,815,724
Goodwill (Note 5)	12,272,482	13,018,102
<b>Total non-current assets</b>	<b>18,251,361</b>	<b>19,847,368</b>
<b>Total assets</b>	<b>\$33,196,297</b>	<b>\$34,696,974</b>
<b>Liabilities and shareholders' equity</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	\$3,924,432	\$3,899,266
Short-term debt (Note 7)	8,057,066	7,649,027
Lease liabilities (Note 9)	518,471	516,372
Acquisition note payable (Note 2)	9,497,017	10,074,013
Deferred revenue	378,728	498,149
<b>Total current liabilities</b>	<b>22,375,714</b>	<b>22,636,827</b>
<b>Non-current liabilities</b>		
Deferred revenue	216,919	290,123
Lease liabilities (Note 9)	2,308,281	2,663,346
<b>Total non-current liabilities</b>	<b>2,525,200</b>	<b>2,953,469</b>
<b>Total liabilities</b>	<b>24,900,914</b>	<b>25,590,296</b>
<b>Shareholders' equity</b>		
Share capital (Note 10)	44,607,119	44,607,119
Contributed surplus (Note 10)	11,857,327	11,652,765
Foreign exchange translation reserve	(499,466)	565,772
Accumulated deficit	(47,669,597)	(47,718,978)
<b>Total shareholders' equity</b>	<b>8,295,383</b>	<b>9,106,678</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$33,196,297</b>	<b>\$34,696,974</b>

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 FINANCIAL STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS) (UNAUDITED)

Expressed in Canadian Dollars

	Three months ended March 31,		Six months ended March 31,	
	2021	2020	2021	2020
<b>Revenue</b>				
Product	\$6,376,359	\$4,626,805	\$11,762,431	\$11,801,448
Development and consulting services	315,145	599,893	856,895	1,333,021
Licensing and royalty fees	49,756	31,874	110,346	72,662
<b>Total revenue</b>	<b>6,741,260</b>	5,258,572	<b>12,729,672</b>	13,207,131
<b>Cost of sales</b>	<b>3,098,870</b>	2,466,453	<b>5,501,754</b>	5,579,228
<b>Gross profit before operating expenses</b>	<b>3,642,390</b>	2,792,119	<b>7,227,918</b>	7,627,903
<b>Operating expenses</b>				
Operations	259,511	530,146	517,994	991,080
Research and development activities	327,948	223,346	545,176	448,651
Sales, marketing and agency fees	1,046,937	2,323,469	2,663,805	5,235,961
General and administrative	1,468,944	3,398,075	3,215,216	5,584,121
	<b>3,103,340</b>	6,475,036	<b>6,942,191</b>	12,259,813
<b>Finance expenses</b>	<b>117,326</b>	225,705	<b>236,346</b>	451,445
<b>Net income (loss)</b>	<b>\$421,724</b>	\$(3,908,622)	<b>\$49,381</b>	\$(5,083,355)
<b>Other comprehensive income (loss)</b>				
<b>Amount that may be reclassified to profit or loss</b>				
Foreign currency translation adjustment	(215,101)	1,770,263	(1,065,238)	1,359,110
<b>Total comprehensive income (loss)</b>	<b>\$206,623</b>	\$(2,138,359)	<b>\$(1,015,857)</b>	\$(3,724,245)
Basic earnings (loss) per share (Note 16)	\$0.02	\$(0.15)	\$0.00	\$(0.20)
Diluted earnings (loss) per share (Note 16)	\$0.02	\$(0.15)	\$0.00	\$(0.20)

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

## Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM STATEMENT OF CHANGES IN EQUITY (UNAUDITED)

