ESCALON MEDICAL CORP
Form 10QSB
November 14, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

[X] Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 30, 2005.

[ ] Transitional report pursuant to Section 13 or 15(d) of the securities Exchange Act of 1934 for the transitional period from _____ to _____.

Commission File Number 0-20127

ESCALON MEDICAL CORP.

(Exact name of small business issuer as specified in its charter)

PENNSYLVANIA	33-0272839
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

565 EAST SWEDESFORD ROAD, SUITE 200
WAYNE, PA 19087

(Address of principal executive offices)

(610) 688-6830

(Registrant's telephone number)

Check whether the issuer (1) filed all reports required by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for 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 is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

Transitional Small Business Disclosure format. Yes [ ] No [X]

At November 7, 2005, 6,075,977 shares of common stock were outstanding.

ESCALON MEDICAL CORP.
FORM 10-QSB QUARTERLY REPORT

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ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2005 (Unaudited)
ASSETS	
Current assets:	
Cash and cash equivalents	$ 5,325,697
Available for sale securities	44,130
Accounts receivable, net	5,041,319
Inventory, net	6,026,165
Note receivable	100,000
Other current assets	719,990
Total current assets	17,257,301
Furniture and equipment, net	964,382
Goodwill	20,166,450

Trademarks and trade names, net	616,906
Patents, net	379,380
Other assets	396,127
Total assets	$ 39,780,546
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities:	
Current portion of long-term debt	$ 233,033
Accounts payable	1,834,913
Accrued expenses	2,272,282
Total current liabilities	4,340,228
Long-term debt, net of current portion	329,565
Accrued post retirement benefits	1,087,000
Total liabilities	5,756,793
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; 5,969,727 and 5,963,477 shares issued and outstanding at September 30, 2005 and June 30, 2005, respectively	5,970
Common stock warrants	1,601,346
Additional paid-in capital	63,909,060
Accumulated deficit	(31,422,140)
Accumulated other comprehensive (loss) income	(70,483)
Total shareholders' equity	34,023,753
Total liabilities and shareholders' equity	$ 39,780,546

See notes to condensed consolidated financial statements

ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended September 30, 2005	2004
Product revenue	$ 7,123,354	$ 4,636,457
Other revenue	670,180	655,704
Revenues, net	7,793,534	5,292,161
Costs and expenses:		
Cost of goods sold	4,105,653	2,671,348
Research and development	756,160	315,762
Marketing, general and administrative	3,284,051	2,182,487
Total costs and expenses	8,145,864	5,169,597

(Loss) income from operations	(352,330)	122,564
Other income and expenses:		
Gain on sale of available for sale securities	1,157,336	-
Equity in Ocular Telehealth Management, LLC	(18,429)	(29,201)
Interest income	4,847	32,092
Interest expense	(10,677)	3,413
Total other income and expenses	1,133,077	6,304
Income before income taxes	780,747	128,868
Income taxes	66,400	12,969
Net income	$ 714,347	$ 115,899
Basic net income per share	$ 0.120	$ 0.021
Diluted net income per share	$ 0.112	$ 0.019
Weighted average shares - basic	5,964,292	5,564,469
Weighted average shares - diluted	6,372,742	6,141,958

See notes to condensed consolidated financial statements

ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three Months Ended September 30, 2005	200
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 714,347	$ 1
Adjustments to reconcile net (loss)/income to net cash (used in)/ provided by operating activities:		
Depreciation and amortization	107,752	
Gain on sale of available for sale securities	(1,157,336)	
Loss of Ocular Telehealth Management, LLC	18,429	
Change in operating assets and liabilities:		
Accounts receivable, net	(289,009)	(5
Inventory, net	(169,880)	(2
Other current and long-term assets	(260,772)	(3
Accounts payable, accrued and other liabilities	285,845	(1,0

Net cash (used in) operating activities	(750,624)	(1,9
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of Drew, net of cash acquired	-	2
Proceeds from the sale of available for sale securities	1,157,336	
Investment in Ocular Telehealth Management, LLC	-	(1
Purchase of fixed assets	(144,649)	(
Net provided by provided by/(used in) investing activities	1,012,687	1
CASH FLOWS FROM FINANCING ACTIVITIES:		
Line of credit repayment	-	(6
Principal payments on term loans	(59,539)	(4,2
Issuance of common stock, private placement		
Issuance of common stock, stock options	10,876	
Net cash used in financing activities	(48,663)	(4,9
Effect of exchange rate changes on cash and cash equivalents	(3,475)	
Net increase/(decrease) in cash and cash equivalents	209,925	(6,7
Cash and cash equivalents, beginning of period	5,115,772	12,6
Cash and cash equivalents, end of period	$ 5,325,697	$ 5,8
SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION:		
Interest paid	$ 10,667	$ 2
Income taxes	$ 93,000	$ 1
Issuance of common stock for Drew acquisition	$ -	$ 7,4
(Decrease)/ Increase in unrealized appreciation on available for sale securities	$ (1,163,187)	$

See notes to condensed consolidated financial statements

ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2005

(UNAUDITED)

	Shares	Amount	Common Stock Warrants	Additional Paid-in Capital	Accumulated Deficit
Balance at June 30, 2005	5,963,477	$ 5,964	$ 1,601,346	$ 63,898,190	$(32,136,487
Net income	-	-	-	-	714,347
Change in unrealized gains on securities	-	-	-	-	-
Foreign currency translation	-	-	-	-	-

Exercise of stock options	6,250	6	-	10,870	-
Balance at September 30, 2005	5,969,727	$ 5,970	$ 1,601,346	$ 63,909,060	$(31,422,140

See notes to condensed consolidated financial statements

ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE (LOSS) INCOME
(UNAUDITED)

	Three Months Ended September 30,	
	2005	2004
Net income	$ 714,347	$ 115,899
Change in unrealized gains on securities	(1,163,187)	-
Foreign currency translation	(57,132)	17,944
Comprehensive loss	$ (505,972)	$ 133,843

See notes to condensed consolidated financial statements

ESCALON MEDICAL CORP. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements include the accounts of Escalon Medical Corp. and its subsidiaries, collectively referred to as "Escalon" or the "Company." Escalon's subsidiaries include Sonomed, Inc. ("Sonomed"), Escalon Vascular Access, Inc. ("Vascular"), Escalon Medical Europe GmbH, Escalon Digital Vision, Inc. ("EMI"), Escalon Pharmaceutical, Inc. ("Pharmaceutical"), Escalon Holdings, Inc. and Drew Scientific Group, Plc ("Drew"). All intercompany accounts and transactions have been eliminated. Additionally, the Company's investment in Ocular Telehealth Management, LLC ("OTM") is accounted for under the equity method.

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, hematology and vascular access. The Company and its products are subject to regulation and inspection by the United States Food and Drug Administration (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 accompanying condensed consolidated financial statements are unaudited

and are presented pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Accordingly, these consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's 2005 Annual Report on Form 10-K under the Securities Exchange Act of 1934 (the "Exchange Act"). In the opinion of management, the accompanying consolidated financial statements reflect all adjustments (which are of a normal recurring nature) necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods presented. The results of operations are not necessarily indicative of the results that may be expected for the full year.

2. ACQUISITION OF DREW SCIENTIFIC GROUP, PLC

On July 23, 2004, Escalon acquired approximately 67% of the outstanding ordinary shares of Drew Scientific Group, Plc ("Drew"), a United Kingdom company, pursuant to the Company's exchange offer for all of the outstanding ordinary shares of Drew, and since that date has acquired all of the Drew shares. The results of Drew's operations have been included in the consolidated financial statements since July 23, 2004.

Drew is a diagnostics company specializing in the design, manufacture and distribution of instruments for blood cell counting and blood analysis. Drew is focused on providing instrumentation and consumables for the physician office and veterinary office laboratories. Drew also supplies the reagent and other consumable materials needed to operate the instruments. The results of Drew's operations have been included in the consolidated financial statements, and Escalon has been operating Drew as an additional business segment since July 23, 2004.

The aggregate purchase price of Drew was $8,525,966, net of acquired cash of $151,996, consisting of direct acquisition costs of $1,246,376, primarily for investment banking, legal and accounting fees that were directly related to the acquisition of Drew, and 900,000 shares of Escalon common stock valued at $7,430,439. The value of the 900,000 shares issued was based on a five day average of the market price of the stock (two days before through two days after the shares were exchanged).

The following table summarizes the purchase price allocation of estimated fair values of assets acquired and liabilities assumed as of the date of acquisition of Drew of July 23, 2004.

Current assets	$ 3,859,771
Furniture and equipment	868,839
Patents	297,246
Other long-term assets	7,406
Goodwill	9,574,655
Total assets acquired	$14,607,917
Line of credit	$ 1,617,208
Current liabilities	3,392,286
Long-term debt	1,072,457

Total liabilities assumed	$ 6,081,951
Net assets acquired	$ 8,525,966

The following pro forma results of operations information has been prepared to give effect to the purchase of Drew as if such transaction had occurred at the beginning of the period being presented. The information presented is not necessarily indicative of results of future operations of the combined companies.

