ESCALON MEDICAL CORP
Form 10-Q
February 14, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

Mark One

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2011

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM TO

Commission File Number: 0-20127

Escalon Medical Corp.

(Exact name of registrant as specified in its charter)

Pennsylvania	**33-0272839**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
435 Devon Park Drive, Building 100 Wayne, PA 19087	**19087**
(Address of principal executive offices)	**(Zip code)**

(610) 688-6830

(Registrant s telephone number, including area code)

N/A

Former name, former address and former fiscal year, if changed since last report

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x Yes ¨ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 7,526,430 shares of common stock, $0.001 par value, outstanding as of February 13, 2012.

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Escalon Medical Corp.

Form 10-Q Quarterly Report

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Part I. Financial Statements

Item 1. Condensed Consolidated Financial Statements

ESCALON MEDICAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited) December 31, 2011	June 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,101,072	$ 1,684,746
Accounts receivable, net	3,218,800	3,802,316
Inventory, net	4,726,296	5,184,272
Other current assets	245,655	248,642
Assets of discontinued operations	0	2,342,137
Total current assets	**9,291,823**	**13,262,113**
Property and equipment, net	447,240	540,919
Goodwill	218,208	218,208
Trademarks and trade names	694,006	694,006
Patents, net	36,684	52,931
Covenant not to compete and customer lists, net	669,807	808,640
Non-current assets of discontinued operations	0	1,699,527
Total assets	**$ 11,357,768**	**$ 17,276,344**
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 260,059	$ 278,278
Related party note payable	300,000	0
Accounts payable	1,767,629	1,746,951
Accrued expenses	1,847,237	1,897,441
Liabilities of discontinued operations	0	1,671,422
Total current liabilities	**4,174,925**	**5,594,092**
Long-term debt, net of current portion	3,889,457	4,506,018
Accrued post-retirement benefits	986,102	986,102
Total long-term liabilities	4,875,559	5,492,120
Total liabilities	**9,050,484**	**11,086,212**
Shareholders equity:		
Preferred stock, $0.001 par value; 2,000,000 shares authorized; no shares issued		
Common stock, $0.001 par value; 35,000,000 shares authorized; 7,526,430 issued and outstanding at December 31, 2011 and June 30, 2011	7,526	7,526
Common stock warrants	132,114	1,733,460
Additional paid-in capital	69,336,688	67,694,959

Accumulated deficit	(66,728,663)	(62,404,014)
Accumulated other comprehensive loss	(440,381)	(841,799)
Total shareholders equity	**2,307,284**	**6,190,132**
Total liabilities and shareholders equity	**$ 11,357,768**	**$ 17,276,344**

See notes to condensed consolidated financial statements

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ESCALON MEDICAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended December 31, 2011	Three Months Ended December 31, 2010	Six Months Ended December 31, 2011	Six Months Ended December 31, 2010
Net revenues:				
Product revenue	$ 6,278,893	$ 6,562,322	$ 12,299,955	$ 12,676,377
Other revenue	0	0	0	6,933
Revenues, net	**6,278,893**	**6,562,322**	**12,299,955**	**12,683,310**
Costs and expenses:				
Cost of goods sold	4,284,316	4,178,261	7,852,825	8,266,985
Marketing, general and administrative	2,571,351	2,777,128	5,047,749	5,441,387
Research and development	320,597	406,389	702,540	802,617
Total costs and expenses	**7,176,264**	**7,361,778**	**13,603,114**	**14,510,989**
Loss from operations	**(897,371)**	**(799,456)**	**(1,303,159)**	**(1,827,679)**
Other (expense) and income:				
Equity in Ocular Telehealth Management, LLC	446	(11,507)	1,144	(34,145)
Loss on disposal of assets	(86,885)	0	(86,885)	0
Interest income	58	45	100	111
Interest expense	(88,059)	(78,231)	(170,549)	(159,878)
Total other (expense) income	**(174,440)**	**(89,693)**	**(256,190)**	**(193,912)**
Net loss from continuing operations before taxes	**(1,071,811)**	**(889,149)**	**(1,559,349)**	**(2,021,591)**
Provision for income taxes	0	0	0	0
Net loss from continuing operations	**(1,071,811)**	**(889,149)**	**(1,559,349)**	**(2,021,591)**
Net income (loss) from discontinued operations including loss of $2,216,046 on liquidation of BHH net assets during 2011	**(2,463,189)**	**(159,450)**	**(2,765,300)**	**323,828**
Net loss	**$ (3,535,000)**	**$ (1,048,599)**	**$ (4,324,649)**	**$ (1,697,763)**
Net income (loss) per share				
Basic:				
Continuing operations	**$ (0.14)**	**$ (0.12)**	**$ (0.21)**	**$ (0.27)**
Discontinued operations	**(0.33)**	**(0.02)**	**(0.37)**	**0.04**
	$ (0.47)	**$ (0.14)**	**$ (0.58)**	**$ (0.23)**
Diluted:				
Continuing operations	**$ (0.14)**	**$ (0.12)**	**$ (0.21)**	**$ (0.27)**
Discontinued operations	**(0.33)**	**(0.02)**	**(0.37)**	**0.04**
	$ (0.47)	**$ (0.14)**	**$ (0.58)**	**$ (0.23)**

Weighted average shares basic	**7,526,430**	**7,526,430**	**7,526,430**	**7,526,430**
Weighted average shares diluted	**7,526,430**	**7,526,430**	**7,526,430**	**7,526,430**

See notes to condensed consolidated financial statements

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ESCALON MEDICAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

For the Six Months Ended December 31,	2011	2010
Cash Flows from Operating Activities:		
Net (loss)	$ (4,324,649)	$ (1,697,763)
Adjustments to reconcile net loss to cash provided by operating activities of continued operations:		
Income (loss) from discontinued operations	2,765,300	(323,828)
Depreciation and amortization	348,735	250,069
Compensation expense related to stock options	40,383	63,257
(Income) loss of Ocular Telehealth Management, LLC	(1,144)	34,145
Change in operating assets and liabilities:		
Accounts receivable, net	583,516	364,564
Inventory, net	457,976	(624,050)
Other current and long-term assets	2,987	200,165
Accounts payable, accrued expenses and other liabilities	(29,525)	186,943
Net cash (used in) operating activities from continuing operations	(156,421)	(1,546,498)
Net cash (used in) provided by operating activities from discontinued operations	(566,953)	581,639
Net cash (used in) operating activities	**(723,374)**	**(964,859)**
Cash Flows from Investing Activities:		
Investment in Ocular Telehealth Management, LLC	0	(45,000)
Purchase of fixed assets	(54,730)	(85,177)
Net cash (used in) investing activities from continuing operations	(54,730)	(130,177)
Net cash (used in) investing activities from discontinued operations	0	(17,323)
Net cash (used in) investing activities	**(54,730)**	**(147,500)**
Cash Flows from Financing Activities:		
Proceeds from related-party note payable	300,000	0
Principal payments on long-term debt	(155,795)	(50,538)
Net cash provided by (used in) financing activities	**144,205**	**(50,538)**
Effect of exchange rate changes on cash & cash equivalents	**50,225**	**74,099**
Net decrease in cash and cash equivalents	**(583,674)**	**(1,088,798)**
Cash and cash equivalents, beginning of period	**1,684,746**	**3,342,422**
Cash and cash equivalents, end of period	**$ 1,101,072**	**$ 2,253,624**
Supplemental Schedule of Cash Flow Information:		
Interest paid	$ 170,550	$ 163,599
Income taxes paid	$ 0	$ 45,000

See notes to condensed consolidated financial statements

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ESCALON MEDICAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

FOR THE SIX MONTHS ENDED DECEMBER 31, 2011

(Unaudited)

	Common Stock		Common Stock	Additional Paid-in	Accumulated	Accumulated Other Comprehensive Income	Total Shareholders
	Shares	Amount	Warrants	Capital	Deficit	(Loss)	Equity
BALANCE AT JUNE 30, 2011	**7,526,430**	**$ 7,526**	**$ 1,733,460**	**$ 67,694,959**	**$ (62,404,014)**	**$ (841,799)**	**$ 6,190,132**
Comprehensive Loss:							
Net loss	0	0	0	0	(4,324,649)	0	**(4,324,649)**
Foreign currency translation	0	0	0	0	0	401,418	**401,418**
Total comprehensive loss					(4,324,649)	401,418	**(3,923,231)**
Expired stock warrants	0	0	(1,601,346)	1,601,346	0	0	**0**
Compensation expense	0	0	0	40,383	0	0	**40,383**
BALANCE AT DECEMBER 31, 2011	**7,526,430**	**$ 7,526**	**$ 132,114**	**$ 69,336,688**	**$ (66,728,663)**	**$ (440,381)**	**$ 2,307,284**