Expressed in Canadian Dollars

	Number of shares	Share capital	Contributed surplus	Accumulated deficit	Foreign exchange translation reserve	Total
<b>Balance at October 1, 2019</b>	25,818,677	\$44,607,119	\$10,717,141	\$(40,766,754)	\$372,612	\$14,930,118
Share-based payment expense	-	-	618,876	-	-	618,876
Net loss for the period	-	-	-	(5,083,355)	-	(5,083,355)
Foreign currency translation adjustment	-	-	-	-	1,359,110	1,359,110
<b>Balance at March 31, 2020</b>	<b>25,818,677</b>	<b>\$44,607,119</b>	<b>\$11,336,017</b>	<b>\$(45,850,109)</b>	<b>\$1,731,722</b>	<b>\$11,824,749</b>
<b>Balance at October 1, 2020</b>	25,818,677	\$44,607,119	\$11,652,765	\$(47,718,978)	\$565,772	\$9,106,678
Share-based payment expense	-	-	204,562	-	-	204,562
Net loss for the period	-	-	-	49,381	-	49,381
Foreign currency translation adjustment	-	-	-	-	(1,065,238)	(1,065,238)
<b>Balance at March 31, 2021</b>	<b>25,818,677</b>	<b>\$44,607,119</b>	<b>\$11,857,327</b>	<b>\$(47,669,597)</b>	<b>\$(499,466)</b>	<b>\$8,295,383</b>

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

	<b>Three months ended March 31,</b>	
	<b>2021</b>	<b>2020</b>
<b>Cash flows from (used in) operating activities</b>		
Net loss for the period	<b>\$49,381</b>	\$(5,083,355)
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation of property, plant and equipment	<b>208,928</b>	217,879
Amortization of intangible assets	<b>108,829</b>	112,929
Depreciation - right of use assets (Note 8)	<b>255,746</b>	244,846
Share-based payment expense (Note 11)	<b>204,562</b>	618,876
Interest expense and accretion	<b>236,346</b>	451,445
Cash generated by operating activities before change in non-cash working capital balances	<b>1,063,792</b>	(3,437,380)
Change in non-cash working capital (Note 19)	<b>(478,229)</b>	(1,111,514)
<b>Total cash flows generated from (used in) operating activities</b>	<b>585,563</b>	(4,548,894)
<b>Cash flows from (used in) investing activities</b>		
Purchase of property, plant and equipment	<b>(91,031)</b>	(251,126)
Restricted cash	<b>(282)</b>	2,204
<b>Total cash flows used in investing activities</b>	<b>(91,313)</b>	(248,922)
<b>Cash flows from financing activities</b>		
Interest paid	<b>(154,392)</b>	(204,760)
Repayment of debt	<b>(600,000)</b>	(765,000)
Proceeds from debt	<b>1,000,000</b>	-
Payment of lease liabilities	<b>(316,248)</b>	(259,249)
<b>Total cash flows used in financing activities</b>	<b>(70,640)</b>	(1,229,009)
Foreign exchange rate changes on cash	<b>(136,092)</b>	301,738
<b>Total cash flows during the period</b>	<b>287,518</b>	(5,725,087)
<b>Cash and cash equivalents, beginning of the period</b>	<b>\$3,506,991</b>	\$9,575,149
<b>Cash and cash equivalents, end of the period</b>	<b>\$3,794,509</b>	\$3,850,062

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

# Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three and six months ended March 31, 2021 and 2020

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## 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, 2021 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, distribution contracts, and sales of products.

The Company is listed on the TSX Venture Exchange, having the symbol COV. The Company also trades on the OTCQX Best Market, having the symbol of CVALF.

The address of the Company’s corporate office and principal place of business is 1660 Tech Avenue, Unit 5, Mississauga, Ontario, Canada.

## 2. GOING CONCERN AND COVID-19

### Going Concern

The Company’s unaudited condensed consolidated interim financial statements have been prepared on a going concern basis which presumes that the Company will continue in operation for the foreseeable future and will be able to realize assets and discharge liabilities in the normal course of its operations.

Related to the fiscal 2019 acquisition of AquaGuard, the Company entered into an Acquisition Note Payable (“Acquisition Note”), with the prior owners of the AquaGuard assets (“Vendor”) pursuant to which milestone payments of \$7.5 million USD have become due. The Company had intended to fund the Acquisition Note milestone payments through the Acquisition Line Facility (“Facility”) with HSBC Bank Canada (“HSBC”), the Company’s primary secured lender.

Consistent with September 30, 2020, at March 31, 2021, the Company was prohibited from making a payment on the Acquisition Note using funds made available under the Facility as originally intended in order to meet the commitments to the Vendor. The Company was also unable to use cash on hand to make the payment to the Vendor without being offside on covenant calculations.