	Three Months Ended September 30,	
	2005	2004
Revenues	$7,793,534	$ 5,926,771
Cost of goods sold	4,105,653	3,088,286
Gross profit	3,687,881	2,838,485
Operating expenses	4,040,211	2,810,440
Other income (expense)	1,133,077	(522)
Net income before taxes	780,747	27,523
Provision for income taxes	66,400	12,969
Net income	$ 714,347	$ 14,554
Basic net income per share	$ 0.120	$ 0.003
Diluted net income per share	$ 0.122	$ 0.002
Weighted average shares - basic	5,964,292	5,564,469
Weighted average shares - diluted	6,372,742	6,141,958

3. STOCK-BASED COMPENSATION

The Company reports stock-based compensation through the disclosure-only requirements of the statement of Financial Accounting Standards No. 123 ("SFAS 123"), "Accounting for Stock-Based Compensation," as amended by Statement of Financial Accounting Standards No. 148 ("SFAS 148"),

"Accounting for Stock-Based Compensation - Transition and Disclosure - an Amendment to FASB No. 123." Compensation expense for options is measured using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). Under APB 25, because the exercise price of the Company's employee stock options is generally equal to the market price of the Company's underlying stock on the

date of grant, no compensation expense is recognized.

SFAS 123 establishes an alternative method of expense recognition for stock-based compensation awards based on fair values. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123.

	Three Months Ended September 30,	
	2005	2004
Net Income, as reported	$ 714,347	$ 115,899
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(305,199)	(284,671)
Pro forma net income	$ 409,148	$ (168,772)
Earnings (loss) per share:		
Basic - as reported	$ 0.120	$ 0.021
Basic - pro forma	$ 0.069	$ (0.030)
Diluted - as reported	$ 0.112	$ 0.019
Diluted - pro forma	$ 0.062	$ (0.030)

The Company has followed the guidelines of SFAS 123 to establish the valuation of its stock options. The fair value of these equity awards was estimated at the date of grant using the Black-Scholes option pricing method. For the purposes of pro forma disclosures, the estimated fair value of the equity awards is amortized to expense over the options' vesting period. For the purposes of applying SFAS 123, the estimated per share value of the options granted during the three-month period ended September 30, 2005 was between $7.18 and $8.06. The fair value was estimated using the following assumptions: dividend yield of 0.0%, volatility of 0.78%; risk-free interest rate of 4.20%; and expected life of 10 years. The volatility assumption is based on volatility experienced in the Company's stock over the last five years. This assumption was made according to the guidance of SFAS 123. There is no reason to believe that future volatility will compare with the historic volatility.

In December 2004, the FASB issued SFAS No.123R ("SFAS No.123R"), (revised 2004), "Share-Based Payments" SFAS No. 123R is a revision of SFAS No. 123 and supersedes ABP Opinion No. 25, which requires the Company to expense share-based payments, including employee stock options. With limited exceptions, the amount of compensation costs will be measured based on the grant date fair value of the equity or liability instrument issued. Compensation cost will be recognized over the period that the employee provides service in exchange for the award. The Company is a small business issuer as defined in Item 10 of Regulation S-B. As a result, the Company will be required to adopt this standard in its fiscal year beginning July 1, 2006. The adoption of this standard for the expensing of stock options is expected to reduce pretax earnings in future periods. The impact of adoption of SFAS No. 123R cannot be predicted at this time because it will depend upon the level of share-based payments made in the future and the model the Company elects to utilize.

4. EARNINGS PER SHARE

The Company follows Financial Accounting Standards Board Statement No. 128, "Earnings Per Share," in presenting basic and diluted earnings per share. The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended September 30,	
	2005	2004
Numerator:		
Numerator for basic and diluted earnings per share:		
Net income	$ 714,347	$ 115,899
Denominator:		
Denominator for basic earnings per share - weighted average shares	5,964,292	5,564,469
Effect of dilutive securities:		
Stock options and warrants	408,450	519,175
Shares reserved for future exchange	-	58,314
Denominator for diluted earnings earnings per share - weighted average and assumed conversion	6,372,742	6,141,958
Basic earnings per share	$ 0.120	$ 0.021
Diluted earnings per share	$ 0.112	$ 0.019

5. INVENTORY

Inventory, stated at lower of cost (determined on a first-in, first-out basis) or market, consisted of the following:

	September 30, 2005	June 30, 2005
Raw materials	$ 3,331,810	$ 3,476,493
Work in process	1,161,087	473,252
Finished goods	1,713,919	2,073,208
	6,206,816	6,022,953
Valuation allowance	(180,651)	(166,668)
Total inventory	$ 6,026,165	$ 5,856,285

6. NOTE RECEIVABLE

Escalon entered into an agreement with an individual who was involved in

the development of the Company's now discontinued Ocufit SR(R) drug delivery system. The Company holds a note receivable from the individual in the amount of $150,000 that was due in May 2005. The note was not paid when due and the individual is currently in default. The Company intends to pursue collection, is currently evaluating collection alternatives and has recorded a $50,000 reserve based upon its current estimate of cost to pursue collection.

7. INTANGIBLE ASSETS

PATENTS

It is the Company's practice to seek patent protection on processes and products in various countries. Patent application costs are capitalized and amortized over their estimated useful lives, not

exceeding 17 years, on a straight-line basis from the date the related patents are issued. Costs associated with patents no longer being pursued are expensed. Accumulated patent amortization was $212,083 and $188,649 at September 30, 2005 and June 30, 2005, respectively. Amortization expense for the three-month periods ended September 30, 2005 and 2004 was $379,380 and $9,484, respectively.

The aggregate amortization expense for each of the next five years for patents is estimated to be approximately $70,000 per year for each of the next five fiscal years.

GOODWILL, TRADEMARKS AND TRADE NAMES

Goodwill, trademarks and trade names represent intangible assets obtained from the EOI, Endologix, Inc. ("Endologix"), Sonomed and Drew acquisitions. Goodwill represents the excess of purchase price over the fair market value of net assets acquired.

In accordance with SFAS 142, effective July 1, 2001, the Company discontinued the amortization of goodwill and identifiable intangible assets that have indefinite lives. Intangible assets that have finite lives continue to be amortized over their estimated useful lives. Management has evaluated the carrying value of goodwill and its identifiable intangible assets that have indefinite lives during each of the fiscal years subsequent to July 1, 2001, utilizing discounted cash flows of the respective business units. After evaluating the discounted cash flow of each of its respective business units, management concluded that the carrying value of goodwill and identifiable intangible assets did not exceed their fair values and therefore were not impaired. In accordance with SFAS 142, these intangible assets will continue to be assessed on an annual basis, and impairment, if any, will be recorded as a charge against income from operations.

The following table presents unamortized intangible assets by business unit as of September 30, 2005 and June 30, 2005.

	SEPTEMBER 30 NET CARRYING AMOUNT	JUNE 30 NET CARRYING AMOUNT
GOODWILL		
Sonomed	$ 9,525,550	$ 9,525,550

Drew	9,574,655	9,574,655
Vascular	941,218	941,218
Medical/Trek/EMI	125,027	125,027
Total	$ 20,166,450	$20,166,450

	SEPTEMBER 30 NET CARRYING AMOUNT	JUNE 30 NET CARRYING AMOUNT
UNAMORTIZED INTANGIBLE ASSETS		
Sonomed	$ 616,906	$ 616,906
Total	$ 616,906	$ 616,906

The following table presents amortized intangible assets by business unit as of September 30, 2005:

AMORTIZED INTANGIBLE ASSETS PATENTS	Gross Carrying Amount	Impairment	Adjusted Gross Carrying Amount	Accumulated Amortization
Drew	$ 297,246	$ -	$ 297,246	$ (69,316)
Vascular (pending issue)	36,916	-	36,916	(4,614)
Medical/Trek/EMI	257,301	-	257,301	(138,153)
	$ 591,463	$ -	$ 591,463	$ (212,083)

The following table presents amortized intangible assets by business unit as of June 30, 2005:

AMORTIZED INTANGIBLE ASSETS PATENTS	Gross Carrying Amount	Impairment	Adjusted Gross Carrying Amount	Accumulated Amortization
Drew	$ 297,246	$ -	$ 297,246	$ (55,908)
Vascular (pending issue)	36,916	-	36,916	-
Medical/Trek/EMI	257,301	-	257,301	(132,741)
	$ 591,463	$ -	$ 591,463	$ (188,649)

=========	=====	==========	==========

8. ACCRUED EXPENSES

The following table presents accrued expenses as of September 30, 2005 and June 30, 2005:

	SEPTEMBER 30, 2005	JUNE 30, 2005
Accrued compensation	$1,110,535	$1,276,639
Warranty accruals	199,836	201,413
Severance accruals	104,389	195,263
Legal accruals	286,606	251,000
Other accruals	570,916	761,355
	$2,272,282	$2,685,670

Severance accruals as of September 30, 2005 and June 30, 2005 relate to certain former directors and officers of Drew who management had the intent to terminate as of the consummation date of the transaction.