See notes to condensed consolidated financial statements

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ESCALON MEDICAL CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Net (loss)	$ (3,535,000)	$ (1,048,599)	$ (4,324,649)	$ (1,697,763)
Foreign currency translation	303,643	89,593	401,418	56,447
Comprehensive (loss)	**$ (3,231,357)**	**$ (959,006)**	**$ (3,923,231)**	**$ (1,641,316)**

See notes to condensed consolidated financial statements

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Escalon Medical Corp. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Basis of Presentation

Escalon Medical Corp. (Escalon or the Company) is a Pennsylvania corporation initially incorporated in California in 1987, and reincorporated in Pennsylvania in November 2001. Within this document, the Company collectively shall mean Escalon and its wholly owned subsidiaries: Sonomed, Inc. (Sonomed), Trek, Inc. (Trek), Escalon Vascular Access, Inc. (Vascular), Escalon Medical Europe GmbH (EME), Escalon Digital Vision, Inc. (EMI), Escalon Pharmaceutical, Inc. (Pharmaceutical), Escalon Holdings, Inc. (EHI), Escalon IP Holdings, Inc., Escalon Vascular IP Holdings, Inc., Sonomed IP Holdings, Inc., Drew Scientific Holdings, Inc., and Drew Scientific Group, Plc (Drew) and its subsidiaries. All intercompany accounts and transactions have been eliminated.

On January 12, 2012 BH Holdings, S.A.S. (BHH) a wholly owned subsidiary of Drew, initiated the filing of an insolvency declaration with the Tribunal de Commerce de Rennes, France (Commercial Court). The Commercial Court on January 18, 2012 opened the liquidation proceedings with continuation of BHH s activity for three months and named an administrator to manage BHH. Since BHH is no longer controlled by Drew it was deconsolidated in the December 31, 2011 consolidated financial statements and prior period amounts are presented as discontinued operations (see footnote 10 to the Notes to Condensed Consolidated Financial Statements for additional information).

The Company sold certain assets of the Vascular business for $5,750,000 on April 30, 2010 to Vascular Solutions, Inc. (see footnote 10 to the Notes to Condensed Consolidated Financial Statements for additional information).

The Company operates in the healthcare market, specializing in the development, manufacture marketing and distribution of medical devices and pharmaceuticals in the areas of ophthalmology, diabetes and hematology. The Company and its products are subject to regulation and inspection by the United States Food and Drug Administration (the FDA). The FDA and other governmental authorities require extensive testing of new products prior to sale and have jurisdiction over the safety, efficacy and manufacture of products, as well as product labeling and marketing.

Management reviews financial information, allocates resources, and manages the business as three segments, Escalon Clinical Diagnostics (ECD), Sonomed-Escalon and Escalon Medical Corp. (Corporate). The ECD segment consists of Drew Scientific, Inc., and its wholly owned subsidiary JAS Diagnostics, Inc. (JAS). ECD develops and sells clinical diagnostic instruments, reagents and chemistries. The Sonomed-Escalon segment consists of Sonomed, Inc., EMI and Trek, all of which are engaged in the development and sale of Ophthalmic medical devices. The Escalon Medical Corp. segment includes the administrative corporate operations of the consolidated group. The Company began including redesignated reporting segments beginning with Form 10-K for the year ended June 30, 2011, and prior period segment information has been reclassified to conform with the current year presentation.

2. Stock-Based Compensation

Valuations are based upon highly subjective assumptions about the future, including stock price volatility and exercise patterns. The fair value of share-based payment awards was estimated using the Black-Scholes option pricing model. Expected volatilities are based on the historical volatility of the Company s stock. The Company uses historical data to estimate option exercise and employee terminations. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

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The Company has historically granted options under the Company s option plans with an option exercise price equal to the closing market value of the stock on the date of the grant and with vesting, primarily for Company employees, either in equal annual amounts over a two- to five-year period or immediately, and, primarily for non-employee directors, immediately.

As of December 31, 2011 and 2010 total unrecognized compensation cost related to non-vested share-based compensation arrangements granted to employees under the 2004 Equity Incentive Plan was $87,726 and $234,221, respectively. The remaining cost is expected to be recognized over a weighted average period of 1.65 years. For the three-month periods ended December 31, 2011 and 2010, $16,484 and $23,898 was recorded as compensation expense, respectively. For the six-month periods ended December 31, 2011 and 2010, $40,383 and $63,257 was recorded as compensation expense, respectively.

The Company did not receive any cash from share option exercises under stock-based payment plans for the three month and six month periods ended December 31, 2011 and 2010. The Company did not realize any tax effect, which would be a reduction in its tax rate, on options due to the full valuation allowances established on its deferred tax assets.

The Company measures compensation expense for non-employee stock-based awards based on the fair value of the options issued as this is used to measure the transaction, and this is more reliable than the fair value of the services received. Fair value is measured as the value of the Company s common stock on the date that the commitment for performance by the counterparty has been reached or the counterparty s performance is complete. The fair value of the equity instrument is charged directly to compensation expense and additional paid-in capital. There was no non-employee compensation expense for the three-month and six-month periods ended December 31, 2011 and 2010.

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3. Earnings (Loss) per Share

The following table sets forth the computation of basic and diluted net loss per share:

	Three Months Ended December 31, 2011	Three Months Ended December 31, 2010	Six Months Ended December 31, 2011	Six Months Ended December 31, 2010
Numerator:				
Numerator for basic and diluted earnings per share				
Net loss from continuing operations	$ (1,071,811)	$ (889,149)	$ (1,559,349)	$ (2,021,591)
Net income (loss) from discontinued operations	(2,463,189)	(159,450)	(2,765,300)	323,828
Net loss	**$ (3,535,000)**	**$ (1,048,599)**	**$ (4,324,649)**	**$ (1,697,763)**
Denominator:				
Denominator for basic earnings per share weighted average shares	7,526,430	7,526,430	7,526,430	7,526,430
Effect of dilutive securities:				
Stock options and warrants	0	0	0	0
Shares reserved for future exchange	0	0		
Denominator for diluted earnings per share weighted average and assumed conversion	**7,526,430**	**7,526,430**	**7,526,430**	**7,526,430**
Net (loss) income per share				
Basic:				
Continuing operations	**$ (0.14)**	**$ (0.12)**	**$ (0.21)**	**$ (0.27)**
Discontinued operations	**(0.33)**	**(0.02)**	**(0.37)**	**0.04**
	$ (0.47)	**$ (0.14)**	**$ (0.58)**	**$ (0.23)**
Diluted:				
Continuing operations	**$ (0.14)**	**$ (0.12)**	**$ (0.21)**	**$ (0.27)**
Discontinued operations	**(0.33)**	**(0.02)**	**(0.37)**	**0.04**
	$ (0.47)	**$ (0.14)**	**$ (0.58)**	**$ (0.23)**

The impact of dilutive securities was omitted from the earnings per share calculation in all periods presented as they would reduce the loss per share and thus were anti-dilutive.

4. Legal Proceedings

The Company, from time to time is involved in various legal proceedings and disputes that arise in the normal course of business. These matters have previously and could pertain to intellectual property disputes, commercial contract disputes, employment disputes, and other matters. The Company does not believe that the resolution of any of these matters has had or is likely to have a material adverse impact on the Company s business, financial condition or results of operations (see footnote 10 for details on BHH court proceeding related to the insolvency declaration).

5. Segmental Information

During the three-month and six-month periods ended December 31, 2011 and 2010, the Company s operations were classified into three principal reportable business units that provide different products or services.

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Management reviews financial information, allocates resources, and manages the business as three segments, ECD, Sonomed-Escalon and Escalon Medical Corp. (Corporate). The ECD segment consists of Drew Scientific, Inc., and its wholly owned subsidiary JAS. ECD develops and sells clinical diagnostic instruments, reagents and chemistries. The Sonomed-Escalon segment consists of Sonomed, Inc., EMI and Trek, all of which are engaged in the development and sale of Ophthalmic medical devices. The Escalon Medical Corp. segment includes the administrative corporate operations of the consolidated group. The Company began to include redesignated reporting segments beginning with Form 10-K for the year ended June 30, 2011, and prior period segment information has been reclassified to conform with the current year presentation.

Separate management of each unit is required because each business unit is subject to different marketing, production and technology strategies.