During the six months ended March 31, 2021, the Company drew \$1,000,000 against the Business Credit Availability Program (“BCAP”) with the Business Development Bank of Canada (“BDC”) facility through HSBC. This facility is interest-only until July 2021 and then is repayable over a four-year term by equal monthly payments.

When entering into the purchase and banking agreements described above, the Company, the Vendor, and HSBC entered into a subordination agreement which provides that no Acquisition Note amounts will be due if the Company is in breach of the Facility agreement. The Vendor can only make a claim against the Company for non-payment under the Acquisition Note in accordance with the terms of the subordination agreement. The Acquisition Note, as outlined in the subordination agreement, is unconditionally and irrevocably deferred, postponed and subordinated in all respects until repayment in full has been made to HSBC, and therefore the Vendor currently has no recourse under the subordination agreement. The Company continues to repay the Facility with HSBC in accordance with the terms and conditions of the Facility, which is currently scheduled to be fully repaid by June 2025.

As of March 31, 2021, the Company did not meet certain covenants related to the Facility with HSBC under the original Facility agreement. Subsequent to March 31, 2021 the Company obtained a waiver from HSBC related

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM STATEMENTS (UNAUDITED)

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to the covenant breaches as of the quarter end. The Company is currently forecasting that it may not meet all of these covenants at various times in Fiscal 2021 but the Company continues to repay the HSBC Facility in accordance with its term and conditions and the Vendor currently has no recourse under the subordination agreement. Should the Company not be successful in obtaining future waivers the Company would be in default of the Facility and HSBC could request repayment of principal and interest at any time. While the Company has a history of requesting and obtaining waivers, no assurances can be provided that the company will be able to continue to obtain waivers and therefore payment may be demanded on the outstanding loan amounts which results in a material uncertainty that may cast significant doubt upon the Company's ability to continue as a going concern and whether assets will be realized and liabilities extinguished in the normal course of business at the amounts stated on the consolidated financial statements. While the Company believes that based on cash on hand and amounts available under the HSBC operating line, it has sufficient future cash flow to support its operating needs for the near future, without access to remaining funds from the Facility, the Company may not generate sufficient operating cash flows to be able to repay the Acquisition Note, should it become due and payable without refinancing this liability, or through the issuance of additional equity of the Company.

On March 25, 2021, the Company and the Vendor entered into a call option agreement that allows the Company to settle, at its option, on or before October 1, 2021, the US\$7.5 million Acquisition Note for a payment of US\$4 million and, subject to the approval of the TSX Venture Exchange ("TSX-V"), the issuance of 200,000 common share purchase warrants with an exercise price of \$4.00. The exercise of the call option by the Company under the call option agreement is conditional on approval from HSBC. If the call option is not exercised and settled by October 1, 2021, then the Company remains obligated to settle the US\$7.5 million Acquisition Note in accordance with its original terms.

To address the future payments required the Company: a) has been in negotiations with the Vendor to renegotiate the terms of the Acquisition Note – including the call option signed March 25, 2021; b) is in discussions with HSBC to obtain waivers on its covenants for future quarters; and, c) has initiated a strategic review process to evaluate ways to enhance shareholder value and determine the highest and best use of the assets of the Company.

The Company generated a net income of \$49,381 for the six months ended March 31, 2021 (2020 – net loss of \$5,083,355) and cash generated in operating activities was \$585,563 (2020 - \$4,548,894) for the same period. As of March 31, 2021, the Company had \$3,794,509 of cash (September 30, 2020 – \$3,506,991) and intends to operate its business and satisfy its obligations as they come due in the ordinary course of business.

These consolidated financial statements do not reflect the adjustments to the carrying values of assets and liabilities or the reported expenses and consolidated statements of financial position classifications that would be necessary if the going concern assumption were inappropriate, and these adjustments could be material.