In addition to normal accrual, other accruals as of September 30, 2005 and June 30, 2005 relate to the remaining lease payments on a facility that had been vacated prior to the Drew acquisition, accruals for litigation existing prior to the Drew acquisition, franchise and ad valorem tax accruals and other sundry operating expenses and accruals

Accrued compensation as of September 30, 2005 and June 30, 2005 primarily relates to payroll, bonus and vacation accruals and payroll tax liabilities.

9. LINE OF CREDIT AND LONG-TERM DEBT

The Company has two long-term debt facilities through its Drew subsidiary: the Texas Mezzanine Fund and Symbiotics, Inc. The Texas Mezzanine Fund term debt is payable in monthly installments of $14,200, which includes interest at a fixed rate of 8.00%. The note is due in April 2008 and is secured by

certain assets of Drew. The outstanding balance of the note was $370,930 and $405,471 as of September 30, 2005 and June 30, 2005, respectively. The Symbiotics, Inc. term debt, which originated from the acquisition of a product line from Symbiotics, Inc., is payable in monthly installments of $8,333 with interest at a fixed rate of 5.00%. The outstanding balance of this note was $191,668 and $216,666 as of September 30, 2005 and June 30, 2005, respectively.

The schedule below presents principal amortization for the next five years under each of the Company's loan agreements as of September 30, 2005:

Twelve Months Ending September 30,	Texas Mezzanine	Symbiotics	Total

2005	$ 133,037	$ 99,996	$ 233,033
2006	156,868	91,672	248,540
2007	81,025	-	81,025
2008	-	-	-
2009	-	-	-
Total	$ 370,930	$191,668	$ 562,598
	Current portion of long-term debt		233,033
	Long-term portion		$ 329,565

10. OTHER REVENUE

Other revenue includes quarterly payments received from:

(1) Bausch & Lomb in connection with the sale of the Silicone Oil product line, which contract expired on August 12, 2005 and from which the Company will not receive any additional royalties;

(2) Royalty payments received from IntraLase Corp. ("IntraLase") relating to the licensing of the Company's intellectual laser technology; and

(3) Royalty payments received from Bio-Rad Laboratories, Inc. ("Bio-Rad").

For the three-month periods ended September 30, 2005 and 2004, Silicone Oil revenue totaled $203,000 and $417,000, respectively, IntraLase royalties totaled $392,000 and $239,000, respectively, and the Bio-Rad royalties totaled $75 ,000 and $0, respectively. Accounts receivable as of September 30, 2005 and June 30, 2005 related to other revenue was approximately $218,000 and $372,000, respectively.

BAUSCH & LOMB SILICONE OIL

The Company's agreement with Bausch & Lomb, which commenced on August 13, 2000, was structured so that the Company received consideration from Bausch & Lomb based on its adjusted gross profit from its sales of Silicone Oil on a quarterly basis. The consideration was subject to a factor, which stepped down through the termination date (August 2005) according to the following schedule:

From 8/13/00 to 8/12/01	100%
From 8/13/01 to 8/12/02	82%
From 8/13/02 to 8/12/03	72%
From 8/13/03 to 8/12/04	64%
From 8/13/04 to 8/12/05	45%

INTRALASE: LICENSING OF LASER TECHNOLOGY

The material terms of the license of the Company's laser patents to IntraLase (the "License Agreement"), which expires in 2013, provide that the Company will receive a 2.5% royalty on product sales that are based on the

licensed laser patents, subject to deductions for third party royalties otherwise due and payable, and a 1.5% royalty on product sales that are not based on the licensed laser patents. The Company receives a minimum annual license fee of $15,000 per year during the remaining term of the license. The minimum annual License Agreement fee is offset against the royalty payments.

The material termination provisions of the License Agreement of the laser technology are as follows:

1. Termination by the Company if IntraLase defaults in the payment of any royalty;

2. Termination by the Company if IntraLase makes any false report;

3. Termination by the Company if IntraLase defaults in the making of any required report;

4. Termination by either party due to the commission of any material breach of any covenant or promise by the other party under the license agreement; or

5. Termination of the License Agreement by IntraLase after 90 days notice (if IntraLase were to terminate, it would not be permitted to utilize the licensed technology necessary to manufacture its current products).

BIO-RAD ROYALTY

The royalty received from Bio-Rad relates to a certain non-exclusive Eighth Amendment to an OEM Agreement ("OEM Agreement") between the Company's Drew subsidiary and Bio-Rad, dated July 19, 1994. Bio-Rad pays a royalty based on sales of certain of Drew's products in certain geographic regions.

The material terms of the OEM Agreement, provided:

- Drew receives an agreed royalty per test;

- Royalty payments will be made depending on the volume of tests provided by Bio-Rad. If less than 3,750 tests per month are provided by Bio-Rad, Bio-Rad will calculate the number of tests used on a quarterly basis in arrears and pay Drew within 45 days of the end of the quarter. If more than 3,750 tests per month are provided by Bio-Rad, Bio-Rad will pay an estimated monthly royalty and within 45 days of the end of the quarter will make final settlement upon the actual number of tests.

While the agreement, as amended by the Eighth Amendment, expired on May 15, 2005, the parties have continued to operate under the terms of the expired agreement pending negotiation of a potential extension and/or revision.

11. COMMITMENTS AND CONTINGENCIES

COMMITMENTS

The Company leases its manufacturing, research and corporate office facilities and certain equipment under non-cancelable operating lease arrangements. The future amounts to be paid under these arrangements as of September 30, 2005 are as follows:

Twelve Months Ending	Lease Obligations
2006	$ 889,749
2007	721,029
2008	411,235
2009	284,615
2010	292,710
Thereafter	425,124
Total	$ 3,024,462

Rent expense charged to operations during the three-month periods ended September 30, 2005 and 2004 was $215,111 and $141,191, respectively.

CONTINGENCIES

ROYALTY AGREEMENT: CLINICAL DIAGNOSTICS SOLUTIONS

Drew and Clinical Diagnostics Solutions, Inc. ("CDS") entered into a Private Label/Manufacturing Agreement dated April 1, 2002 for the right to sell formulations or products of CDS including reagents, controls and calibrators ("CDS products") on a private label basis. The agreement term is 15 years and automatically renews year-to-year thereafter. Drew is obligated to pay CDS a royalty of 7.5% on all sales of CDS products produced from Drew's United Kingdom facility.

INTRALASE CORP. LEGAL PROCEEDINGS

In October 1997, Escalon and IntraLase entered into a License Agreement wherein Escalon granted IntraLase the exclusive right to use Escalon's intellectual laser properties, including patented and non-patented technology, in exchange for an equity interest in IntraLase as well as royalties based on a percentage of net sales of future products. The shares of common stock were restricted for sale until April 6, 2005 (see note 15)

On June 10, 2004, Escalon gave IntraLase notice of its intention to terminate the License Agreement due to IntraLase's failure to pay certain royalties that Escalon believed were due under the License Agreement. On June 21, 2004, IntraLase sought a preliminary injunction and temporary restraining order with the United States District Court for the Central District of California, Southern District against Escalon to prevent termination of the License Agreement. Contemporaneously, IntraLase filed an action for declaratory relief asking the Court to validate its interpretation of certain terms of the License Agreement relating to the amount of royalties owed to Escalon ("First Action"). The parties mutually agreed to the entry of a temporary restraining order which was entered by the Court shortly thereafter. At the close of discovery, IntraLase and Escalon filed cross-motions for summary judgment. On May 5, 2005, the District Court, having ruled on such motions, entered judgment in the First Action.

The Court, in ruling on the parties' cross-motions for summary judgment, did not agree with IntraLase's interpretation of certain terms and declared that, under the terms of the License Agreement, IntraLase must pay Escalon royalties on revenue from maintenance contracts and one-year warranties.

Further, the Court rejected IntraLase's argument that it is entitled to deduct the value of non-patented components of its ophthalmic products, which it sells as an integrated unit, from the royalties due Escalon. Non-patented components of the products include computer monitors, joysticks, keyboards, universal power supplies, microscope assemblies, installation kits and syringes. In addition, the Court rejected IntraLase's assertion that accounts receivable are not "consideration received" under the License Agreement and expressly ruled that IntraLase must pay Escalon royalties on IntraLase's accounts receivable. The Court agreed with IntraLase, however, holding that IntraLase is not required to pay royalties on research grants. The Court also held that IntraLase must give Escalon an accounting of third-party royalties.

Further, the Court agreed with Escalon in finding that royalties are "monies" and the default in the payment of royalties must be remedied within 15 days of written notice of the default. The Court rejected IntraLase's position concerning the effective date of the Amended and Restated License Agreement holding that the effective date of such Agreement was dated October 17, 2000. IntraLase has appealed the judgment to the Ninth Circuit Court of Appeals. Currently, briefing is scheduled to occur in February/March, 2006.