Segment Statements of Operations (in thousands) Three months ended December 31,

	ECD		Sonomed-Escalon		Corporate		Total	
	2011	2010	2011	2010	2011	2010	2011	2010
Revenues, net:								
Product revenue	$ 3,093	$ 3,388	$ 3,186	$ 3,174	$ 0	$ 0	$ 6,279	$ 6,562
Other revenue								
Total revenues, net	3,093	3,388	3,186	3,174			6,279	6,562
Costs and expenses:								
Cost of goods sold	2,822	2,454	1,462	1,724			4,284	4,178
Research & Development	110	183	211	224			321	407
Marketing, General & Admin	1,268	1,734	1,064	937	239	106	2,571	2,777
Total costs and expenses	4,200	4,371	2,737	2,885	239	106	7,176	7,362
(Loss) income from operations	(1,107)	(983)	449	289	(239)	(106)	(897)	(800)
Other (expense) income:								
Loss on Disposal of Assets	(87)						(87)	
Equity in OTM						(11)		(11)
Interest income								
Interest expense	(80)	(78)			(8)		(88)	(78)
Total other (expense) income	(167)	(78)			(8)	(11)	(175)	(89)
(Loss) income before taxes	(1,274)	(1,061)	449	289	(247)	(117)	(1,072)	(889)
Income taxes								
Net (loss) income from continuing operations	($ 1,274)	($ 1,061)	$ 449	$ 289	($ 247)	($ 117)	($ 1,072)	($ 889)

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Segment Statements of Operations (in thousands)
Six months ended December 31,

	ECD		Sonomed-Escalon		Corporate		Total	
	2011	2010	2011	2010	2011	2010	2011	2010
Revenues, net:								
Product revenue	$ 6,707	$ 7,028	$ 5,593	$ 5,649	$ 0	$ 0	$ 12,300	$ 12,677
Other revenue		7						7
Total revenues, net	6,707	7,035	5,593	5,649			12,300	12,684
Costs and expenses:								
Cost of goods sold	5,166	5,173	2,686	3,093			7,852	8,266
Research & Development	272	372	430	431			702	803
Marketing, General & Admin	2,768	3,515	2,043	1,695	237	232	5,048	5,442
Total costs and expenses	8,206	9,060	5,159	5,219	237	232	13,602	14,511
(Loss) income from operations	(1,499)	(2,025)	434	430	(237)	(232)	(1,302)	(1,827)
Other (expense) income:								
Equity in OTM					1	(34)	1	(34)
Loss on Disposal of Assets	(87)						(87)	
Interest income						(1)		(1)
Interest expense	(164)	(160)			(7)		(171)	(160)
Total other (expense) income	(251)	(160)			(6)	(35)	(257)	(195)
(Loss) income before taxes	(1,750)	(2,185)	434	430	(243)	(267)	(1,559)	(2,022)
Income taxes								
Net (loss) income from continuing operations	($ 1,750)	($ 2,025)	$ 434	$ 430	($ 243)	($ 267)	($ 1,559)	($ 2,022)

The Company operates in the healthcare market, specializing in the development, manufacture and marketing of (1) ophthalmic medical devices and pharmaceuticals; (2) in-vitro diagnostic (IVD) instrumentation and consumables for use in human and veterinary hematology. On April 30, 2010, the Company sold its Vascular business. The business segments reported above are the segments for which separate financial information is available and for which operating results are evaluated regularly by executive management in deciding how to allocate resources and assessing performance. The accounting policies of the business segments are the same as those described in the summary of significant accounting policies in Form 10-K for the year ended June 30, 2011. For the purposes of this illustration, corporate expenses, which consist primarily of executive management and administrative support functions, are allocated across the business segments based upon a methodology that has been established by the Company, which includes a number of factors and estimates and that has been consistently applied across the business segments. These expenses are otherwise included in the corporate segment.

During three- and six-month periods ended December 31, 2011 and 2010, ECD derived its revenue from the sale of instrumentation and consumables for blood cell counting and blood analysis in the areas of diabetes, cardiovascular diseases and human and veterinary hematology. Sonomed-Escalon derived its revenue from the sale of A-Scans, B-Scans and pachymeters. These products are used for diagnostic or biometric applications in ophthalmology. Revenue is from the sale of ISPAN gas products and various disposable ophthalmic surgical products and from CFA digital imaging systems and related products.

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6. Related-Party Transactions

The Company and a member of the Company s Board of Directors are founding and equal members of Ocular Telehealth Management, LLC (OTM). OTM is a diagnostic telemedicine company providing remote examination, diagnosis and management of disorders affecting the human eye. OTM s initial focus is on the diagnosis of diabetic retinopathy by creating access and providing annual dilated retinal examinations for the diabetic population. Through December 31, 2011, the Company has invested $444,000 in OTM. As of December 31, 2011, the Company owned 45% of OTM. The Company provides administrative support functions to OTM. There was no gain or loss for the three-month period ended December 31, 2011 and recognized a loss of $12,000 for the three-month period ended December 31, 2010. For the six-month periods ended December 31, 2011 and 2010 the Company recorded a gain of $1,000 and a loss of $34,000 respectively. At December 31, 2011 OTM had total assets, liabilities and equity of, $2,000, $80,000 and ($78,000), respectively.

During six-month period ended December 31, 2011, Richard J. DePiano, Sr., the Company s CEO participated in an accounts receivable factoring program that was implemented by the Company. Under the program, Mr. DePiano advanced the Company $300,000 which represented 100% of an amount due from various Drew customers. The receivables were not eligible to be sold to the Company s usual factoring agent. Interest on the transaction is 1.25% per month, which is equal to the best price offered by the Company s usual factoring agent. The transaction excluded fees typically charged by the factoring agent and provided much needed liquidity to the Company.

7. Recently Issued Accounting Standards

In January 2010, FASB issued ASU No. 2010-06, Improving Disclosures about Fair Value Measurements. This update provides amendments to Subtopic 820-10 that requires new disclosure to include transfers in and out of Levels 1 and 2 and activity in Level 3 fair value measurements. Further, this update clarifies existing disclosures on level of disaggregation and disclosures about inputs and valuation techniques. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities and should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either Level 2 or Level 3. The new disclosures and clarifications of existing disclosures became effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The adoption of this ASU did not have a material impact on the Company s consolidated financial statements

In April 2010, the FASB issued ASU 2010-13, Compensation Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades, or ASU 2010-13. ASU 2010-13 provides amendments to Topic 718 to clarify that an employee share-based payment award with an exercise price denominated in currency of a market in which a substantial portion of the entity s equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. The amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2010. The Company does not expect the adoption of ASU 2010-13 to have a significant impact on its consolidated financial statements.

In May 2011, the FASB issued ASU No. 2011-04 which provides a consistent definition of fair value in GAAP and International Financial Reporting Standards and ensures that their respective fair value measurement and disclosure requirements are the same (except for minor differences in wording and style). The amendments change certain fair value measurement principles and enhance the disclosure requirements particularly for level 3 fair value measurements. The standard will become effective for the

Company during interim and annual periods beginning after December 15, 2011 and should be applied prospectively. The Company does not believe that the implementation of this standard will have a material impact on its financial position, results of operation and cash flows.

In June 2011, the FASB issued ASU No. 2011-05 which requires an entity to present all non-owner changes in stockholders equity either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders equity. This standard will become effective for the Company in fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Company does not believe that the implementation of this standard will have a material impact on its financial position, results of operation and cash flows.

In September 2011, the FASB issued ASU No. 2011-08, Intangibles Goodwill and Other (Topic 350): Testing Goodwill for Impairment, which simplifies how an entity tests goodwill for impairment. Under that option, an entity no longer would be required to calculate the fair value of a reporting unit unless the entity determines, based on that qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. The amendments will be effective for the company for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 and should be applied prospectively. The Company does not believe that the implementation of this standard will have a material impact on its financial position, results of operation and cash flows.

8. Fair Value Measurements

On July 1, 2008, the Company adopted the FASB-issued authoritative guidance for the fair value of financial assets and liabilities. This standard defines fair value and establishes a hierarchy for reporting the reliability of input measurements used to assess fair value for all assets and liabilities. The FASB issued authoritative guidance defines fair value as the selling price that would be received for an asset, or paid to transfer a liability, in the principal or most advantageous market on the measurement date. The hierarchy established prioritizes fair value measurements based on the types of inputs used in the valuation technique. The inputs are categorized into the following levels:

Level 1 Observable inputs such as quoted prices in active markets for identical assets or liabilities.

