

Covalon Technologies Ltd.

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

For the three months ended December 31, 2022 and 2021

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**MANAGEMENT’S COMMENTS ON UNAUDITED
CONDENSED CONSOLIDATED INTERIM 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

	December 31, 2022	September 30, 2022
Assets		
Current assets		
Cash and cash equivalents	\$14,062,520	\$14,061,631
Cash in escrow (Note 3)	-	1,370,700
Accounts receivable	4,939,365	4,732,430
Inventories (Note 4)	6,544,189	4,965,668
Prepaid expenses	1,196,847	2,097,628
Total current assets	26,742,921	27,228,057
Non-current assets		
Restricted cash	135,440	-
Property, plant and equipment (Note 6)	1,185,514	1,215,970
Intangible assets (Note 5)	1,356,784	1,277,327
Right-of-use assets (Note 8)	589,835	656,727
Total non-current assets	3,267,573	3,150,024
Total assets	\$30,010,494	\$30,378,081
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable and accrued liabilities	\$4,360,276	\$3,720,208
Lease liabilities (Note 4)	608,951	609,578
Deferred revenue (Note 7)	163,846	209,070
Total current liabilities	5,133,073	4,538,856
Non-current liabilities		
Deferred revenue (Note 7)	20,317	51,401
Lease liabilities (Note 9)	1,389,641	1,559,063
Total non-current liabilities	1,409,958	1,610,464
Total liabilities	6,543,031	6,149,320
Shareholders' equity		
Share capital (Note 10)	43,562,126	43,843,344
Contributed surplus	11,195,019	11,277,493
Foreign exchange translation reserve	2,996,424	3,013,209
Accumulated deficit	(34,286,106)	(33,905,285)
Total shareholders' equity	23,467,463	24,228,761
Total liabilities and shareholders' equity	\$30,010,494	\$30,378,081

Contingencies and commitments (Note 18)

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 December 31,	
	2022	2021
Revenue		
Product	\$5,245,264	\$4,497,698
Development and consulting services	818,346	388,367
Licensing and royalty fees	121,795	50,280
Total revenue	6,185,405	4,936,345
Cost of sales	2,490,573	2,643,968
Gross profit before operating expenses	3,694,832	2,292,377
Operating expenses		
Operations	207,879	438,178
Research and development activities	285,975	308,026
Sales and marketing	2,029,936	1,170,177
General and administrative	1,526,895	1,471,275
	4,050,685	3,387,656
Finance expenses	24,968	12,223
Net (loss) from continuing operations	(380,821)	(1,107,502)
Net (loss) from discontinued operations (Note 3)	-	(409,295)
Net (loss)	\$(380,821)	\$(1,516,797)
Other comprehensive income (loss)		
Amount that may be reclassified to profit or loss		
Foreign currency translation adjustment continuing operations	(16,785)	(486,584)
Total comprehensive loss	\$(397,606)	\$(2,003,381)
Loss per common share of continuing operations		
Basic (loss) per share (Note 16)	\$(0.02)	\$(0.04)
Diluted (loss) per share (Note 16)	\$(0.02)	\$(0.04)
Income (loss) per common share of discontinued operations		
Basic earnings (loss) per share (Note 16)	\$(0.00)	\$(0.02)
Diluted earnings (loss) per share (Note 16)	\$(0.00)	\$(0.02)
Loss per common share		
Basic (loss) per share (Note 16)	\$(0.02)	\$(0.06)
Diluted (loss) per share (Note 16)	\$(0.02)	\$(0.06)

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

	Number of shares	Share capital	Contributed surplus	Accumulated deficit	Foreign exchange translation reserve	Total
Balance at October 1, 2021	25,868,677	\$44,676,999	\$11,833,354	\$(24,242,072)	\$1,106,246	\$33,374,527
Share-based payment expense (Note 11)	-	-	27,590	-	-	27,590
Exercise of stock options	30,000	178,817	(112,817)	-	-	66,000
Net loss for the period	-	-	-	(1,516,797)	-	(1,516,797)
Foreign currency translation adjustment	-	-	-	-	(486,584)	(486,584)
Balance at December 31, 2021	25,898,677	\$44,855,816	\$11,748,127	\$(25,758,869)	\$619,662	\$31,464,736
Balance at October 1, 2022	25,287,777	\$43,843,344	\$11,277,493	\$(33,905,285)	\$3,013,209	\$24,228,761
Share-based payment expense (Note 11)	-	-	156,307	-	-	156,307
Buyback of common shares (Note 10)	(162,200)	(281,218)	(238,781)	-	-	(519,999)
Net loss for the period	-	-	-	(380,821)	-	(380,821)
Foreign currency translation adjustment	-	-	-	-	(16,785)	(16,785)
Balance at December 31, 2022	25,125,577	\$43,562,126	\$11,195,019	\$(34,286,106)	\$2,996,424	\$23,467,463