Intralase, after entry of the Court's ruling, attempted to cure its default under the License Agreement, but underpaid based upon a purported interpretation of "accounts receivable" that discounts the receivables recorded on the sales substantially, and in a manner that appears to directly contradict Intralase's own published financial statements.

In May 2005, IntraLase also filed a second suit against Escalon in the Central District of California, case number SAVC 05-440-AHS ("Second Action"), again for declaratory relief as well as for reformation of the License Agreement. In this action, IntraLase has asked the Court to, among other things, validate its interpretation of certain other terms of the License Agreement relating to the amount of royalties owed to Escalon and a declaration concerning Escalon's audit rights under the License Agreement. Escalon filed a motion to dismiss the Second Action on jurisdictional and substantive grounds. The motion has been fully briefed and is currently under consideration by the Court for the Central District of California.

On May 15, 2005, Escalon, not having been served with IntraLase's Second Action, filed a Complaint against IntraLase in the Delaware Court of Chancery for, among other things, breach of contract, breach of fiduciary duty arising out of IntraLase's bad faith conduct under, and multiple breaches of, the License Agreement ("Delaware Action"). Escalon seeks declaratory relief, specified damages, and specific performance of its rights under the License Agreement, including its express right under the Agreement to have independent certified accountants audit the books and records of IntraLase to verify and compute payments due Escalon.

On June 3, 2005, IntraLase, after having been served with Escalon's Complaint, filed its First Amended Complaint in the Second Action adding new matters that had already been raised by Escalon in its Delaware Action. IntraLase also filed a motion to dismiss Escalon's Delaware Action. In July, 2005, the parties agreed to postpone briefing on IntraLase's motion until after the California Court has ruled on Escalon's motion to dismiss the Second Action.

Separately, on April 22, 2005, Escalon, as record holder of common stock of IntraLase, made a formal written demand to inspect certain of IntraLase's books and records pursuant to Section 220 of the Delaware General Corporation Law. IntraLase rejected Escalon's demand. Escalon recently filed an action in the Delaware Court of Chancery against IntraLase seeking to enforce its shareholder rights to inspect IntraLase's books and records. The 220 Case is currently in the discovery stage.

Escalon is cognizant of the legal expenses and costs associated with the IntraLase matter. Escalon, however, is taking all necessary actions to protect its rights and interests under the License Agreement. Escalon expects expenses associated with this litigation to adversely impact earnings in the near term. Escalon believes that IntraLase has sufficient funds to support such payments based on its filings with the SEC and filings in connection with the First Action.

DREW LEGAL PROCEEDINGS

CARVER LITIGATION

On December 17, 2002, Edward Carver, David DeCava and Diane Carver, former principal shareholders of CDC Technologies, Inc., filed a complaint in the State of Connecticut, Superior Court, Judicial District of Waterbury at Waterbury against CDC Acquisition, IV Diagnostics and certain other principal shareholders of CDC Technologies seeking a total of approximately $420,000 for, among other things, repayment of loans made to CDC Technologies, payment of past wages and reimbursement of business expenses. The Plaintiffs' claims arose out of a certain asset purchase for stock transaction in which CDC Acquisition, a wholly owned subsidiary of Drew, acquired the assets of CDC Technologies and IV Diagnostics. CDC Acquisition and IV Diagnostics, also a subsidiary of Drew, asserted counterclaims against the plaintiffs for, among other things, breach of fiduciary duty, unfair trade and conversion. In addition, CDC Acquisition and IV Diagnostics asserted cross-claims against its co-defendants for indemnification pursuant to the transaction agreements. A bench trial was held in June, 2005. In August, 2005 the Court rendered a decision resulting in the Court's award of only $76,000 to Plaintiffs. CDC Acquisition and IV Diagnostics filed a motion for reconsideration of certain issues ruled upon by the Court. The motion was denied. Plaintiffs' counsel filed a motion for attorneys' fees seeking over $181,000. The Court recently granted such motion but awarded only $3,000 to plaintiffs' counsel. On November 1, 2005, CDC Acquisition and IV Diagnostics timely appealed the Court's ruling that CDC Acquisitions and IV Diagnostics are liable to the plaintiffs. Further, CDC Acquisition and IV Diagnostics are presently negotiating with co-defendants over the companies' indemnification claims.

On December 30, 2002, Source One, a distributor of CDC Technologies, Inc. filed suit in state court in Minnesota, later removed to the United States District Court in Minnesota, against CDC Technologies, Edward Carver and CDC Acquisition, Inc. and IV Diagnostics, as successors in interest to CDC Technologies. CDC Acquisition and IV Diagnostics asserted cross-claims against Carver for indemnification. The court granted summary judgment to the plaintiff against defendants and awarded plaintiff approximately $185,000 plus interest and costs. The Court also found Carver liable to CDC Acquisition for indemnification. Plaintiff agreed to accept $140,000 from CDC Acquisition in settlement of its claims. CDC Acquisition settled its indemnification claim against Carver for $75,000.

The $140,000 settlement, $79,000 award (including legal fees) and $75,000 indemnification referred to above have been recorded by the Company during the year ended June 30, 2005. The Company does not believe that these matters have, had or are likely to have a material adverse impact on the Company's business, financial condition or future results of operations.

OTHER LEGAL PROCEEDINGS

Escalon, from time to time is involved in various legal proceedings and

disputes that arise in the normal course of business. These matters have included intellectual property disputes, 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.

12. SEGMENTAL INFORMATION

During the three-month periods ended September 30, 2005 and 2004, the Company operations were classified into four principal reportable segments that provide different products or services. One of the business segments, Drew, became a reportable segment following its acquisition by the Company on July 23, 2004.

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

SEGMENTAL STATEMENTS OF OPERATIONS (IN THOUSANDS) - THREE MONT

	Drew		Sonomed		Vascular		Medic
	2005	2004	2005	2004	2005	2004	2005
Product revenue	$ 4,071	$ 1,904	$ 1,798	$ 1,644	$ 931	$ 695	$ 3
Other revenue	75	-	-	-	-	-	5
Total revenue	4,146	1,904	1,798	1,644	931	695	9
Costs and expenses:							
Cost of goods sold	2,594	1,251	976	859	320	320	2
Operating expenses	1,822	937	1,040	629	529	409	6
Total costs and expenses	4,416	2,188	2,016	1,488	849	729	8
(Loss)/income from operations	(270)	(284)	(218)	156	82	(34)	
Other income and expenses:							
Equity in OTM	-	-	-	-	-	-	(
Gain on sale of available for sale securities	-	-	-	-	-	-	1,1
Interest income		4	-	-	-	-	
Interest expense	(10)	(24)	-	(81)	-	(1)	
Total other income and expenses	(10)	(20)	-	(81)	82	(1)	1,1
(Loss)/income before taxes	(280)	(304)	(218)	75	82	(35)	1,1
Income taxes	-	-	-	-	-	-	
Net (loss)/income	$ (280)	$ (304)	$ (218)	$ 75	$ 82	$ (35)	$ 1,1

Depreciation and amortization	$ 55	$ 46	$ 5	$ 7	$ 17	$ 11	$
Assets	$ 15,295	$ 15,128	$13,623	$ 12,844	$ 2,208	$ 2,226	$ 8,6
Expenditures for long-lived assets	$ 88	$ 2	$ 0	$ 19	$ 13	$ 7	

13. SHAREHOLDERS' EQUITY

WARRANTS TO PURCHASE COMMON STOCK

In connection with debt issued by a former lender to Escalon in November 2001, the Company issued the lender warrants to purchase 60,000 shares of the Company's common stock at $3.66 per share. The lender exercised the warrants on December 13, 2004, in a cashless exercise receiving 32,855 shares of the Company's common stock in satisfaction of the warrants.

In connection with the private placement of the Company's common stock in March 2004, the Company issued to several accredited investors warrants to purchase 120,000 shares of the Company's common stock at $15.60 per share. The warrants are currently exercisable and expire in March 2009.

14. RELATED-PARTY TRANSACTIONS

Escalon 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 solution focuses on the diagnosis of diabetic retinopathy by creating access and providing annual dilated retinal examinations for the diabetic population. OTM was founded to harness the latest advances in telecommunications, software and digital imaging in order to create greater access and a more successful disease management for populations that are susceptible to ocular disease. Through September 30, 2005, Escalon had invested $256,000 in OTM. As of September 30, 2005, Escalon owned 45% of OTM. The members of OTM have agreed to review the operations of OTM after 24 months, at which time the

members each have the right to sell their membership interest back to OTM at fair market value. The Company provides administrative support functions to OTM. From inception through September 30, 2005, OTM had revenue of approximately $10,000 and incurred expenses of approximately $160,000. This investment is accounted for under the equity method of accounting and is included in other assets.