Level 2 Directly or indirectly observable inputs for quoted and other than quoted prices for identical or similar assets and liabilities in active or non-active markets.

Level 3 Unobservable inputs not corroborated by market data, therefore requiring the entity to use the best available information available in the circumstances, including the entity s own data.

Certain financial instruments are carried at cost on the condensed consolidated balance sheets, which approximates fair value due to their short-term, highly liquid nature. These instruments include cash and cash equivalents, accounts receivable, accounts payable, accrued expenses, related party note payable and other liabilities.

The Company determined that the fair value of the outstanding debt approximates the outstanding balances based on the remaining maturity of the note for the Biocode debt and other Level 3 measurements. By other level 3 measurements we are referring to unobservable inputs not corroborated by market data, therefore requiring the entity to use the best available information available in the circumstances, including the entity s own data . We included this reference because in determining the estimated fair value of our debt we first attempted to use a commonly accepted valuation methodology of applying rates currently available to the Company for debt with similar terms and remaining maturities. The long-term debt currently on our balance sheet is related to the acquisition of certain assets of Biocode Hycell on December 31, 2008. The acquisition was 100% financed by the seller. Management concluded that given the financial state of the Company and the overall state of the credit markets there is no financial institution that would make available funds to us for the 100% financing of a foreign entity with similar terms and remaining maturities, or in fact, on any terms. We then considered whether there was any level 3 considerations, as defined above, which might aid us in determining the fair market value of this unique form of debt. We determined that there was not and came to the conclusion that given the weakened state of our Company and overall market conditions there was no other source of financing available to us, from any source on any terms, other than the willing seller of the Biocode assets. Therefore, we concluded that the fair market value of the debt remains equal to its book value.

9. Continuing Operations

The accompanying consolidated financial statements have been prepared on the going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has incurred recurring operating losses, will no longer has the benefit of cash inflows from Vascular and has commenced making the debt service payments on May 31, 2011 related to the Biocode acquisition (see footnote 10 for further information on the Biocode acquisition debt). These conditions raise substantial doubt about the Company s ability to continue as a going concern. If the Company is unsuccessful in its efforts to raise additional capital in the near term, the Company may be required to significantly reduce its research, development, and administrative activities, including further reduction of its employee base. The financial statements do not include any adjustments relating to the realization of the carrying value of assets or the amounts and classification of liabilities that might be necessary should we be unable to continue as a going concern. Our continuance as a going concern is dependent on our future profitability and on the on-going support of our shareholders, affiliates and creditors. In order to mitigate the going concern issues, we are actively pursuing business partnerships, managing our continuing operations, and seeking capital funding on an ongoing basis via the issuance of securities and private placements, although we may not succeed in these mitigation efforts.

The filing of the insolvency declaration at BHH will have a material effect on results of operations in subsequent periods. BHH s product line revenues from operations were $ 4,763,056, $5,254,574 and $2,647,877 in fiscal 2011, 2010, 2009, respectively. Losses from operations, net of taxes, were ($1,232,904), ($635,952) and ($1,068,040) in 2011, 2010, 2009, respectively.

As part of ongoing austerity measures that have been implemented over the past two years at Drew, management decided in June 2011 to outsource the manufacturing of Drew s instruments and cease all manufacturing out of its Dallas facility. Research and development activities performed in Dallas will also be eliminated and will be outsourced on an as needed basis. Management continues to work with outsource partners to perfect the manufacturing of Drew s instruments and anticipates that the Dallas facility will cease manufacturing activities on or about February 29, 2012.

If the Company is unable to achieve continued improvement in this area in the near term, it is not likely that our existing cash and cash flow from operations will be sufficient to fund activities throughout the next 6 to 12 months without curtailing certain business activities. The Company s forecast of the period of time through which its financial resources will be adequate to support its operations is a forward-looking statement and involves risks and uncertainties, and actual results could vary as a result of a number of factors, including the factors discussed in Risk Factors of the Company s Form 10-K for the year ended June 30, 2011.

If the Company seeks to raise funds in the future, the Company may be required to raise those funds through public or private financings, strategic relationships or other arrangements at prices and other terms that may not be as favorable as they would without such qualification. The sale of additional equity and debt securities may result in additional dilution to the Company s shareholders. Additional financing may not be available in amounts or on terms acceptable to the Company or at all.

10. Discontinued Operations

BH Holdings, S.A.S

On January 12, 2012 BHH initiated the filing of an insolvency declaration with the Tribunal de Commerce de Rennes, France (Commercial Court). The Commercial Court on January 18, 2012 opened the liquidation proceedings with continuation of BHH s activity for three months and named an administrator to manage BHH. Since Drew no longer has a controlling financial interest in BHH it was deconsolidated in the December 31, 2011 financial statements and prior period amounts are presented as discontinued operations.

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The Company incurred a loss of $2,216,000 related to the deconsolidation of BHH. The deconsolidation loss was calculated by measuring the difference between:

a. The aggregate of:

(1) The fair value of any consideration received, (there was no consideration received);

(2) The fair value of any retained noncontrolling investment in the former subsidiary at the date the subsidiary is deconsolidated; and

(3) The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated (there was no noncontrolling interest in the former subsidiary).

b. The carrying amount of the former subsidiary s assets and liabilities.

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The following table summarizes the results of discontinued operations of BHH for the three-month and six-month periods ended December 31, 2011 and 2010 (in thousands):

	For the Three Months Ended December 31, 2011	2010
Total revenue, net	$ 970	$ 1,039
Costs and expenses:		
Cost of goods sold	167	67
Research & Development	0	0
Marketing, General & Admin	1,050	997
Total costs and expenses	1,217	1,064
Loss from discontinued operations	**(247)**	**(25)**
Loss on liquidation of net assets from discontinued operations	(2,216)	0
Loss before income taxes	**(2,463)**	**(25)**
Income taxes	0	0
Net loss from discontinued operations	**$ (2,463)**	**$ (25)**

	For the Six Months Ended December 31, 2011	2010
Total revenue, net	$ 1,970	$ 2,397
Costs and expenses:		
Cost of goods sold	574	341
Research & Development	0	0
Marketing, General & Admin	1,945	1,903
Total costs and expenses	2,519	2,244
Income (loss) from discontinued operations	**(549)**	**153**
Loss on liquidation of net assets from discontinued operations	(2,216)	0
Income before income taxes	**(2,765)**	**153**
Income taxes	0	0
Net (loss) income from discontinued operations	**$ (2,765)**	**$ 153**

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Assets and liabilities of discontinued operations included in the consolidated balance sheets are summarized as follows at December 31, 2011 and June 30, 2011, (in thousands):

	December 31, 2011	June 30, 2011
Assets		
Cash	$ 0	$ 230
Accounts receivable	0	965
Inventory	0	1,076
Other Current Assets	0	70
Fixed assets	0	110
Patents and customer list, net	0	1,481
Other Assets	0	109
Total Assets	0	4,041
Liabilities		
Accounts Payable	0	370
Accrued expenses	0	1,147
Other Current Liabilities	0	155
Total Liabilities	0	1,672
Net assets of discontinued operations	$ 0	$ 2,369

Discontinued operation of Vascular

In an effort to enhance stockholder value, improve working capital and enable the Company to focus on its core in-vitro diagnostics and ophthalmology manufacturing businesses, on April 30, 2010 the Company divested certain assets held by its Vascular Access subsidiaries to Vascular Solutions, Inc. The total sales price was $5,750,000, consisting of cash of $5,000,000 at closing and $750,000 payable in cash upon the successful completion of the transfer of the manufacturing to Vascular Solutions, Inc. plus a one-time earn-out payment in an amount equal to 25% of the net sales of the VascuView TAP products sold by Vascular Solutions, Inc. between July 1, 2010 and June 30, 2011. The manufacturing transfer was completed on August 31, 2010. During this four-month transition, the Company continued to manufacture product in its Wisconsin facility under a supply agreement concurrently entered into with Vascular Solutions, Inc. The supply agreement ended on August 30, 2010 and the Company has no significant continuing involvement in the operations of Vascular. Vascular Access generated approximately $565,000 in gross profit related to the supply agreement.