	<b>Carrying amount (\$)</b>	<b>Future cash flows (\$)</b>	<b>Less than 1 year (\$)</b>	<b>Between 1 and 5 years (\$)</b>	<b>Greater than 5 years (\$)</b>
Accounts payable and accrued liabilities	3,924,432	3,924,432	3,924,432	-	-
Short-term debt	8,057,066	8,057,066	8,057,066	-	-
Acquisition note payable	9,497,017	9,497,017	9,497,017	-	-
Lease liabilities	2,826,752	3,244,735	638,400	2,478,050	128,285
<b>Total</b>	<b>24,305,267</b>	<b>24,723,250</b>	<b>22,116,915</b>	<b>2,478,050</b>	<b>128,285</b>



# Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three and six months ended March 31, 2021 and 2020

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## COVID-19

In March 2020, the World Health Organization characterized the outbreak of the novel strain of coronavirus, specifically identified as COVID-19, as a global pandemic. In response to the outbreak, governmental authorities in Canada and internationally have introduced various recommendations and measures to try to limit the pandemic, including travel restrictions, border closures, non-essential business closures, quarantines, self-isolations, shelters-in-place, and social distancing. The governmental responses have caused material disruption to business globally, economic slowdowns, and shifts in economic markets. The significant uncertainty related to the virus, and the governmental responses, has negatively impacted the Company's suppliers, as well as customers and their demand for our products and services.

During the six months ended March 31, 2021, the Company applied for and was approved for funding of \$338,862 (2020 - \$nil) under the Canadian Emergency Wage Subsidy Program ("CEWS"). The Company applied for, and received, US\$1,103,860 in a second draw of the United States Paycheck Protection Program loan ("US PPP Loan") from the US Small Business Administration under the US Paycheck Protection Program. The US PPP Loan will be forgiven if certain conditions are met (including the funds being used for eligible payroll and rent expenses during the eligibility period) and a loan forgiveness application is completed. Amounts received but not yet used to offset eligible expenses were recorded as a liability and at March 31, 2021 this was US\$342,400 (2020 - \$nil). Any ineligible portion of the US PPP Loan will otherwise carry interest of 1%. The Company also received funds from other subsidy programs of \$43,093 during the six months ended March 31, 2021.

Subsequent to March 31, 2021 the Company's first draw of the US PPP Loan was forgiven by the Small Business Administration. The full amount of US\$1,103,861 and all related interest has been forgiven with no repayments required.

Operationally, the Company has been negatively impacted by the COVID-19 pandemic, and the efforts to mitigate the pandemic, as have many of the Company's employees, customers, and vendors regardless of geographic location. The Company's direct sale staff have been limited in their ability to call on customers in the United States and the United Kingdom. There have also been increased costs associated with shipping products, and a slow-down in receiving regulatory approvals. As a result of this uncertainty there is a higher level of estimation uncertainty as it relates to the assessment of impairment for intangibles, provisions for inventory and receivables, and general future cash flows. Our distribution relationships with several companies in North America and internationally have been impacted due to the material disruption to business globally, economic slowdowns, and shifts in economic markets caused by governmental responses to the COVID-19 pandemic. Demand for some of the Company's products also temporarily decreased as facilities adjust to patient demand and procedure types.

### **3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND BASIS OF PRESENTATION**

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, 2020, which were prepared in accordance with IFRS.

The accounting policies adopted are consistent with those of the previous financial year end.

On October 31, 2018, amendments to IAS 1 and IAS 8 to clarify and align the definition of material and provide guidance to help improve consistency in the application of materiality when used in other IFRS standards. These amendments were effective for years beginning on or after January 1, 2020 and are to be applied prospectively.

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three and six months ended March 31, 2021 and 2020

The Company adopted the amendments on October 1, 2020 and there was no impact on the unaudited condensed consolidated interim financial statements.

The unaudited condensed consolidated interim financial statements were authorized for issue by the Board of Directors on May 28, 2021.

#### 4. INVENTORIES

Inventories consist of the following:

	March 31, 2020	September 30, 2020
Raw materials	\$2,892,905	\$2,983,418
Finished goods	5,369,797	6,300,288
Inventory provision	(1,913,157)	(2,083,932)
	<u>\$6,349,545</u>	<u>\$7,199,774</u>

Cost of product sales for the three and six month period ended March 31, 2021 includes \$2,744,313 (2020 - \$1,917,394) and \$4,972,455 (2020 - \$4,380,860), respectively in inventoried materials.