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

	Three months ended December 31,	
	2022	2021
Cash flows from (used in) operating activities		
Net loss for the period from continuing operations	\$(380,821)	\$(1,107,502)
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation of property, plant and equipment (Note 6)	143,272	21,102
Amortization of intangible assets (Note 5)	47,582	13,129
Depreciation - right of use assets (Note 7)	59,231	21,438
Share-based payment expense (Note 11)	156,307	21,034
Interest expense and accretion	29,853	12,223
Cash used in operating activities before change in non-cash working capital balances	55,424	(1,018,576)
Net changes in non-cash working capital balances:		
Accounts receivable	(248,059)	2,908,892
Prepaid expenses	886,451	(213,202)
Inventories	(1,628,927)	(161,134)
Accounts payable and accrued liabilities	607,397	(984,514)
Deferred revenue	(79,407)	9,318
Total net changes in non-cash working capital balances	(462,545)	1,559,360
Total cash flows from (used in) operating activities	(407,121)	540,784
Cash flows from (used in) investing activities		
Purchase of property, plant and equipment (Note 6)	(127,895)	(105,766)
Purchase of intangible assets (Note 7)	(144,487)	-
Restricted cash	(135,440)	(26)
Total cash flows used in investing activities	(407,822)	(105,792)
Cash flows from (used in) financing activities		
Buyback of common shares	(519,999)	-
Exercise of options	-	66,000
Payment of lease liabilities	(170,191)	(76,403)
Total cash flows used in financing activities	(690,190)	(10,403)
Foreign exchange rate changes on cash	135,322	(39,621)
Total cash flows during the period of continuing operations	(1,369,811)	384,968
Total cash flows during the period of discontinued operations	1,370,700	(960,534)
Total cash flows during the period	889	(575,566)
Cash and cash equivalents, beginning of the period	\$14,061,631	\$22,946,923
Cash and cash equivalents, end of the period	\$14,062,520	\$22,371,357

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

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

1. CORPORATE INFORMATION

Covalon Technologies Ltd. (“the Company”) is incorporated under the laws of Ontario and is engaged in the business of researching, developing, manufacturing, and marketing of patent-protected medical products that improve patient outcomes and save lives in the areas of infection management, advanced wound care, and surgical procedures. The unaudited condensed consolidated interim financial statements of Covalon Technologies Ltd. for the three months ended December 31, 2022 comprise the results of the Company and its wholly owned subsidiaries. The Company leverages its patented medical technology platforms and expertise in two ways: (i) by developing products that are sold under the Company’s name; and (ii) by developing and commercializing medical products for other medical companies under development and license contracts. The Company has received regulatory approval on numerous products and leverages contract manufacturers to make its products and distribution contracts to sell its commercialized products to medical customers. 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. 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, 2022, which were prepared in accordance with IFRS.

The accounting policies adopted are consistent with those of the previous financial year end. Certain comparative amounts within operating expenses have been reclassified to conform to current period classification.

The unaudited condensed consolidated interim financial statements were authorized for issue by the Board of Directors on February 22, 2023.

Accounting standards issued but not yet adopted

IAS 1 – Presentation of Financial Statements

On January 23, 2020, the IASB issued an amendment to IAS 1 to clarify that liabilities are classified as either current or non-current, depending on the rights that exist at the end of the reporting period. The standard is effective for periods beginning on or after January 1, 2023, and the Company has assessed that there will be no impact of applying the new standard on the consolidated financial statements.