The following table summarizes the results of discontinued operations of Vascular for the three-month and six-month periods ended December 31, 2011 and 2010 (in thousands):

	For the Three Months Ended December 31,	
	2011	2010
Total revenue, net	$ 0	$ 4
Costs and expenses:		
Cost of goods sold	0	0
Research & Development	0	11
Marketing, General & Admin	0	126
Total costs and expenses	0	137

Loss from discontinued operations	**$ 0**	**($ 133)**

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	For the Six Months Ended December 31, 2011	2010
Total revenue, net	$ 0	$ 638
Costs and expenses:		
Cost of goods sold	0	283
Research & Development	0	29
Marketing, General & Admin	0	155
Total costs and expenses	0	467
Income from discontinued operations	**$ 0**	**$ 171**

There are no assets and liabilities of discontinued operations included in the consolidated balance sheets at December 31, 2011 and June 30, 2011 related to Vascular Access.

11. Expiration of common stock warrants

Common stock warrants in the amount of $1,601,346 have expired and were released to additional paid-in capital.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations Forward Looking Statements

Certain statements contained in, or incorporated by reference in, this report are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, which provide current expectations or forecasts of future events. Such statements can be identified by the use of terminology such as anticipate, believe, could, estimate, expect, forecast, intend, may, p project, should, will, and similar words or expressions. The Company s forward-looking statements include certain information relating to general business strategy, growth strategies, financial results, liquidity, discontinued operations, product development, the introduction of new products, the potential markets and uses for the Company s products, the Company s regulatory filings with the FDA, acquisitions, the development of joint venture opportunities, intellectual property and patent protection and infringement, the loss of revenue due to the expiration on termination of certain agreements, the effect of competition on the structure of the markets in which the Company competes, increased legal, accounting and Sarbanes-Oxley compliance costs, defending the Company in litigation matters and the Company s cost saving initiatives. The reader must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by assumptions that fail to materialize as anticipated. Consequently, no forward-looking statement can be guaranteed, and actual results may vary materially. It is not possible to foresee or identify all factors affecting the Company s forward-looking statements, and the reader therefore should not consider the list of such factors contained in its periodic report on Form 10-K for the year ended June 30, 2011 and this Form 10-Q quarterly report to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions.

Executive Overview Six-Month Period Ended December 31, 2011

The following highlights are discussed in further detail within this report. The reader is encouraged to read this report in its entirety to gain a more complete understanding of factors impacting Company performance and financial condition.

Product revenue from continuing operations decreased approximately $377,000 or 3.0% during the six-month period ended December 31, 2011 as compared to the same period last fiscal year.

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Product revenue decreased 4.6% and 1.0%, respectively at the ECD and Sonomed-Escalon business segments during the six-month period ended December 31, 2011 when compared to the same period last fiscal year.

There is no other revenue during the six-month period ended December 31, 2011 as compared to $7,000 during the same period last fiscal year.

Cost of goods sold as a percentage of product revenue from continuing operations decreased to approximately 63.8% during the six-month period ended December 31, 2011, as compared to approximately 65.2% for the same period last fiscal year.

Operating expenses decreased approximately $494,000 or 7.9% during the six-month period ended December 31, 2011 as compared to the same period in the prior fiscal year.

Company Overview

The following discussion should be read in conjunction with interim condensed consolidated financial statements and the notes thereto, which are set forth in Item 1 this report.

The Company operates in the healthcare market specializing in the development, manufacture, marketing and distribution of medical devices and pharmaceuticals in the areas of ophthalmology, diabetes, and hematology. The Company and its products are subject to regulation and inspection by the FDA. The FDA requires extensive testing of new products prior to sale and has jurisdiction over the safety, efficacy and manufacture of products, as well as product labeling and marketing. The Company s Internet address is www.escalonmed.com.

Critical Accounting Policies

The preparation of financial statements requires management to make estimates and assumptions that impact amounts reported therein. The most significant of those involve the application of FASB-issued authoritative guidance concerning Revenue Recognition, Goodwill and Other Intangible Assets, discussed further in the notes to consolidated financial statements included in the Form 10-K for the year ended June 30, 2011. The financial statements are prepared in conformity with accounting principles generally accepted in the United States of America, and, as such, include amounts based on informed estimates and judgments of management. For example, estimates are used in determining valuation allowances for deferred income taxes, uncollectible receivables, obsolete inventory, sales returns and rebates, warranty liabilities and purchased intangible assets. Actual results achieved in the future could differ from current estimates. The Company used what it believes are reasonable assumptions and, where applicable, established valuation techniques in making its estimates.

Revenue Recognition

The Company recognizes revenue from the sale of its products at the time of shipment, when title and risk of loss transfer. The Company provides products to its distributors at agreed wholesale prices and to the balance of its customers at set retail prices. Distributors can receive discounts for accepting high volume shipments. The discounts are reflected immediately in the net invoice price, which is the basis for revenue recognition. No further material discounts are given.

The Company s considerations for recognizing revenue upon shipment of product to a distributor are based on the following:

Persuasive evidence that an arrangement (purchase order and sales invoice) exists between a willing buyer (distributor) and the Company that outlines the terms of the sale (company information, quantity of goods, purchase price and payment terms). The buyer (distributor) does not have a right of return.

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Shipping terms are ex-factory shipping point. At this point the buyer (distributor) takes title to the goods and is responsible for all risks and rewards of ownership, including insuring the goods as necessary.

The Company s price to the buyer (distributor) is fixed and determinable as specifically outlined on the sales invoice. The sales arrangement does not have customer cancellation or termination clauses.

The buyer (distributor) places a purchase order with the Company; the terms of the sale are cash, COD or credit. Customer credit is determined based on the Company s policies and procedures related to the buyer s (distributor s) creditworthiness. Based on this determination, the Company believes that collectibility is reasonably assured.

The Company assesses collectibility based on creditworthiness of the customer and past transaction history. The Company performs ongoing credit evaluations of its customers and does not require collateral from its customers. For many of the Company s international customers, the Company requires an irrevocable letter of credit to be issued by the customer before the purchase order is accepted.

Valuation of Intangible Assets

The Company annually evaluates for impairment its intangible assets and goodwill in accordance with SFAS 142, Goodwill and Other Intangible Assets, or whenever events or changes in circumstances indicate that the carrying value may not be recoverable, see footnote 4 to consolidated financial statements included in the Company s Form 10-K for the year ended June 30, 2011 for details on a goodwill impairment charge related to the carrying amount of EMI s goodwill. These intangible assets include goodwill, trademarks and trade names. Recoverability of these assets is measured by comparison of their carrying amounts to future discounted cash flows the assets are expected to generate. If identifiable intangibles are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds its fair market value. The Company does not amortize intangible assets with indefinite useful lives, rather such assets are required to be tested for impairment at least annually or sooner whenever events or changes in circumstances indicate that the assets may be impaired. The Company performs its intangible asset impairment tests on or about June 30, of each year. Any such impairment charge could be significant and could have a material adverse impact on the Company s financial statements if and when an impairment charge is recorded.

Income/(Loss) Per Share

The Company computes net income/(loss) per share under the provisions of FASB issued authoritative guidance.

Under the provisions of FASB issued authoritative guidance, basic and diluted net income/(loss) per share is computed by dividing the net income/(loss) for the period by the weighted average number of shares of common stock outstanding during the period. The calculation of diluted net income/(loss) per share excludes potential common shares if the impact is anti-dilutive. Basic earnings per share are computed by dividing net income/(loss) by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share are determined in the same manner as basic earnings per share, except that the number of shares is increased by assuming exercise of dilutive stock options and warrants using the treasury stock method.

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Taxes

Estimates of taxable income of the various legal entities and jurisdictions are used in the tax rate calculation. Management uses judgment in estimating what the Company s income will be for the year. Since judgment is involved, there is a risk that the tax rate may significantly increase or decrease in any period.

In determining income/(loss) for financial statement purposes, management must make certain estimates and judgments. These estimates and judgments occur in the calculation of certain tax liabilities and in the determination of the recoverability of certain deferred tax assets, which arise from temporary differences between the tax and financial statement recognition of revenue and expense. FASB issued authoritative guidance concerning accounting for income taxes also requires that the deferred tax assets be reduced by a valuation allowance, if based on the available evidence, it is more likely that not that all or some portion of the recorded deferred tax assets will not be realized in future periods.

In evaluating the Company s ability to recover the Company s deferred tax assets, management considers all available positive and negative evidence including the Company s past operating results, the existence of cumulative losses and near-term forecasts of future taxable income that is consistent with the plans and estimates management is using to manage the underlying businesses.

Through December 31, 2011, the Company has recorded a valuation allowance against the Company s net operating losses for substantially all of the deferred tax asset due to uncertainty of their realization as a result of the Company s earnings history, the number of years the Company s net operating losses and tax credits can be carried forward, the existence of taxable temporary differences and near-term earnings expectations. The amount of the valuation allowance could decrease if facts and circumstances change that materially increase taxable income prior to the expiration of the loss carryforwards. Any reduction would reduce (increase) the income tax expense (benefit) in the period such determination is made by the Company.