Commencing July 2004, a relative of a senior executive officer of Escalon began providing legal services to the Company in connection with various legal proceedings. Expenditures related to this individual during the three-month periods ended September 2005 and 2004 were $0 and $13,062, respectively. Commencing in August 2005, this individual was retained as an employee of the Company.

15. INTRALASE INITIAL PUBLIC OFFERING

In October 1997, Escalon licensed its intellectual laser properties to IntraLase in exchange for an equity interest of 252,535 shares of Common Stock (as adjusted for splits), as well as royalties on future product sales. The

Company has historically accounted for these shares a $0 basis because a readily determinable market value was previously not available. On October 7, 2004, IntraLase announced the initial public offering of shares of its common stock at a price of $13.00 per share. The shares of common stock were restricted for a period of less than one year and were permitted to be sold after April 6, 2005 pursuant to a certain Fourth Amended Registration Rights Agreement between the Company and IntraLase. The Company sold 191,000 shares of IntraLase common stock in May 2005 at $17.9134 per share resulting in net proceeds, after fees and commissions, of $3,411,761. As of June 30, 2005, the Company's remaining 61,535 shares of IntraLase were classified as available-for-sale securities and had a market value of $1,207,317.

On July 8, 2005, Company sold an additional 58,535 shares of IntraLase common stock at $19.8226 per share resulting in gross proceeds of $1,160,316. After paying broker commissions and other fees of $2,980, the Company received net proceeds of $1,157,336. The net proceeds from the sale were recorded in other income and expense. The Company's remaining 3,000 shares of IntraLase at September 30, 2005 are classified as available-for-sale securities

16. SUBSEQUENT EVENTS

On October 14, 2005, the Company announced that its subsidiary, Escalon Medical Imaging, Inc., signed a letter of intent to acquire substantially all of the assets of MRP Group, Inc. ("MRP"). The transaction, which is expected to close in the Company's second fiscal quarter ending December 31, 2005, is subject to customary closing conditions, including the completion of a definitive agreement.

MRP is a privately held ophthalmic technology solutions provider that currently offers two retinal imaging systems and has approximately 200 systems installed at leading medical and retinal care centers. If the transaction is successfully completed, upon closing, the operating results of MRP will be included in the consolidated results of the Company, and MRP will become part of the Medical/Trek/EMI business unit.

On October 11, 2005 the Company signed a non-exclusive co-marketing agreement with privately held Anka Systems, Inc. ("Anka"), a provider of web-based connectivity solutions for the ophthalmic physician. Anka's connectivity solutions are used in major eye healthcare centers and provide seamless integration of data from various clinical modalities commonly used in eye healthcare settings. Upon closing of the MRP acquisition, the co-marketing agreement will enable Escalon to jointly market its existing digital imaging hardware and MRP's digital imaging hardware with Anka's connectivity solutions. By integrating the sales and marketing efforts, the alliance should provide economies of operation and a greater market reach. Anka is an early stage privately held company located in the Washington D.C. area.

The Company extended a $300,000 loan, pursuant to a demand mote, to Anka. Under the terms of this note repayment will occur within six months after written demand or immediately upon an event of default.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

EXECUTIVE OVERVIEW - THREE-MONTH PERIOD ENDED SEPTEMBER 30, 2005

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.

- On July 23, 2004, Escalon acquired 67% of the outstanding ordinary shares of Drew pursuant to the Company's exchange offer for all of the outstanding ordinary shares of Drew, and since that date has acquired all of the Drew shares. The Company has been operating Drew as a separate business unit since its acquisition and its results of its operations are included in the "Management's Discussion and Analysis or Plan of Operation" for all periods since the acquisition in July 2004. Prior to the acquisition, Drew's ability to obtain raw materials and components was severely restricted due to prolonged liquidity constraints. These constraints were pervasive throughout all of Drew's locations and affected all aspects of Drew's operations. Escalon's operational priorities with respect to Drew have been to stabilize and increase Drew's revenue base and to infuse Drew with working capital in the areas of manufacturing, sales and marketing and product development in an effort to remove the pre-acquisition liquidity constraints.

- In connection with the acquisition of Drew, the Company issued 900,000 shares of its common stock during the fiscal year ended June 30, 2005, of which 841,686 shares were issued in the three month period ended September 30, 2004.

- Product revenue increased approximately 53.6% during the three-month period ended September 30, 2005 as compared to the same period last fiscal year. The increase is primarily related to strong sales in the Company's Drew, Sonomed and Vascular business units. Sales at these business units increased approximately 138.1%, 9.4% and 34.0% during the three month period ended September 30, 2005 when compared to the same period last fiscal year.

- During July 2005, the Company sold 58,555 shares of IntraLase common stock that had originally been received in connection with the license of its intellectual laser properties to IntraLase in 1997 (see note 15 to the notes to the condensed consolidated financial statements). The stock was sold at $19.8226 per share and yielded net proceeds of $1,157,336 after the payment of brokers' commissions and other fees. The net proceeds were recorded as other income in the three-month period ended September 30, 2005.

- Other revenue increased approximately $14,500 or 2% during the three-month period ended September 30, 2005 as compared to the same period last fiscal year. The increase primarily relates to an increase in royalty payments received from Intralase and Bio Rad, which offset lower royalties received from Bauch and Lomb in connection with the Silicone Oil Product line. During the three-month periods ended September 30, 2005 and 2004, 2.6% and 7.9%, respectively, of the Company's revenue was received from the Bauch and Lomb contract, which expired in August 2005. Accordingly, the Company will receive no additional revenue related to this contract.

- Cost of goods sold as a percentage of product revenue increased slightly to approximately 57.64% of revenues during the three-month period ended September 30, 2005, as compared to approximately 57.61% of product revenue for the same period last fiscal year. The increase is primarily due to the significant increase in the revenues of the Drew business unit, which offset margin improvements in the Company's other business units. Gross margins in the Drew business unit, while improving in the three-month period ended September 30, 2005 as compared to the same period in the prior fiscal year, have historically been lower than those in the

Company's other business units. The aggregate cost of goods sold as a percentage of product

revenue of the Sonomed, Vascular and Medical/Trek/EMI business units during the three-month period ended September 30, 2005 decreased to approximately 49.5% of product revenue from approximately 52% in the same period last fiscal year.

- Operating expenses, while decreasing slightly as a percentage of product revenue, increased approximately 50.5% during the three-month period ended September 30, 2005 as compared to the same period in the prior fiscal year. During the three-month period ended September 30, 2005, the Company incurred higher personnel costs to support the growth in the Company's business operations, higher advertising, marketing, travel and trade show costs related to both the higher sales volumes and the continued emphasis to increase sales, especially in international markets, and increased research and development costs to support planned introductions of new and or enhanced products, especially in the Drew and Sonomed business units. In addition, the Company continues to experience an unusually high amount of legal and accounting fees primarily related to Intralase litigation costs, and increased auditor's fees in proportion to the increase in the Company's size due to the acquisition of Drew and initial costs related to compliance with the Sarbanes -Oxley Act of 2002. While the Company expects these legal, accounting and compliance expenses to impact earnings in the near term, it does not believe that all of these expenses will continue in the future at such high levels.

CAUTIONARY FACTORS THAT MAY AFFECT FUTURE RESULTS

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," "plan," "possible," "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, product development, the introduction of new products, the potential markets and uses for the Company's products, the Company's regulatory filings with the United States Food and Drug Administration (the "FDA"), acquisitions, the development of joint venture opportunities, 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 and defending the Company in litigation matters. 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 following list of such factors to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions.

The Company cautions the reader to consider carefully these factors as well as the specific factors discussed with each specific forward-looking statement in this quarterly report and in the Company's other filings with the

SEC. In some cases, these factors have impacted, and in the future (together with other unknown factors) could impact the Company's ability to implement the Company's business strategy and may cause actual results to differ materially from those contemplated by such forward-looking statements. No assurance can be made that any expectation, estimate or projection contained in a forward-looking statement can be achieved.

The Company also cautions the reader that forward-looking statements speak only as of the date made. The Company undertakes no obligation to update any forward-looking statement, but investors are advised to consult any further disclosures by the Company on this subject in the Company's filings with the SEC, in which the Company discusses in more detail various important factors that could cause actual results to differ from expected or historical results. Although it is not possible to create a comprehensive list of all factors that may cause actual results to differ from the Company's forward-looking statements, the most important factors include, without limitation, the following:

ANY ACQUISITIONS, STRATEGIC ALLIANCES, JOINT VENTURES AND DIVESTITURES THAT THE COMPANY EFFECTS COULD RESULT IN FINANCIAL RESULTS THAT DIFFER FROM MARKET EXPECTATIONS.