Definition of Accounting Estimates (Amendments to IAS 8)

On February 12, 2021, the IASB issued Definition of Accounting Estimates (Amendments to IAS 8). The amendments will require the disclosure of material accounting policy information rather than disclosing significant accounting policies and clarifies how to distinguish changes in accounting policies from changes in accounting estimates. The amendments are effective for annual periods beginning on or after January 1, 2023. The Company intends to adopt this amendment in its Consolidated Financial Statements for the annual period

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

beginning October 1, 2023. The adoption of this amendment is not expected to have a material impact on the consolidated financial statements.

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.

Operationally, the Company continues to be 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 supply chains emanating from China continue to be adversely affected as a result of COVID-19, and as a result, there continue to be increased costs associated with shipping product. Our distribution relationships with companies in China, and those internationally whom have supply chain connectivity with China, 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. The Company continues experiencing slow-downs in receiving regulatory approvals due to labour supply challenges, which could have adverse effects to revenue.

As a result of the supply chain issues emanating from China the Company continues to experience, demand for some of the Company's products can also be affected by higher lead times in sourcing product, which may have adverse impacts to revenue. The Company has not experienced material payment delays or defaults from customers as a result of the COVID-19 pandemic and its impact on their respective businesses.

As a result of these uncertainties there is a higher level of estimation uncertainty as it relates to the assessment provisions for inventory and receivables and related future cash flows. The Company continues to evaluate the current and potential impact of the COVID-19 pandemic on its business, affairs, operations, financial condition, liquidity, availability of credit, and results of operations.

3. AQUAGUARD SALE

On July 29, 2021, the Company sold the AquaGuard product line to TIDI Products, LLC ("TIDI"), an arm's length party, for \$37,837,852 including post-closing adjustments related to actual amounts of inventory and indebtedness. The purchase price of \$37,837,852 included \$2,513,200 placed in escrow for indemnity claims (which escrow amounts would be released 50% in 12 months following closing and the remaining 50% on September 30, 2022, assuming there were no claims). On August 2, 2022, 50% of the funds were received from escrow, and on October 3, 2022, the final 50% was received from escrow. The financial information related to the AquaGuard product line is reported in the current and comparative periods as discontinued operations.

The financial performance information presented for the three months ended December 31, 2022, and December 31, 2021, is summarized below and is included in the condensed consolidated interim statements of operations and comprehensive loss as net loss from discontinued operations:

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NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

	December 31, 2022	December 31, 2021
Revenue	-	483,010
Cost of sales and operating expenses	-	874,306
Finance expenses	-	17,999
Net (loss) from discontinued operations	-	(409,295)

Disclosures with respect to the consolidated statements of cash flows for the three months ended December 31, 2022 and December 31, 2021 are as follows:

	December 31, 2022	December 31, 2021
Cash flows from operating activities	-	(862,852)
Cash flows from investing activities	1,370,700	(12,623)
Cash flows from financing activities	-	(85,059)
Total cash flow	1,370,700	(960,534)

4. INVENTORIES

Inventories consist of the following:

	December 31, 2022	September 30, 2022
Raw materials	\$2,126,169	\$1,524,083
Finished goods	7,334,056	6,337,693
Inventory provision	(2,916,036)	(2,896,108)
	\$6,544,189	\$4,965,668

Cost of product sales for the three months ended December 31, 2022, includes \$2,490,573 (2021 - \$2,643,968), respectively in inventoried materials. Inventoried materials for the three months ended December 31, 2022 includes \$nil (2021 - \$719,691) in inventory provisions as a result of inventory obsolescence.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

5. INTANGIBLE ASSETS

Intangible assets are comprised of the following amounts:

	Deferred Development Costs (\$)	Brand (\$)	Patents (\$)	Trademarks (\$)	Computer Software (\$)	Total (\$)
Cost						
Balance at September 30, 2022	2,286,362	-	1,080,912	82,362	372,252	3,821,888
Additions	-	-	-	-	144,487	144,487
Foreign exchange	(27,189)	-	(12,854)	(980)	(6,802)	(47,825)
Balance at December 31, 2022	2,259,173	-	1,068,058	81,382	509,937	3,918,550
Accumulated amortization						
Balance at September 30, 2022	1,996,030	-	548,531	-	-	2,544,561
Amortization	28,310	-	12,907	-	6,365	47,582
Foreign exchange	(23,806)	-	(6,555)	-	(16)	(30,377)
Balance at December 31, 2022	2,000,534	-	554,883	-	6,349	2,561,766
Carrying amounts						
At September 30, 2022	290,332	-	532,381	82,362	372,252	1,277,327
At December 31, 2022	258,639	-	513,175	81,382	503,588	1,356,784