The Company has adopted FASB issued guidance related to accounting for uncertainty in income taxes, which provides a comprehensive model for the recognition, measurement, and disclosure in financial statements of uncertain income tax positions that a company has taken or expects to take on a tax return. Under the FASB guidance a company can recognize the benefit of an income tax position only if it is more likely than not (greater than 50%) that the tax position will be sustained upon tax examination, based solely on the technical merits of the tax position. Otherwise, no benefit can be recognized. The tax benefits recognized are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Additionally, companies are required to accrue interest and related penalties, if applicable, on all tax exposures for which reserves have been established consistent with jurisdictional tax laws. The Company has elected to recognize interest expense and penalties related to uncertain tax positions as a component of its provision for income taxes.

Stock-Based Compensation

Stock-based compensation expense for all stock-based compensation awards granted after July 1, 2006 is based on the grant-date fair value estimate in accordance with the provisions of the FASB issued guidance. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award.

Valuations are based on highly subjective assumptions about the future, including stock price volatility and exercise patterns. The fair value of share-based payment awards was estimated using the Black-Scholes option pricing model. Expected volatilities are based on the historical volatility of the Company s stock. The Company uses historical data to estimate option exercise and employee terminations. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

Three and Six-Month Periods Ended December 31, 2011 and 2010

The following table shows consolidated product revenue from continuing operations by business segment as well as identifying trends in business segment product revenues for the three- and six-month periods ended December 31, 2011 and 2010. Table amounts are in thousands:

	For the Three Months Ended December 31,			For the Six Months Ended December 31,		
	2011	2010	% Change	2011	2010	% Change
Product Revenue:						
ECD	$ 3,093	$ 3,388	-8.7%	$ 6,707	$ 7,028	-4.6%
Sonomed-Escalon	3,186	3,174	0.4%	5,593	5,649	-1.0%
Total	**$ 6,279**	**$ 6,562**	**-4.3%**	**$ 12,300**	**$ 12,677**	**-3.0%**

Consolidated product revenue decreased approximately $283,000, or 4.3%, to $6,279,000 during the three-month period ended December 31, 2011, as compared to the same period last fiscal year.

In the ECD business segment, product revenue decreased $295,000, or 8.7%, during the three-month period ended December 31, 2011 as compared to the same period last fiscal year. The decrease is related to a decline in diabetes instruments and reagents related to the decision to outsource the manufacturing of instruments. During the three months ended December 31, 2011, Drew s outsource partner was behind schedule in perfecting the manufacture of Drew s DS5 diabetes instrument which has limited the number of instruments available for sale during the period. Drew anticipates receiving the first allotment of outsourced DS5 instruments that will be ready for sale in February 2012. Drew is investigating outsource partners for its Drew 2280 hematology analyzer, as well as, pursuing alternative hematology instruments from other manufacturers. Drew continues to manufacture its Hemavet analyzer at is Dallas facility and expects to begin outsourcing its manufacture during the third fiscal quarter.

In the Sonomed-Escalon segment, product revenue increased $12,000 or 0.4%, to $3,186,000 during the three-month period ended December 31, 2011, as compared to the same period last fiscal year. The revenue increase is attributed to the increased sales of Trek surgical and gas products.

Consolidated product revenue decreased approximately $377,000, or 3.0%, to $12,300,000 during the six-month period ended December 31, 2011 as compared to the same period last fiscal year.

In the ECD business segment, product revenue decreased $321,000, or 4.6%, for the six-month period ended December 31, 2011 as compared to the same period last fiscal year. The decrease is related to a decline in diabetes instruments and reagents related to the decision to outsource the manufacturing of instruments. During the six months ended December 31, 2011 Drew s outsource partner was behind schedule in perfecting the manufacture of Drew s DS5 diabetes instrument which limited the number of instruments available for sale during the period. Drew anticipates receiving the first allotment of outsourced DS5 instruments which will be ready for sale in February 2012. Drew is investigating outsource partners for its Drew 2280 hematology analyzer, as well as, pursuing alternative hematology instruments from other manufacturers. Drew continues to manufacture its Hemavet analyzer at its Dallas facility and expects to begin outsourcing its manufacture during the third fiscal quarter.

In the Sonomed-Escalon business segment, product revenue decreased $56,000, or 1.0%, for the six-month period ended December 31, 2011 as compared to the same period last fiscal year.

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The following table shows consolidated other revenue by business segment as well as identifying trends in business segment other revenues for the three- and six-month periods ended December 31, 2011 and 2010. Table amounts are in thousands:

	For the Three Months Ended December 31,			For the Six Months Ended December 31,		
	2011	2010	% Change	2011	2010	% Change
Other Revenue:						
ECD	$ 0	$ 0	0.0%	$ 0	$ 7	-100.0%
Sonomed-Escalon	0	0	0.0%	0	0	0.0%
Total	**$ 0**	**$ 0**	**0.0%**	**$ 0**	**$ 7**	**-100.0%**

There was no other revenue during the three-month periods ended December 31, 2011 and 2010.

There was no other revenue during the six-month period ended December 31, 2011 as compared to $7,000 during the same period last fiscal year.

The following table presents consolidated cost of goods sold from continuing operations by reportable business segment and as a percentage of related segment product revenues for the three- and six-month periods ended December 31, 2011 and 2010. Table amounts are in thousands:

	For the Three Months Ended December 31,				For the Six Months Ended December 31,			
	2011	%	2010	%	2011	%	2010	%
Cost of Goods Sold:								
ECD	$ 2,822	91.2%	$ 2,454	72.4%	$ 5,166	77.0%	$ 5,173	73.6%
Sonomed-Escalon	1,462	45.9%	1,724	54.3%	2,686	48.0%	3,093	54.8%
Total	**$ 4,284**	**68.2%**	**$ 4,178**	**63.7%**	**$ 7,852**	**63.8%**	**$ 8,266**	**65.2%**

Consolidated cost of goods sold from continuing operations totaled approximately $4,284,000, or 68.2% of product revenue, for the three-month period ended December 31, 2011, as compared to $4,178,000 or 63.7%, of product revenue for the same period last fiscal year.

Cost of goods sold in the ECD business segment totaled $2,822,000 or 91.2% of product revenue, for the three-month period ended December 31, 2011 as compared to $2,454,000 or 72.4% of product revenue, for the same period last fiscal year. The increase in cost of goods sold as a percentage of product revenue is contributed to an inventory write-off at the Drew Dallas facility of approximately $480,000 related to the continuing process of outsourcing manufacturing and closing the facility.

Cost of goods sold in the Sonomed-Escalon business segment totaled $1,462,000, or 45.9% of product revenue, for the three-month period ended December 31, 2011 as compared to $1,724,000, or 54.3% of product revenue, for the same period last fiscal year. The decrease in cost of goods sold as a percentage of product revenue during the period ended December 31, 2011 as compared to the prior period is related to the reduced labor costs and change of product mix in favor of higher margin domestic Axis and VuMax sales.

Consolidated cost of goods sold totaled approximately $7,852,000, or 63.8% of product revenue, for the six-month period ended December 31, 2011, as compared to $8,266,000, or 65.2% of product revenue, for the same period last fiscal year.

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Cost of goods sold in the ECD business segment totaled $5,166,000, or 77.0% of product revenue, for the six-month period ended December 31, 2011 as compared to $5,173,000, or 73.6% product revenue, for the same period last fiscal year. Margins on ECD s instruments continue to range between 0% and 20% depending on the product. These lower margin sales are offset by the margins achieved on reagent sales which typically range from 50% to 75%. The increase in cost of goods sold as a percent of product revenue is related to an inventory write-off at our Dallas facility offset by the relative mix of these product groups during the six-month period ended December 31, 2011 as compared to the same period last year.

Cost of goods sold in the Sonomed-Escalon business segment totaled $2,686,000, or 48.0% of product revenue, for the six-month period ended December 31, 2011 as compared to $3,093,000, or 54.8% of product revenue, for the same period last fiscal year. The decrease in cost of goods sold as a percentage of product revenue during the period ended December 31, 2011 as compared to the prior period is related to the reduced labor costs and change of product mix in favor of higher margin domestic Axis and VuMax sales.