#### 5. INTANGIBLE ASSETS AND GOODWILL

Goodwill is comprised of the following amounts:

	Goodwill (\$)
Balance at October 1, 2020	13,018,102
Foreign exchange	(745,620)
<b>Balance at March 31, 2021</b>	<u><b>12,272,482</b></u>

Intangible assets are comprised of the following amounts:

	Deferred Development Costs (\$)	Brand (\$)	Patents (\$)	Trademarks (\$)	Computer Software (\$)	Total (\$)
<b>Cost</b>						
Balance at September 30, 2020	2,224,978	1,133,815	971,638	83,704	177,994	4,592,129
Foreign exchange	(127,437)	(64,940)	(55,652)	(4,794)	(10,195)	(263,018)
Balance at March 31, 2021	<u>2,097,541</u>	<u>1,068,875</u>	<u>915,986</u>	<u>78,910</u>	<u>167,799</u>	<u>4,329,111</u>
<b>Accumulated amortization</b>						
Balance at September 30, 2020	1,719,944	113,382	448,313	-	159,216	2,440,855
Amortization	53,565	27,296	25,303	-	2,665	108,829
Foreign exchange	(99,637)	(7,069)	(26,210)	-	(9,175)	(142,091)
Balance at March 31, 2021	<u>1,673,872</u>	<u>133,609</u>	<u>447,406</u>	<u>-</u>	<u>152,706</u>	<u>2,407,593</u>
<b>Carrying amounts</b>						
At September 30, 2020	505,034	1,020,433	523,325	83,704	18,778	2,151,274
<b>At March 31, 2021</b>	<u><b>423,669</b></u>	<u><b>935,266</b></u>	<u><b>468,580</b></u>	<u><b>78,910</b></u>	<u><b>15,093</b></u>	<u><b>1,921,518</b></u>

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

For the three and six months ended March 31, 2021 and 2020

### 6. PROPERTY, PLANT AND EQUIPMENT

	Furniture and Fixtures (\$)	Lab Equipment (\$)	Leasehold Improvements (\$)	Total (\$)
<b>Cost</b>				
Balance at September 30, 2020	901,046	2,751,986	484,315	4,137,347
Additions	23,797	62,591	4,643	91,031
Foreign exchange	(52,124)	(159,153)	(27,805)	(239,082)
Balance at March 31, 2021	872,719	2,655,424	461,153	3,989,296
<b>Accumulated depreciation</b>				
Balance at September 30, 2020	552,852	1,523,979	235,557	2,312,388
Depreciation	49,374	123,116	36,438	208,928
Foreign exchange	(47,812)	(89,853)	(14,257)	(151,922)
Balance at March 31, 2021	554,414	1,557,242	257,738	2,369,394
<b>Carrying amounts</b>				
At September 30, 2020	348,194	1,228,007	248,758	1,824,959
<b>At March 31, 2021</b>	<b>318,305</b>	<b>1,098,182</b>	<b>203,415</b>	<b>1,619,902</b>

### 7. DEBT

During the year ended September 30, 2018, the Company entered into the Facility with HSBC. This Facility was amended during the year ended September 30, 2020, to allow for an additional borrowing line supported by the Business Credit Availability Program (“BCAP”) with the Business Development Bank of Canada (“BDC”), in the amount of \$1,000,000. The Facility includes an Acquisition Line, Operating line, and other credit facilities.

During the six months ended March 31, 2021, the Company drew \$1,000,000 against the BCAP facility through HSBC. This facility is interest-only until July 2021 and then is repayable over a four-year term by equal monthly payments.

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 EBITDA; 2) fixed charged coverage ratio; 3) current ratio; and 4) maintaining a cash balance of \$1,500,000 as well as other reporting requirements. As of March 31, 2021, 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 March 31, 2021. The carrying amount of the acquisition line is \$3,102,066 as of March 31, 2021. Subsequent to March 31, 2021, the Company obtained a waiver for the breach of covenants thereof as described in Note 2.