As at September 30, 2022, included in computer software is an amount of \$372,252 which primarily relates to new information systems where amortization had not yet commenced as they had not yet been placed into service, and during the three months ended December 31, 2022, these assets were placed into service and amortization commenced.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

6. PROPERTY, PLANT AND EQUIPMENT

	Furniture and Fixtures (\$)	Lab Equipment (\$)	Leasehold Improvements (\$)	Total (\$)
Cost				
Balance at September 30, 2022	689,748	1,988,726	377,492	3,055,966
Additions	7,719	120,176	-	127,895
Foreign exchange	(7,904)	(23,950)	(4,489)	(36,343)
Balance at December 31, 2022	689,563	2,084,952	373,003	3,147,518
Accumulated depreciation				
Balance at September 30, 2022	350,312	1,170,877	318,807	1,839,996
Depreciation	37,186	93,452	12,634	143,272
Foreign exchange	(3,961)	(14,158)	(3,145)	(21,264)
Balance at December 31, 2022	383,537	1,250,171	328,296	1,962,004
Carrying amounts				
At September 30, 2022	339,436	817,849	58,685	1,215,970
At December 31, 2022	306,026	834,781	44,707	1,185,514

7. DEFERRED REVENUE

	December 31, 2022	September 30, 2022
Balance, beginning of year	\$260,471	\$577,097
<u>Add:</u>		
Deferred licensing and services revenue	-	444,214
Deferred product	\$122,525	709,654
<u>Less:</u>		
Recognition of deferred product	(145,361)	(746,938)
Recognition of deferred licensing and services revenue	(50,374)	(791,970)
Foreign exchange	(3,098)	68,414
Balance, end of year	184,163	260,471
Current portion	(163,846)	(209,070)
Non-current portion	\$20,317	\$51,401

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

8. RIGHT-OF-USE ASSETS

	Right-of-use assets (\$)
Balance at October 1, 2022	656,727
Depreciation	(59,231)
Foreign exchange	(7,661)
Balance at December 31, 2022	589,835

The Company leases office space in Mississauga, Canada and Seattle, USA. Following the sale of AquaGuard (note 3) the leased facility in Seattle was impaired during the year ended September 30, 2021, as it is not currently expected to generate any future cash in flows. The Company intends to pursue sublease arrangements and will assess for reversal of impairment should the facts change.

9. LEASE LIABILITIES

Lease liabilities are comprised of the following amounts:

	Lease liabilities (\$)
Balance at October 1, 2022	2,168,641
Interest	29,853
Payments	(170,191)
Foreign exchange	(29,711)
Balance at December 31, 2022	1,998,592
Less: Current portion	608,951
Long-term portion	1,389,641

Following the impairment of the right of use asset related to the Company's Seattle lease agreement at September 30, 2021 (note 8), an onerous contract liability was recognized in accounts payable and accrued liabilities related to future variable lease payments that are not included in the lease liability. At December 31, 2022 the amount of this liability was \$395,642 (September 30, 2022 - \$396,713).

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 May 25, 2022, the Company announced that it had filed its intention to make a normal course issuer bid ("NCIB") for its common shares with the TSX Venture Exchange for up to 1,296,433 shares, representing 5% of the issued and outstanding common shares. Repurchases under the NCIB program were approved by the TSX Venture Exchange, commenced on June 2, 2022, and are authorized to continue until the earlier of: (a) May 31, 2023; and (b) the date in which the maximum number of common shares purchasable under the NCIB have been acquired by the Company. All common shares that are repurchased by the Company under the NCIB program will be cancelled, with any excess or deficiency as compared to the weighted average cost of common shares being charged to contributed surplus.

Under the NCIB, the Company is limited in making daily purchases of up to 8,000 common shares.

Covalon Technologies Ltd.