In the normal course of business, the Company engages in discussions with third parties regarding possible acquisitions, strategic alliances, joint ventures and divestitures. As a result of any such transactions, the Company's financial results may differ from the investment community's expectations in a given quarter. In addition, acquisitions and alliances may require the Company to integrate a different company culture, management team, business infrastructure, accounting systems and financial reporting systems, although there is no assurance that any such acquisitions or alliances will occur. The Company may have difficulty developing, manufacturing and marketing the products of a newly acquired company in a way that enhances the performance of the Company's combined businesses or product lines to realize the value from expected synergies. Depending on the size and complexity of an acquisition, the Company's successful integration of the entity depends on a variety of factors including the retention of key employees and the management of facilities and employees in separate geographical areas. These efforts require varying levels of management resources, which may divert the Company's attention from other business operations. The Company acquired Drew during the first quarter of fiscal 2005. Drew does not have a history of producing positive operating cash flows and, as a result, at the time of acquisition, was operating under financial constraints and was under-capitalized and is expected to negatively impact the Company's financial results in the short-term. As Drew is integrated into the Company, management will be working to reverse the situation, while at the same time seeking to strengthen Drew's market position. Escalon loaned approximately $6,891,000 to Drew. The funds have been primarily used to procure components to build up inventory to support the manufacturing process, to pay off accounts payable and debt of Drew, and expand the sales and marketing and research and development efforts. Escalon anticipates that further working capital will likely be required by Drew. If the Company does not realize the expected benefits or synergies of such transactions, the Company's consolidated financial position, results of operations and stock price could be negatively impacted. Also, the Company's results may be adversely impacted because of acquisition-related costs, amortization costs for certain intangible assets and impairment losses related to goodwill in connection with such transactions.

COSTS ASSOCIATED WITH INTRALASE LITIGATION MAY ADVERSELY IMPACT EARNINGS IN THE NEAR TERM.

Escalon is cognizant of the escalating legal expenses and costs associated with the IntraLase matter. Escalon, however, is taking all necessary actions to protect its rights and interests under the License Agreement. Escalon expects expenses associated with this litigation to adversely impact earnings in the near term. If Escalon is successful in the litigation, there is a cure feature written into the stipulation to the temporary restraining order, which would enable IntraLase to continue to pay royalties Escalon believes are due under the License Agreement. Escalon believes that IntraLase has sufficient funds to support such payments based upon its filings with the Securities and Exchange Commission and filings in connection with this litigation. If IntraLase is successful in the litigation, they would continue to pay royalties under their calculations.

THE COMPANY'S RESULTS FLUCTUATE FROM QUARTER TO QUARTER.

The Company has experienced quarterly fluctuations in operating results and anticipates continued fluctuations in the future. A number of factors contribute to these fluctuations:

- Acquisitions, such as Drew, and subsequent integration of the acquired company, although there is no assurance that such acquisitions will occur;

- The timing and expense of new product introductions by the Company or its competitors, although there is no assurance that any new products will be successfully developed or gain market acceptance;

- The cancellation or delays in the purchase of the Company's products;

- Fluctuations in customer demand for the Company's products;

- Fluctuations in royalty income;

- The gain or loss of significant customers;

- Changes in the mix of products sold by the Company;

- Competitive pressures on prices at which the Company can sell its products; and

- Announcements of new strategic relationships by the Company or its competitors.

The Company sets its spending levels in advance of each quarter based, in part, on the Company's expectations of product orders and shipments during that quarter. A shortfall in revenue, therefore, in any particular quarter as compared to the Company's plan could have a material adverse impact on the Company's results of operations and cash flows. Also, the Company's quarterly results could fluctuate due to general market conditions in the healthcare industry or global economy generally, or market volatility unrelated to the Company's business and operating results.

FAILURE OF THE MARKET TO ACCEPT THE COMPANY'S PRODUCTS COULD ADVERSELY IMPACT THE COMPANY'S BUSINESS AND FINANCIAL CONDITION.

The Company's business and financial condition will depend in part upon the market acceptance of the Company's products. The Company cannot assure that the Company's products will achieve market acceptance. Market acceptance depends

on a number of factors including:

- The price of the products;
- The receipt of regulatory approvals for multiple indications;
- The establishment and demonstration of the clinical safety and efficacy of the Company's products; and
- The advantages of the Company's products over those marketed by the Company's competitors.

Any failure to achieve significant market acceptance of the Company's products will have a material adverse impact on the Company's business.

THE COMPANY NO LONGER RECEIVES REVENUE FROM THE SALE OF SILICONE OIL BY BAUSCH & LOMB WHICH EXPIRED ON AUGUST 12, 2005.

The Company received approximately 2.6% and 7.9% of its net revenue during the three-month periods ended September 30, 2005 and 2004, respectively, from Bausch & Lomb's sales of Silicone Oil. The Company was entitled to receive this revenue from Bausch & Lomb, in varying amounts, through August 12, 2005. The Company's agreement with Bausch & Lomb, which commenced on August 13, 2000, was structured so that the Company received consideration from Bausch & Lomb based on its adjusted gross profit from its sales of Silicone Oil on a quarterly basis. The consideration was subject to a factor, which declined according to the following schedule:

From 8/13/00 to 8/12/01	100%
From 8/13/01 to 8/12/02	82%
From 8/13/02 to 8/12/03	72%
From 8/13/03 to 8/12/04	64%
From 8/13/04 to 8/13/05	45%

The revenue associated with the sale of Silicone Oil by Bausch & Lomb had no associated expense and consequently provided a gross margin of 100%. The elimination of this revenue will have a significant negative impact on gross margin. The Company will not receive any future revenue related to the Silicone Oil royalty as the contract expired on August 12, 2005.

THE COMPANY'S PRODUCTS ARE SUBJECT TO STRINGENT ONGOING REGULATION BY THE FDA AND SIMILAR HEALTH CARE REGULATORY AUTHORITIES, AND IF THE FDA'S APPROVALS OR CLEARANCES OF THE COMPANY'S PRODUCTS ARE RESTRICTED OR REVOKED, THE COMPANY COULD FACE DELAYS THAT WOULD IMPAIR THE COMPANY'S ABILITY TO GENERATE FUNDS FROM OPERATIONS.

The FDA and similar health care regulatory authorities in foreign countries extensively regulate the Company's activity. The Company must obtain either 510(K) clearances or pre-market approvals and new drug application approvals prior to marketing a product in the United States. Foreign regulation also requires that the Company obtain other approvals from foreign government agencies prior to the sale of products in those countries. Also, the Company may be required to obtain FDA approval before exporting a product or device that has not received FDA marketing clearance or approval.

The Company has received the necessary FDA approvals for all products that

the Company currently markets. Any restrictions on or revocation of the FDA approvals and clearances that the Company has obtained, however, would prevent the continued marketing of the impacted products and other devices. The restrictions or revocations could result from the discovery of previously unknown problems with the product. Consequently, FDA revocation would impair the Company's ability to generate funds from operations.

The FDA and comparable agencies in state and local jurisdictions and in foreign countries impose substantial requirements upon the manufacturing and marketing of pharmaceutical and medical device equipment and related disposables, including the obligation to adhere to the FDA's Good Manufacturing Practice regulations. Compliance with these regulations requires time-consuming detailed validation of manufacturing and quality control processes, FDA periodic inspections and other procedures. If the FDA finds any deficiencies in the validation processes, for example, the FDA may impose restrictions on marketing the specific products until such deficiencies are corrected.

The Company has received CE approval on several of the Company's products that allows the Company to sell the products in the countries comprising the European community. In addition to the CE mark, however, some foreign countries may require separate individual foreign regulatory clearances. The Company cannot assure that the Company will be able to obtain regulatory clearances for other products in the United States or foreign markets.

The process for obtaining regulatory clearances and approvals underlying clinical studies for any new products or devices and for multiple indications for existing products is lengthy and will require substantial commitments of Escalon's financial resources and Escalon's management's time and effort. Any delay in obtaining clearances or approvals or any changes in existing regulatory requirements would materially adversely impact the Company's business.

Escalon's failure to comply with the applicable regulations would subject the Company to fines, delays or suspensions of approvals or clearances, seizures or recalls of products, operating restrictions, injunctions or civil or criminal penalties, which would adversely impact the Company's business, financial condition and results of operations.

THE SUCCESS OF COMPETITIVE PRODUCTS COULD HAVE AN ADVERSE IMPACT ON THE COMPANY'S BUSINESS.

The Company faces intense competition in the medical device and pharmaceutical markets, which are characterized by rapidly changing technology, short product life cycles, cyclical oversupply and rapid price erosion. Many of the Company's competitors have substantially greater financial, technical, marketing, distribution and other resources. The Company's strategy is to compete primarily on the basis of technological innovation, reliability, quality and price of the Company's products. Without timely introductions of new products and enhancements, the Company's products will become technologically obsolete over time, in which case the Company's revenues and operating results would suffer. The success of the Company's new product offerings will depend on several factors, including the Company's ability to:

- Properly identify customer needs;
- Innovate and develop new technologies, services and applications;
- Establish adequate product distribution coverage;
- Obtain and maintain required regulatory approvals from the FDA and other regulatory agencies;

- Protect the Company's intellectual property;

- Successfully commercialize new technologies in a timely manner;

- Manufacture and deliver the Company's products in sufficient volumes on time;

- Differentiate the Company's offerings from the offerings of the Company's competitors;

- Price the Company's products competitively;

- Anticipate competitors' announcements of new products, services or technological innovations; and

- Anticipate general market and economic conditions.