A reconciliation of the operating line is as follows:

	<u>March 31, 2021 (\$)</u>
Balance – October 1, 2020	3,955,000
Interest accrued during the period	90,137
Interest paid during the period	(90,137)
Balance – Ending	3,955,000
Less: Current portion	3,955,000

## Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

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As of March 31, 2021, the Company has \$3,955,000 drawn and outstanding on the revolving operating line. This facility is repayable on demand by HSBC which could occur if there was a deficiency in the borrowing base of assets used to support this line. The interest rate associated with the operating line is Prime Rate plus 1.5%. During the six months ended March 31, 2021, the Company recognized \$90,137 of interest expense on this loan.

A reconciliation of the Acquisition Line is as follows:

	<u>March 31, 2021 (\$)</u>
Balance – October 1, 2020	3,694,027
Repayments of principal	(600,000)
Interest accrued during the period	69,246
Interest paid during the period	(61,207)
Balance – Ending	<u>3,102,066</u>
Less: Current portion	3,102,066
Non-current portion	<u>-</u>

This facility is repayable on demand by HSBC which could occur if there was a default on the financial covenants and the event of default was not waived by HSBC. As of March 31, 2021, the Company has \$3,102,066 drawn and outstanding on the acquisition line. During the six months ended March 31, 2021, the Company recognized \$69,246 of interest and accretion expense on the Acquisition Line. The Company will require HSBC approval to further access funds available under this line (as discussed in Note 2).

A reconciliation of the BCAP facility is as follows:

	<u>March 31, 2021 (\$)</u>
Balance – October 1, 2020	-
Proceeds received	1,000,000
Interest accrued during the period	3,048
Interest paid during the period	(3,048)
Balance – Ending	<u>1,000,000</u>
Less: Current portion	1,000,000
Non-current portion	<u>-</u>

This facility is interest-only until July 2021, and then is repayable over a four-year term. As of March 31, 2021, the Company has \$1,000,000 drawn and outstanding on the acquisition line. During the six months ended March 31, 2021, the Company recognized \$3,048 of interest expense on the BCAP line.

### 8. RIGHT-OF-USE ASSETS

	<u>Right-of-use assets (\$)</u>
Balance at October 1, 2020	2,815,724
Depreciation	(255,746)
Foreign exchange	(159,546)
<b>Balance at March 31, 2021</b>	<u><b>2,400,432</b></u>

The Company leases office space in Mississauga, Canada and Seattle, USA.

# Covalon Technologies Ltd.

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## 9. LEASE LIABILITIES

Lease liabilities are comprised of the following amounts:

	<b>Lease liabilities (\$)</b>
Balance at October 1, 2020	3,179,718
Interest	76,963
Payments	(316,248)
Foreign exchange	(113,681)
<b>Balance at March 31, 2021</b>	<b>2,826,752</b>
Less: Current portion	518,471
Long-term portion	2,308,281

## 10. SHAREHOLDERS' EQUITY

### Common Shares

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

On October 1, 2018, Covalon acquired AquaGuard, a division of Cenorin LLC., and issued 75,136 common shares of the Company in escrow with release dates of 12 months, 18 months and 24 months after the acquisition date. During the six months ended March 31, 2021 25,045 (2020 - 25,045) shares were released from escrow leaving a balance of nil.

### Warrants

The following is a summary of all warrants:

	<b>Number of Warrants</b>	<b>Weighted average exercise Price</b>	<b>Weighted Average Expiry (years)</b>
<b>Balance at September 30, 2020</b>	<b>2,750,000</b>	<b>\$2.00</b>	<b>3.97</b>
Exercised during the period	-	-	
<b>Balance at March 31, 2021</b>	<b>2,750,000</b>	<b>\$2.00</b>	<b>3.72</b>

## 11. SHARE-BASED PAYMENTS

### Option Plan Details

The Company has a 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: 34% 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 stock options from October 1, 2020 to March 31, 2021:

Grant Date	Expiry Date	Exercise Price	Opening Balance	Forfeited/ Expired	Closing Balance	Vested	Unvested	Weighted Average Expiry (years)
7-Mar-16	7-Mar-21	\$1.13	100,000	(100,000)	-	-	-	-
23-Jun-16	23-Jun-21	\$1.29	110,834	-	110,834	110,834	-	0.23
14-Sep-16	14-Sep-21	\$2.29	20,000	-	20,000	20,000	-	0.46
8-Feb-17	8-Feb-22	\$2.20	168,333	-	168,333	168,333	-	0.86
20-Jun-17	20-Jun-22	\$2.47	348,333	(2,500)	345,833	345,833	-	1.22
25-Oct-17	25-Oct-22	\$3.80	60,000	-	60,000	60,000	-	1.57
21-Dec-17	21-Dec-22	\$4.65	137,500	-	137,500	137,500	-	1.73
24-Jan-18	24-Jan-23	\$6.02	60,000	-	60,000	60,000	-	1.82
27-Sep-18	27-Sep-23	\$8.50	130,000	(4,166)	125,834	83,889	41,945	2.49
22-Dec-18	22-Dec-23	\$4.28	322,501	(27,501)	295,000	97,350	197,650	2.73
15-Mar-19	15-Mar-24	\$5.03	150,000	(5,000)	145,000	47,850	97,150	2.96
			<b>1,607,501</b>	<b>(139,167)</b>	<b>1,468,334</b>	<b>1,131,589</b>	<b>336,745</b>	<b>1.76</b>
			<b>\$3.73</b>	<b>\$2.14</b>	<b>\$3.88</b>	<b>\$3.55</b>	<b>\$5.02</b>	

### Share Based Payment Expense

Total expense arising from share-based payment transactions recognized during the three and six months ended March 31, 2021, as part of employee benefit expense were \$80,484 (2020 - \$221,387) and \$204,562 (2020 - \$618,876).

## 12. FINANCIAL RISK MANAGEMENT

The following is a discussion of market, credit, and liquidity risks and related mitigation strategies that have been identified.

### Credit Risk

The Company is exposed to credit risk associated with its cash and cash equivalents and accounts receivable. 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, 2021 and September 30, 2020 is nominal.

Accounts receivable 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.

Accounts receivable are subject to normal industry risks in each geographic region in which the Company operates. The Company attempts to manage these risks by dealing with creditworthy customers; however, due to the limited number of potential customers in each market this is not always possible. As at March 31, 2021, three customers accounted for 62% (2020 – three customers for 30%) of the accounts receivable balance. These customers, who are distributors and strategic partners of the Company, represent a large portion 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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The aging of accounts receivable is as follows:

	March 31, 2021	September 30, 2020
Current	<b>\$4,109,186</b>	\$3,283,144
30-60 days past due	<b>42,809</b>	22,053
Over 60 days past due	<b>19,240</b>	28,240
	<b>4,171,235</b>	3,333,437

### 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 rates. During fiscal 2019, the Company took on floating rate debt to fund an acquisition and working capital. At March 31, 2021, if interest rates had been 1% higher or lower then the interest expense would have been \$40,285 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>March 31, 2021</u>				<u>September 30, 2020</u>			
	<u>Canadian</u>	<u>USD</u>	<u>GBP</u>	<u>Total</u>	<u>CAD</u>	<u>USD</u>	<u>GBP</u>	<u>Total</u>
Cash and cash equivalents	\$355,866	\$3,365,891	\$72,752	<b>\$3,794,509</b>	\$199,176	\$3,267,280	\$40,535	<b>\$3,506,991</b>
Accounts Receivable	\$(820,328)	\$4,987,012	\$4,551	<b>\$4,171,235</b>	\$2,283	\$3,324,634	\$6,520	<b>\$3,333,437</b>
Acquisition note payable	-	\$9,497,017	-	<b>\$9,497,017</b>	-	\$10,074,013	-	<b>\$10,074,013</b>
Accounts payable and accrued liabilities	\$513,915	\$3,261,408	\$149,109	<b>\$3,924,432</b>	\$609,370	\$3,122,046	\$167,850	<b>\$3,899,266</b>
Lease liabilities	\$1,173,276	\$1,653,476	-	<b>\$2,826,752</b>	\$1,296,801	\$1,882,917	-	<b>\$3,179,718</b>

### Fair Value

The fair values of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, acquisition note payable and lease liabilities approximate their carrying values, due to their relatively short periods to maturity. The fair value of debt approximates the carrying amount as it has a floating interest rate.