The following table presents consolidated marketing, general and administrative expenses from continuing operations as well as identifying trends in business segment marketing, general and administrative expenses for the three- and six-month periods ended December 31, 2011 and 2010. Table amounts are in thousands:

	For the Three Months Ended December 31,			For the Six Months Ended December 31,		
	2011	**2010**	**% Change**	**2011**	**2010**	**% Change**
Marketing, General and Administrative:						
ECD	$ 1,031	$ 1,284	-19.7%	$ 2,122	$ 2,570	-17.4%
Sonomed-Escalon	820	791	3.7%	1,505	1,449	3.9%
Corporate	720	702	2.6%	1,421	1,423	-0.1%
Total	**$ 2,571**	**$ 2,777**	**-7.4%**	**$ 5,048**	**$ 5,442**	**-7.2%**

Consolidated marketing, general and administrative expenses decreased $206,000 or 7.4%, to $2,571,000 during the three-month period ended December 31, 2011 as compared to the same period last fiscal year.

Marketing, general and administrative expenses in the ECD business segment decreased $253,000, or 19.7%, to $1,031,000 for the three-month period ended December 31, 2011 as compared to the same period last fiscal year. The decrease is related to a reduction in force and other administrative expenses related to the planned closure of the Dallas facility during the three-month period ended December 31, 2011 as compared to the same period ended December 31, 2010.

Marketing, general and administrative expenses in the Sonomed business segment increased $29,000, or 3.7%, to $820,000 for the three-month period ended December 31, 2011 as compared to the same period last fiscal year. The increase is due to increased sales force and advertising expense offset by decreased royalty expense and meeting and exhibits expense during the three-month period ended December 31, 2011 as compared to the same period last year.

Marketing, general and administrative expenses in the corporate business segment increased $18,000, or 2.6%, to $720,000 for the three-month period ended December 31, 2011 as compared to the same period last fiscal year.

Consolidated marketing, general and administrative expenses decreased $394,000, or 7.2%, to $5,048,000 for the six-month period ended December 31, 2011 as compared to the same period last fiscal year.

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Marketing, general and administrative expenses in the ECD business segment decreased $447,000, or 17.4%, to $2,122,000 for the six-month period ended December 31, 2011 as compared to the same period last fiscal year. The decrease is related to a reduction in force and other administrative expenses related to the planned closure of the Dallas facility for the six-month period ended December 31, 2011 as compared to the same period last year.

Marketing, general and administrative expenses in the Sonomed business segment increased $56,000, or 3.9%, to $1,505,000 for the six-month period ended December 31, 2011 as compared to the same period last fiscal year. The increase is due to increased sales force and advertising expense offset by decreased royalty expense, meeting and exhibits expense and reduced bad debts expense during the six-month period ended December 31, 2011 as compared to the same period last year.

Marketing, general and administrative expenses in the Corporate business segment decreased $2,000, or 0.1%, to $1,421,000 for the six-month period ended December 31, 2011 as compared to the same period last fiscal year.

The following table presents consolidated research and development expenses as well as identifying trends in business segment research and development expenses for the three- and six-month periods ended December 31, 2011 and 2010. Table amounts are in thousands:

	For the Three Months Ended December 31,			For the Six Months Ended December 31,		
	2011	**2010**	**% Change**	**2011**	**2010**	**% Change**
Research and Development:						
ECD	$ 110	$ 183	-39.9%	$ 272	$ 372	-26.9%
Sonomed-Escalon	211	224	-5.8%	430	431	-0.2%
Total	**$ 321**	**$ 407**	**-21.1%**	**$ 702**	**$ 803**	**-12.6%**

Consolidated research and development expenses decreased $86,000, or 21.1%, to $321,000 during the three-month period ended December 31, 2011 as compared to the same period last fiscal year.

Research and development expenses in the ECD business segment decreased $73,000, or 39.9%, to $110,000 during the three-month period ended December 31, 2011 as compared to the same period last fiscal year. The decrease is due to the cost model implemented in June 2009, which significantly reduced the research and development headcount in favor of outsourcing substantially all future research and development projects on an as needed basis, which was less for the three-month period ended December 31, 2011 as Drew completed the development of its new diabetes instrument the DS-360 in January 2010 and has not undertaken any substantial research and development projects on instruments and is concentrating its efforts on less costly reagent development.

Research and development expenses in the Sonomed-Escalon business segment decreased $13,000, or 5.8%, to $211,000 during the three-month period ended December 31, 2011 as compared to the same period last fiscal year. The decrease is attributed to decreased consulting expense offset by increased prototype expense during the three-month period ended December 31, 2011 as compared to the same period last year.

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Consolidated research and development expenses decreased $101,000 or 12.6%, to $702,000 during the six-month period ended December 31, 2011 as compared to the same period last fiscal year.

Research and development expenses in the ECD business segment decreased $100,000, or 26.9%, to $272,000 during the six-month period ended December 31, 2011 as compared to the same period last fiscal year. The decrease is due to the cost model implemented in June 2009, which significantly reduced the research and development headcount in favor of outsourcing substantially all future research and development projects on an as needed basis, which was substantially less for the six-month period ended December 31, 2011 as Drew completed the development of its new diabetes instrument the DS-360 in January 2010 and has not undertaken any substantial research and development projects on instruments and is concentrating its efforts on less costly reagent development.

Research and development expenses in the Sonomed-Escalon business segment decreased $1,000, or 0.2%, to $430,000 during the six-month period ended December 31, 2011 as compared to the same period last fiscal year. The decrease is attributed to decreased consulting expense offset by increased salary and prototype expense during the six-month period ended December 31, 2011 as compared to the same period last year

The Company had no significant gain or loss during the three-month period ended December 31, 2011 and recognized a loss of $11,000 related to its investment in OTM during the three-month period ended December 31, 2010; and recognized a gain of $1,000 and a loss of $34,000 for the six-month periods ended December 31, 2011 and 2010.

There was immaterial interest income during the three-month periods and six-month periods ended December 31, 2011 and 2010.

Interest expense was $88,000 and $78,000 for the three-month periods ended December 31, 2011 and 2010, respectively, and $170,000 and $160,000 for the six-month periods ended December 31, 2011 and 2010, respectively.

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Liquidity and Capital Resources

Changes in overall liquidity and capital resources from continuing operations as of December 31, 2011 and June 30, 2011 are reflected in the following table (in thousands):

	December 31, 2011	June 30, 2011
Current Ratio:		
Current assets	$ 9,292	$ 13,262
Less: Current liabilities	4,175	5,594
Working capital	**$ 5,117**	**$ 7,668**
Current ratio	**2.2 to 1**	**2.4 to 1**
Debt to Total Capital Ratio:		
Notes payable and current maturities	$ 560	$ 278
Long-term debt	3,889	4,506
Total debt	4,449	4,784
Total equity	2,307	6,190
Total capital	**$ 6,756**	**$ 10,974**
Total debt to total capital	**65.9%**	**43.6%**

Working Capital Position

Working capital decreased approximately $2,551,000 as of December 31, 2011, and the current ratio decreased to 2.2 to 1 when compared to June 30, 2011. The decrease in working capital was caused primarily by the loss from continuing operations of approximately $1,559,000 for the six months ended December 31, 2011 and the write-off of BHH assets and liabilities.

The filing of the insolvency declaration at BHH will have a material effect on results of operations in subsequent periods. BHH s product line revenues from operations were $ 4,763,056, $5,254,574 and $2,647,877 in fiscal 2011, 2010, 2009, respectively. Losses from operations, net of taxes, were ($1,232,904), ($635,952) and ($1,068,040) in 2011, 2010, 2009, respectively.

Cash Used in Operating Activities

During the six-month periods ended December 31, 2011 and 2010, the Company generated cash outflows from continuing operating activities of $156,000 and $1,546,000, respectively. The net decrease in cash used in operating activities of approximately $1,390,000 for the six-month period ended December 31, 2011, as compared to the same period in the prior fiscal year is due primarily to the following factors:

For the six-month period ended December 31, 2011, the Company had a net loss from continuing operations of $1,559,000 and experienced net cash in flows from a decrease in accounts receivable and inventory of $583,000 and $457,000 respectively, non-cash expenditures on depreciation and amortization and compensation expense related to stock options of approximately $349,000 and $40,000, respectively. These cash in-flows were partially offset by decrease in accounts payable, accrued expenses and other liabilities of $29,000 and cash used in discontinued operations of $567,000.

In the prior fiscal period the Company had a net loss from continuing operations of $2,022,000 and experienced net cash in flows from a decrease in accounts receivable of $364,000, an increase in accounts payable, accrued expenses and other liabilities of $187,000, cash from discontinued operation of $582,000, non-cash expenditures on depreciation and amortization and compensation expense related to stock options of approximately $250,000 and $63,000, respectively. These cash in-flows were partially offset by increases in inventory of $624,000.