The Company cannot ensure that the Company will be able to compete effectively in the competitive environments in which the Company operates.

THE COMPANY'S PRODUCTS EMPLOY PROPRIETARY TECHNOLOGY, AND THIS TECHNOLOGY MAY INFRINGE ON THE INTELLECTUAL PROPERTY RIGHTS OF THIRD PARTIES.

The Company holds several United States and foreign patents for the Company's products. Other parties, however, hold patents relating to similar products and technologies. If patents held by others were adjudged valid and interpreted broadly in an adversarial proceeding, the court or agency could deem them to cover one or more aspects of the Company's products or procedures. Any claims for patent infringements or claims by the Company for patent enforcement would consume time, result in costly litigation, divert technical and management personnel or require the Company to develop non-infringing technology or enter into royalty or licensing agreements. The Company cannot be certain that the Company will not be subject to one or more claims for patent infringement, that the Company would prevail in any such action or that the Company's patents will afford protection against competitors with similar technology.

If a court determines that any of the Company's products infringes, directly or indirectly, on a patent in a particular market, the court may enjoin the Company from making, using or selling the product. Furthermore, the Company may be required to pay damages or obtain a royalty-bearing license, if available, on acceptable terms.

LACK OF AVAILABILITY OF KEY SYSTEM COMPONENTS COULD RESULT IN DELAYS, INCREASED COSTS OR COSTLY REDESIGN OF THE COMPANY'S PRODUCTS.

Although some of the parts and components used to manufacture the Company's products are available from multiple sources, the Company currently purchases most of the Company's components from single sources in an effort to obtain volume discounts. Lack of availability of any of these parts and components could result in production delays, increased costs, or costly redesign of the Company's products. Any loss of availability of an essential component could result in a material adverse change to Escalon's business, financial condition and results of operations. Some of the Company's suppliers are subject to the FDA's Good Manufacturing Practice regulations. Failure of these suppliers to comply with these regulations could result in the delay or limitation of the supply of parts or components to the Company, which would adversely impact the Company's financial condition and results of operations.

THE COMPANY'S ABILITY TO MARKET OR SELL THE COMPANY'S PRODUCTS MAY BE ADVERSELY IMPACTED BY LIMITATIONS ON REIMBURSEMENTS BY GOVERNMENT

PROGRAMS, PRIVATE INSURANCE PLANS AND OTHER THIRD PARTY PAYORS.

The Company's customers bill various third party payors, including government programs and private insurance plans, for the health care services provided to their patients. Third party payors may reimburse the customer, usually at a fixed rate based on the procedure performed, or may deny reimbursement if they determine that the use of the Company's products was elective, unnecessary, inappropriate, not cost-effective, experimental or used for a non-approved indication. Third party payors may deny reimbursement notwithstanding FDA approval or clearance of a product and may challenge the prices charged for the medical products and services. The Company's ability to sell the Company's

products on a profitable basis may be adversely impacted by denials of reimbursement or limitations on reimbursement, compared with reimbursement available for competitive products and procedures. New legislation that further reduces reimbursements under the capital cost pass-through system utilized in connection with the Medicare program could also adversely impact the marketing of the Company's products.

FUTURE LEGISLATION OR CHANGES IN GOVERNMENT PROGRAMS MAY ADVERSELY IMPACT THE MARKET FOR THE COMPANY'S PRODUCTS.

In the past several years, the federal government and Congress have made proposals to change aspects of the delivery and financing of health care services. The Company cannot predict what form any future legislation may take or its impact on the Company's business. Legislation that sets price limits and utilization controls adversely impact the rate of growth of the markets in which the Company participates. If any future health care legislation were to adversely impact those markets, the Company's product marketing could also suffer, which would adversely impact the Company's business.

THE COMPANY MAY BECOME INVOLVED IN PRODUCT LIABILITY LITIGATION, WHICH MAY SUBJECT THE COMPANY TO LIABILITY AND DIVERT MANAGEMENT ATTENTION.

The testing and marketing of the Company's products entails an inherent risk of product liability, resulting in claims based upon injuries or alleged injuries or a failure to diagnose associated with a product defect. Some of these injuries may not become evident for a number of years. Although the Company is not currently involved in any product liability litigation, the Company may be party to litigation in the future as a result of an alleged claim. Litigation, regardless of the merits of the claim or outcome, could consume a great deal of the Company's time and attention away from the Company's core businesses. The Company maintains limited product liability insurance coverage of $1,000,000 per occurrence and $2,000,000 in the aggregate, with umbrella policy coverage of $5,000,000 in excess of such amounts. A successful product liability claim in excess of any insurance coverage may adversely impact the Company's financial condition and results of operations. The Company cannot assure that product liability insurance coverage will continue to be available to the Company in the future on reasonable terms or at all.

THE COMPANY'S INTERNATIONAL OPERATIONS COULD BE ADVERSELY IMPACTED BY CHANGES IN LAWS OR POLICIES OF FOREIGN GOVERNMENTAL AGENCIES AND SOCIAL AND ECONOMIC CONDITIONS IN THE COUNTRIES IN WHICH THE COMPANY OPERATES.

The Company derives a portion of its revenue from sales outside the United States. Changes in the laws or policies of governmental agencies, as well as social and economic conditions, in the countries in which the Company operates could impact the Company's business in these countries and the Company's results

of operations. Also, economic factors, including inflation and fluctuations in interest rates and foreign currency exchange rates, and competitive factors such as price competition, business combinations of competitors or a decline in industry sales from continued economic weakness, both in the United States and other countries in which the Company conducts business, could adversely impact the Company's results of operations.

THE COMPANY IS DEPENDENT ON ITS MANAGEMENT AND KEY PERSONNEL TO SUCCEED.

The Company's principal executive officers and technical personnel have extensive experience with the Company's products, the Company's research and development efforts, the development of marketing and sales programs and the necessary support services to be provided to the Company's customers. Also, the Company competes with other companies, universities, research entities and other organizations to attract and retain qualified personnel. The loss of the services of any of the Company's executive officers or other technical personnel, or the Company's failure to attract and retain other skilled and experienced personnel, could have a material adverse impact on the Company's ability to maintain or expand businesses.

THE MARKET PRICE OF THE COMPANY'S STOCK HAS HISTORICALLY BEEN VOLATILE, AND THE COMPANY HAS NOT PAID CASH DIVIDENDS.

The volatility of the Company's common stock imposes a greater risk of capital losses on shareholders as compared to less volatile stocks. In addition, such volatility makes it difficult to ascribe a stable valuation to a shareholder's holdings of the Company's common stock. The following factors have and may continue to have a significant impact on the market price of the Company's common stock:

- Any acquisitions, strategic alliances, joint ventures and divestitures that the Company effects;
- Announcements of technological innovations;
- Changes in marketing, product pricing and sales strategies or new products by the Company's competitors;
- Changes in domestic or foreign governmental regulations or regulatory requirements; and
- Developments or disputes relating to patent or proprietary rights and public concern as to the safety and efficacy of the procedures for which the Company's products are used.

Moreover, the possibility exists that the stock market, and in particular the securities of technology companies such as Escalon, could experience extreme price and volume fluctuations unrelated to operating performance.

The Company has not paid cash dividends on its common stock and does not anticipate paying cash dividends in the foreseeable future.

THE IMPACT OF TERRORISM OR ACTS OF WAR COULD HAVE A MATERIAL ADVERSE IMPACT ON THE COMPANY'S BUSINESS.

Terrorist acts or acts of war, whether in the United States or abroad, could cause damage or disruption to the Company's operations, its suppliers, channels to market or customers, or could cause costs to increase, or create political or economic instability, any of which could have a material adverse

impact on the Company's business.

THE COMPANY'S CHARTER DOCUMENTS AND PENNSYLVANIA LAW MAY INHIBIT A TAKEOVER.

Certain provisions of Pennsylvania law and the Company's Bylaws could delay or impede the removal of incumbent directors and could make it more difficult for a third party to acquire, or discourage a third party from attempting to acquire, control of the Company. These provisions could limit the share price that certain investors might be willing to pay in the future for shares of the Company's common stock. The Company's Board of Directors is divided into three classes, with directors in each class elected for three-year terms. The Bylaws impose various procedural and other requirements that could make it more difficult for shareholders to effect certain corporate actions. The Company's Board of Directors may issue shares of preferred stock without shareholder approval on such terms and conditions, and having such rights, privileges and preferences, as the Board may determine. The rights of the holders of common stock will be subject to, and may be adversely impacted by, the rights of the holders of any preferred stock that may be issued in the future. The Company has no current plans to issue any shares of preferred stock.

COMPANY OVERVIEW

The following discussion should be read in conjunction with interim condensed consolidated financial statements and the notes thereto, which are set forth elsewhere in 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, hematology and vascular access. 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.