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Expressed in Canadian Dollars

On June 29, 2022, in connection with the NCIB, the Company entered into an automatic share purchase plan (“ASPP”) with a designated broker. The ASPP is intended to allow for the purchase of the Company’s common shares under the NCIB at times when the Company would ordinarily not be permitted to purchase its common shares due to regulatory restrictions and customary self-imposed blackout periods. Pursuant to the ASPP, prior to entering into a blackout period, the Company may instruct the designated broker to make purchases under the NCIB in accordance with the terms of the ASPP. Such purchases will be made by the designated broker in its sole discretion based on parameters established by the Company prior to the blackout period in accordance with the rules of the TSX Venture Exchange, applicable securities laws and the terms of the ASPP. In accordance with the terms of the ASPP, the Company is able to terminate any instructions given to the designated broker with minimal notice. The Company has continued with the ASPP since June 29, 2022 without notice to terminate.

As at September 30, 2022, the Company had purchased 640,900 of its common shares under the NCIB. For the three months ended December 31, 2022, the Company purchased an additional 162,200 of its common shares under the NCIB. Subsequent to December 31, 2022, the Company has purchased an additional 115,600 of its common shares under the NCIB. The Company has purchased a total of 918,700 of its common shares since repurchases commenced under the NCIB.

Warrants

The following is a summary of all warrants:

	Number of Warrants	Weighted average exercise Price	Weighted Average Expiry (years)
Balance at September 30, 2022	2,920,000	\$2.14	2.10
Exercised during the period	-	-	-
Balance at December 31, 2022	2,920,000	\$2.14	1.85

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.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

The following is a summary of changes in stock options from October 1, 2022 to December 31, 2022:

Grant Date	Expiry Date	Exercise Price	Opening Balance	Granted	Forfeited/Expired	Closing Balance	Vested	Unvested	Weighted Average Expiry (years)
25-Oct-17	25-Oct-22	\$3.80	60,000	-	(60,000)	-	-	-	-
21-Dec-17	21-Dec-22	\$4.65	55,000	-	(55,000)	-	-	-	-
24-Jan-18	24-Jan-23	\$6.02	60,000	-	-	60,000	60,000	-	0.07
27-Sep-18	27-Sep-23	\$8.50	67,500	-	-	67,500	67,500	-	0.74
22-Dec-18	22-Dec-23	\$4.28	47,500	-	(7,500)	40,000	40,000	-	0.98
15-Mar-19	15-Mar-24	\$5.03	40,000	-	-	40,000	40,000	-	1.21
28-Mar-22	28-Mar-27	\$2.19	465,000	-	(7,500)	457,500	-	457,500	4.24
06-Sep-22	06-Sep-27	\$2.50	437,500	-	-	437,500	-	437,500	4.68
			1,232,500	-	(130,000)	1,102,500	207,500	895,000	3.75
Weighted Average Exercise Price			\$3.19	\$0.00	\$4.09	\$3.09	\$6.30	\$2.34	

Share Based Payment Expense

Total share-based payment expense recognized during the three months ended December 31, 2022 for continuing operations, as part of employee benefits was \$156,307 (2021 - \$21,034).

Total share-based payment expense recognized during the three months ended December 31, 2022 for discontinued operations, as part of employee benefits was \$nil (2021 - \$6,556).

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 December 31, 2022 and September 30, 2022 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 December 31, 2022, three customers accounted for 49% (September 30, 2022 – three customers for 71%) of the accounts receivable balance. These customers, who are distributors and strategic partners of the Company, represent a large portion

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Expressed in Canadian Dollars

of the Company's sales. Credit risk exposure is mitigated by strong credit granting policies, the use of Letters of Credit, and due diligence procedures for new customers.

The aging of accounts receivable is as follows:

	December 31, 2022	September 30, 2022
Current	\$4,270,212	\$4,449,960
30-60 days past due	391,553	203,988
Over 60 days past due	277,600	78,482
	4,939,365	4,732,430

Interest Rate Risk

The Company is subject to interest rate risk on its cash and cash equivalents. The Company believes that interest rate risk is low due to market based variable interest rates.

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>December 31, 2022</u>				<u>September 30, 2022</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	\$305,475	\$13,677,125	\$79,920	\$14,062,520	\$307,483	\$13,599,225	\$154,923	\$14,061,631
Accounts receivable	\$6,321	\$4,933,044	-	\$4,939,365	\$1,340	\$4,731,090	-	\$4,732,430
Restricted cash and cash in escrow	-	\$135,440	-	\$135,440	-	\$1,370,700	-	\$1,370,700
Accounts payable and accrued liabilities	\$400,917	\$3,951,535	\$7,824	\$4,360,276	\$961,691	\$2,711,995	\$46,522	\$3,720,208
Lease liabilities	\$714,126	\$1,284,466	-	\$1,998,592	\$805,625	\$1,363,016	-	\$2,168,641

If exchange rates were to change by 5% at December 31, 2022 total comprehensive loss would change by \$679,085 (September 30, 2022 - \$786,720).