Cash Flows used in (provided by) Investing and Financing Activities

Cash flows used in investing activities of $55,000 is related to fixed asset purchases during the six-month period ended December 31, 2011. Cash flows used in investing activities of $130,000 is related to fixed asset purchases of $85,000 and investment in OTM of $45,000, respectively, during the same period of last fiscal year.

Cash flows provided by financing activities were approximately $144,000 during the six-month period ended December 31, 2011, attributed to proceeds from related-party note payable of $300,000 and offset by outflows for principal payment of long-term debt of $156,000. Cash flows used in financing activities for the same period last fiscal year were approximately $50,000 related to principal payment of long-term debt.

Debt History

On December 31, 2008, Drew acquired certain assets of Biocode for $5,900,000 (4,200,000 Euros) plus acquisition costs of approximately $300,000. The sales price was payable in cash of approximately $324,000 (approximately 231,000 Euros) and $5,865,000 in debt from Drew. The seller-provided financing is collateralized by certain assets of Biocode and guaranteed by Drew. Biocode assets were vertically integrated into the Company s clinical diagnostics business that includes Drew and JAS.

On April 29, 2011 the Company amended its seller financed debt in connection with the Biocode transaction. Under the terms of the debt refinancing, the Company agreed to pay the balance of the seller provided financing of 3,375,000 Euros by the sum per month in euros having an exchange value of $50,000 United States Dollars as of the date of payment. Interest rate remained unchanged and interest will accrue on the outstanding amount of the purchase price at an interest rate of 7% per year on the basis of the actual days elapsed and a 365 day year. The first payment under the amended agreement was paid on May 31, 2011. Upon the 60th month after this Amendment, the Company agreed to pay the balance of the outstanding amount in euros in full in one payment.

On January 12, 2012 BH Holdings, S.A.S. (BHH) a wholly owned subsidiary of Drew, initiated the filing of an insolvency declaration with the Tribunal de Commerce de Rennes, France (Commercial Court). The Commercial Court on January 18, 2012 opened the liquidation proceedings with continuation of BHH s activity for three months and named an administrator to manage BHH. Since BHH is no longer controlled by Drew it was deconsolidated in the December 31, 2011 financial statements and prior period amounts are presented as discontinued operations (see footnote 10 to the Notes to Condensed Consolidated Financial Statements for additional information). This debt was guaranteed by Drew and as a result of the insolvency declaration the debt has been transferred to Drew. The debt holder has agreed that the terms of the debt will not change as a result of the insolvency declaration and has waived the default under the terms of agreement.

Continuing Operations

The accompanying consolidated financial statements have been prepared on the going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has incurred recurring operating losses, no longer has the benefit of cash inflows from Vascular and has commences making the debt service payments on May 31, 2011 related to the Biocode acquisition. These conditions raise substantial doubt about the Company s ability to continue as a going concern. If the Company is unsuccessful in its efforts to raise additional capital in the near term, the Company may be required to significantly reduce its research, development, and administrative activities, including further reduction of its employee base. The financial statements do not include any adjustments relating to the realization of the carrying value of assets or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. The Company s continuance as a going concern is

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dependent on the Company s future profitability and on the on-going support of the Company s shareholders, affiliates and creditors. In order to mitigate the going concern issues, the Company is actively pursuing business partnerships, managing the Company s continuing operations, and seeking capital funding on an ongoing basis via the issuance of securities and private placements although the Company may not succeed in these mitigation efforts.

The filing of the insolvency declaration at BHH will have a material effect on results of operations in subsequent periods. BHH s product line revenues from operations were $ 4,763,056, $5,254,574 and $2,647,877 in fiscal 2011, 2010, 2009, respectively. Losses from operations, net of taxes, were ($1,232,904), ($635,952) and ($1,068,040) in 2011, 2010, 2009, respectively.

As part of ongoing austerity measures that have been implemented over the past two years at Drew, management decided in June 2011 to outsource the manufacturing of Drew s instruments and cease all manufacturing out of its Dallas facility. Research and development activities performed in Dallas will also be eliminated and will be outsourced on an as needed basis. Management continues to work with outsource partners to perfect the manufacturing of Drew s instruments and anticipates that the Dallas facility will cease manufacturing activities on or about February 29, 2012.

If the Company is unable to achieve continued improvement in this area in the near term, it is not likely that our existing cash and cash flow from operations will be sufficient to fund activities throughout the next 6 to 12 months without curtailing certain business activities. The Company s forecast of the period of time through which its financial resources will be adequate to support its operations is a forward-looking statement and involves risks and uncertainties, and actual results could vary as a result of a number of factors, including the factors discussed in Risk Factors of the Company s Form 10-K for the year ended June 30, 2011.

If the Company seeks to raise funds in the future, the Company may be required to raise those funds through public or private financings, strategic relationships or other arrangements at prices and other terms that may not be as favorable as they would without such qualification. The sale of additional equity and debt securities may result in additional dilution to the Company s shareholders. Additional financing may not be available in amounts or on terms acceptable to the Company or at all.

Off-Balance Sheet Arrangements and Contractual Obligations

The Company was not a party to any off-balance sheet arrangements during the three and six-month periods ended December 31, 2011 and 2010.

The following table presents the Company s contractual obligations as of December 31, 2011 (interest is not included in the table as it is immaterial):

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt	**$ 4,149,516**	$ 260,059	$ 577,877	$ 3,311,580	$ 0
Operating lease agreements	**3,607,613**	842,134	1,598,682	962,088	204,709
Total	**$ 7,757,129**	**$ 1,102,194**	**$ 2,150,835**	**$ 4,299,391**	**$ 204,709**

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

The table below provides information about the Company s financial instruments consisting of fixed interest rate debt obligations. For debt obligations, the table represents principal cash flows and related interest rates by expected maturity dates.

	Interest Rate	Due during the year ending December 31 2012	2013	2014	2015	2016
Note Payable Drew	7%	$ 260,059	$ 278,859	$ 299,018	$ 320,634	$ 2,990,946

Item 4T. Controls and Procedures

(A) Evaluation of Disclosure Controls and Procedures

The Company s management, with the participation of the Company s Chief Executive Officer and Principal Financial and Accounting Officer, have established disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to the officers who certify the Company s financial reports and to other members of senior management and the Board of Directors.

Based on their evaluation of the effectiveness of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of December 31, 2011, the Chief Executive Officer and Principal Financial and Accounting Officer of the Company have concluded that such disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to the Company s management, including its Chief Executive Officer and Principal Financial and Accounting Officer, to allow timely decisions regarding required disclosure.

(B) Internal Control over Financial Reporting

There have not been any changes in the Company s internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act), during the second fiscal quarter ended December 31, 2011 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

See note 4 of the notes to the condensed consolidated financial statements for further information regarding the Company s legal proceedings (see footnote 10 for details on the court proceedings related to the insolvency declaration at BHH).

Item 1A. Risk Factors

There are no material changes from the risks previously disclosed in the Company s Annual Report on Form 10-K for the year ended June 30, 2011.

Item 5. Other Information

On January 23, 2012 the Company filed a Form 8-K under Item 2.06 concerning a material impairment related to the insolvency declaration of its subsidiary BHH. BHH initiated the filing of an insolvency declaration (declaration de cessation des paiements) with the Tribunal de Commerce de Rennes (Commercial Court) on January 18, 2012. At the time of the Form 8-K filing the Company was unable in good faith to make a determination of the impairment charges resulting from the insolvency declaration. On February 8, 2012 the Company finalized the calculation of the impairment and determined it to be $2,216,046. The Company incorporates by reference into this Item 5 the information the Company includes in footnote 10 to the Company s Condensed Consolidated Financial Statements relating to the BHH insolvency declaration.

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Item 6. Exhibits

31.1	Certificate of Chief Executive Officer under Rule 13a-14(a).
31.2	Certificate of Principal Financial and Accounting Officer under Rule 13a-14(a).
32.1	Certificate of Chief Executive Officer under Section 1350 of Title 18 of the United States Code.
32.2	Certificate of Principal Financial and Accounting Officer under Section 1350 of Title 18 of the United States Code.

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Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Escalon Medical Corp.

(Registrant)

Date: February 14, 2012

By: /s/ Richard J. DePiano
Richard J. DePiano
Chairman and Chief
Executive Officer

Date: February 14, 2012

/s/ Robert O Connor
Robert O Connor
Chief Financial Officer