### 13. 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 short-term debt. Its objectives when managing capital are to ensure that the Company will continue as a going concern, so that it can provide services

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to its customers and returns to its shareholders. The capital at March 31, 2021 is \$16,352,449 (September 30, 2020 – \$16,755,705).

The Company manages its capital structure and adjusts 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.

### 14. 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,	
	2021	2020	2021	2020
Compensation and short-term employee benefits	\$239,442	\$287,411	\$478,884	\$574,673
Share based payment expense	24,902	115,640	62,406	255,200
	<b>264,344</b>	<b>\$403,051</b>	<b>541,290</b>	<b>\$829,873</b>

During the year end September 30, 2013, a non-interest bearing loan of \$50,000 was made to a key employee. As of March 31, 2021, \$10,000 of this loan remained outstanding.

### 15. EXPENSES BY NATURE

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

	Three months ended March 31,		Six months ended March 31,	
	2021	2020	2021	2020
Inventoried materials	\$2,744,313	\$1,917,394	\$4,972,455	\$4,380,860
Wages, benefits, consulting fees, director compensation	2,789,560	3,418,152	5,921,503	7,042,739
Government subsidies	(1,043,547)	-	(1,346,001)	-
Share based payments	80,484	221,387	204,562	618,876
Depreciation and amortization	282,803	282,276	573,503	575,654
Professional fees	332,482	483,953	820,023	1,032,785
Other expenses	1,016,115	2,618,327	1,297,900	4,188,127
Total	<b>\$6,202,210</b>	<b>\$8,941,489</b>	<b>\$12,443,945</b>	<b>\$17,839,041</b>

#### Depreciation and amortization

	For the three months ended March 31,		For the six months ended March 31,	
	2021	2020	2021	2020
Cost of product sales	\$79,821	\$86,547	\$160,330	\$167,985
Operations	641	852	1,301	1,688
Research and development activities	7,464	8,874	15,050	17,584
General and administrative	194,877	186,003	396,822	388,397
Total depreciation and amortization	<b>\$282,803</b>	<b>\$282,276</b>	<b>\$573,503</b>	<b>\$575,654</b>



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## 16. EARNINGS (LOSS) PER SHARE

The weighted average number of shares outstanding during the three and six months ended March 31, 2021 was 25,818,677 and 25,818,677, respectively (March 31, 2020 – 25,818,677 and 25,818,677).

Details of dilutive securities outstanding are as follows:

Potentially dilutive securities	Three months ended		Six months ended	
	March 31,		March 31,	
	2021	2020	2021	2020
Common shares potentially dilutive				
- all stock options	4,976	90,304	9,952	90,304
- all warrants	-	-	-	-
Total potentially dilutive shares	4,976	90,304	9,952	90,304
Diluted earnings (loss) per share	\$0.02	\$(0.15)	\$0.00	\$(0.20)

## 17. CONTINGENCIES AND COMMITMENTS

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 that a loss becomes probable.

## 18. SEGMENT REPORTING

The Company generated revenue of \$5,286,671 (2020 – \$4,651,611) in the US, \$1,128,706 (2020 – \$181,497) in the Middle East, \$13,980 (2020 – \$52,448) in Canada, and \$311,903 (2020 – \$373,016) in the rest of the world.

The Company generated revenue of \$9,813,741 (2020 – \$11,074,465) in the US, \$1,881,146 (2020 – \$1,110,946) in the Middle East, \$38,263 (2020 – \$58,903) in Canada, and \$996,522 (2020 – \$962,817) in the rest of the world.

As of March 31, 2021, the Company had \$3,883,003 of its property, plant, and equipment, right-of-use assets and intangible assets located in Canada and \$2,058,849 in the USA. Goodwill in the amount of \$12,272,482 is attributed to the US.

## 19. CHANGES IN NON-CASH WORKING CAPITAL ITEMS

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

	Three months ended March 31,	
	2021	2020
Accounts receivable	\$(1,035,716)	\$1,343,550
Prepaid expenses	134,305	(249,964)
Inventories	440,834	(614,889)
Accounts payable and accrued liabilities	250,188	(1,965,750)
Deferred revenue	(267,840)	375,539
	<b>\$(478,229)</b>	<b>\$(1,111,514)</b>