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

Fair Value

The fair values of cash and cash equivalents, cash in escrow, accounts receivable, accounts payable and accrued liabilities and lease liabilities approximate their carrying values, due to their relatively short periods to maturity.

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 lease liabilities and accounts payable and accrued liabilities that are due as reflected in the following table:

	Carrying amount (\$)	Future cash flows (\$)	Less than 1 year (\$)	Between 1 and 5 years (\$)	Greater than 5 years (\$)
Accounts payable and accrued liabilities	4,360,276	4,360,276	4,360,276	-	-
Lease liabilities	1,998,592	2,133,499	688,183	1,445,316	-
Total	6,358,868	6,493,775	5,048,459	1,445,316	-

13. CAPITAL MANAGEMENT

The Company defines capital that it manages as its shareholders' equity comprising share capital, contributed surplus, and foreign exchange translation reserve accumulated deficit. Its objectives when managing capital are to ensure that the Company will continue as a going concern, so that it can provide services to its customers and returns to its shareholders. The capital at December 31, 2022 is \$23,467,463 (September 30, 2022 – \$24,228,761).

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 include 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 December 31,	
	2022	2021
Compensation and short-term employee benefits	\$288,456	\$232,848
Share based payment expense	20,752	6,124
	309,208	238,972

During the year end September 30, 2013, a non-interest bearing loan of \$50,000 was made to a key employee. As of December 31, 2022, \$10,000 of this loan remained outstanding.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

15. EXPENSES BY NATURE

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

	Three months ended December 31,	
	2022	2021
Inventoried materials	\$2,434,540	\$2,589,673
Wages, benefits, consulting fees, director compensation	2,633,377	2,345,859
Share based payments	156,307	21,034
Depreciation and amortization	250,085	109,964
Facility	62,683	173,165
Professional fees	241,116	445,496
Other expenses	763,150	346,433
Total	\$6,541,258	\$6,031,624

Depreciation and amortization

	For the three months ended December 31,	
	2022	2021
Cost of product sales	\$56,033	\$54,295
Operations	22,255	23,511
Research and development activities	37,419	6,226
General and administrative	134,378	25,932
Total depreciation and amortization	\$250,085	\$109,964

16. LOSS PER SHARE

The weighted average number of shares outstanding during the period ended December 31, 2022 was 25,177,915 (December 31, 2021 – 25,872,264).

For both the three months ended December 31, 2022, and December 31, 2021, the computation of diluted loss per share from both continuing and discontinued operations is equal to the basic loss per share due to the Company incurring losses.

For the period ended December 31, 2022, of the 1,102,500 (2021 – 1,063,332) stock options and 2,920,000 (2021 – 2,950,000) warrants not included in the calculation of diluted loss per share 3,127,500 (2021 – 3,824,616) were exercisable.

Covalon Technologies Ltd.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Expressed in Canadian Dollars

17. SEGMENT REPORTING

During the three months ended December 31, 2022, the Company generated continuing operations revenue of \$3,891,659 (2021 – \$3,591,954) in the US, \$1,364,057 (2021 – \$739,022) in the Middle East, \$37,433 (2021 – \$6,890) in Canada, and \$892,256 (2021 – \$598,479) in the rest of the world.

As of December 31, 2022, the Company had \$3,086,358 (September 30, 2022 - \$3,098,014) of its property, plant, and equipment, right-of-use assets and intangible assets located in Canada and \$45,775 (September 30, 2022 - \$52,010) in the USA.

18. CONTINGENCIES AND COMMITMENTS

The following are commitments of the Company beyond December 31, 2022:

	September 30,		
	2023	2024	2025
Purchase obligations	\$158,528	-	-
Telecommunications and office equipment leases	36,250	46,605	9,345
	<u>\$194,778</u>	<u>\$46,605</u>	<u>\$9,345</u>

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.