In February 1996, the Company acquired substantially all of the assets and certain liabilities of EOI, a developer and distributor of ophthalmic surgical products. Prior to this acquisition, the Company devoted substantially all of its resources to the research and development of ultrafast laser systems designed for the treatment of ophthalmic disorders. As a result of the EOI acquisition, Escalon changed its market focus and is no longer developing laser technology. In October 1997, the Company licensed its intellectual laser property to IntraLase, in return for an equity interest and future royalties on sales of products. IntraLase undertook responsibility for funding and developing the laser technology through to commercialization. IntraLase began selling products related to the laser technology during fiscal 2002 and announced its initial public offering of its common stock in October 2004. See Note 10 to Condensed Consolidated Financial Statements for further information. The Company is in dispute with IntraLase over royalty payments owed to the Company. See Part II, Item 1, "Legal Proceedings" and Note 11 of the Notes to Condensed Consolidated Financial Statements for further information.

To further diversify its product portfolio, in January 1999, the Company's Vascular subsidiary acquired the vascular access product line from Endologix, formerly Radiance Medical Systems, Inc. Vascular's products use Doppler technology to aid medical personnel in locating arteries and veins in difficult circumstances. Currently, this product line is concentrated in the cardiac catheterization market. In January 2000, the Company purchased Sonomed, a

privately held manufacturer of ophthalmic ultrasound diagnostic equipment.

On July 23, 2004, Escalon acquired 67% of the outstanding ordinary shares of Drew, a United Kingdom company, pursuant to the Company's exchange offer for all of the outstanding ordinary shares of Drew, and since that date has acquired all of the Drew shares. Drew is a diagnostics company specializing in the design, manufacture and distribution of instruments for blood cell counting and blood analysis. Drew is focused on providing instrumentation and consumables for the physician office and veterinary office laboratories. Drew also supplies the reagent and other consumable materials needed to operate the instruments.

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 for SFAS 142, discussed further in Note 7 of the Notes to the Condensed Consolidated Financial Statements included in this report. 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 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 an immediate right of return.

- 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

Escalon 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. These intangible assets include goodwill, trademarks and trade names. Factors the Company considers important that could trigger an impairment review include significant under-performance relative to historical or projected future operating results or significant negative industry or economic trends. If these criteria indicate that the value of the intangible asset may be impaired, an evaluation of the recoverability of the net carrying value of the asset is made. If this evaluation indicates that the intangible asset is not recoverable, the net carrying value of the related intangible asset will be reduced to fair value. Any such impairment charge could be significant and could have a material adverse impact on the Company's financial statements if an when an impairment charge is recorded. No impairment losses were recorded for goodwill, trademarks and trade names during any of the periods presented based on these evaluations.

INCOME/(LOSS) PER SHARE

The Company computes net income/(loss) per share under the provisions of SFAS No. 128, Earnings per Share (SFAS 128), and Staff Accounting Bulletin, No. 98 (SAB 98).

Under the provisions of SFAS 128 and SAB 98, 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 effect 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.

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 of the deferred tax assets, which arise from temporary differences between the tax and financial

statement recognition of revenue and expense. SFAS 109 also requires that the deferred tax assets be reduced by a valuation allowance, if based on the available evidence, it is more likely than 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 September 30, 2005, the Company has recorded a full valuation allowance against the Company's net operating losses due to the 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.

THREE-MONTH PERIODS ENDED SEPTEMBER 30, 2005 AND 2004

The following table shows consolidated product revenue by business segment as well as identifying trends in business segment product revenues for the three-month periods ended September 30, 2005 and 2004.

	Three-Month Period Ended September 30,		
	2005	2004	% Change
Product revenue:			
Drew	$ 4,071	$ 1,904	138.13%
Sonomed	1,798	1,644	9.37%
Vascular	931	695	33.96%
Medical/Trek/EMI	323	393	(17.81)%
	$ 7,123	$ 4,636	53.65%

Product revenue increased approximately $2,487,000, or 53.65%, to $7,123,000 during the three-month period ended September 30, 2005 as compared to the same period last fiscal year. In the Drew business unit, product revenue increased $2,167,000 or 138.13% as compared to the same period last fiscal year. The increase is due primarily to the increased sale in both domestic and international markets of diabetics and hematology instruments. Sales of instruments increased by approximately $1,400,000 in the three-month period ended September 30, 2005 as compared to the same period last prior year. Sales of spare parts and reagents and controls, which are used to operate the instruments, also increased during the period to support the increase in the installed base of the related instruments. In the Sonomed business unit, product revenue increased $154,000 or 9.4% as compared to the same period last fiscal year The increase in product revenue was primarily caused by an increase in sales of the Company's EZ AB scan ultrasound systems and an increase in export sales, which were partially offset by a decrease in demand for the Company's pachymeter product. The domestic market for pachymeters had previously expanded

due to enhanced techniques in glaucoma screening performed by optometrists. Historically, the typical optometrist had not been a user of the pachymeter. Domestic demand for the pachymeter returned to historic levels during the fourth quarter of fiscal 2004 due to market saturation and increased price competition within the marketplace. In the Vascular business unit, revenue increased $236,000, or 34.0%, to $931,000 during the three-month period ended September 30, 2005 as compared to the same period last fiscal year. The increase in product revenue in the Vascular business unit was primarily caused by an increase in direct sales to end users by the Company's domestic sales team and, to a lesser extent, increases in the European market. These increases were partially offset by decreases in revenue from the Company's distributor network. The Company terminated its relationship with several of its distributors during the

prior fiscal year. In the Medical/Trek/EMI business unit, product revenue decreased $70,000, or 17.81%, to $323,000 during the three-month period ended September 30, 2005 as compared to the same period last fiscal year. The decrease in Medical/Trek/EMI product revenue is primarily attributed to a decrease in OEM revenue from Bausch & Lomb.

Other revenue increased $14,000, or 2%, to $670,000 during the three-month period ended September 30, 2005 as compared to the same period last fiscal year. The increase is primarily attributed to a $153,000 increase in royalty payments received from IntraLase related to the licensing of the Company's intellectual laser technology. IntraLase royalties increased partially due to a court order amending IntraLase's method of calculating its royalty payments to the Company (see notes 10 and 11 to the condensed consolidated financial statements). An increase in royalties of $75,000 from Bio-Rad related to an OEM agreement between Bio-Rad and Drew also contributed to the increase. While this agreement terminated as of May 15, 2005, the parties have continued to operate under the terms of the expired agreement pending negotiation of a potential extension and/or revision. These increases were partially offset by a $214,000 decrease in royalties received from Bausch & Lomb in connection with their sales of Silicone Oil. The Company's contract with Bausch & Lomb called for annual step-downs in the calculation of Silicone Oil revenue to be received by the Company from 64% from August 13, 2003 to August 12, 2004 to 45% from August 13, 2004 to August 12, 2005. The Company's contract with Bausch & Lomb ended in August 2005, accordingly, the Company will receive no future royalties under this agreement. See note 10 of the notes to the condensed consolidated financial statements for a description of the step-down provisions under the contract with Bausch & Lomb.

The following table presents consolidated cost of goods sold by reportable business segment and as a percentage of related segment product revenues for the three-month periods ended September 30, 2005 and 2004.

	Three-Month Period Ended September 30,			
Cost of goods	2005		2004	
sold:	Dollars	%	Dollars	%
	(in thousands)		(in thousands)	
Drew	$ 2,594	63.72%	$ 1,251	65.65%
Sonomed	976	54.28%	859	52.25%

Vascular	320	34.37%	320	46.04%
Medical/Trek/EMI	216	66.87%	242	61.58%
	$ 4,106	57.64%	$ 2,672	57.61%

Cost of goods sold totaled approximately $4,106,000, or 57.64% of product revenue, for the three-month period ended September 30, 2005, as compared to $2,672 000 or 57.61% of product revenue for the same period last fiscal. The increase is primarily due to the corresponding increase in revenues of 53.65%.

Cost of goods sold in the Drew business unit totaled $2,594,000 or 63.72% of product revenue for the three-month period ended September 30, 2005 as compared to $1,251,000, or 65.65% of product revenue for the same period last fiscal year. The decrease is due to a decrease in material costs resulting from the easing of pre acquisition liquidity constraints at Drew following its acquisition by Escalon and operating efficiencies gained through both manufacturing changes implemented post-acquisition and higher production volumes during the three-month period ended September 30, 2005 as compared to the same period last fiscal year. These benefits were partially offset by a change in product mix, with sales of instruments representing a higher percentage of total sales in current fiscal year period. Instrument sales historically have lower margins than the sales of reagents and controls which are used to operate the instruments.

Cost of goods sold in the Sonomed business unit totaled $976,000 or 54.38% of product revenue for the three-month period ended September 30, 2005 as compared to $859,000 or 52.25% of product revenue for the same period last fiscal year. The primary reason for the decrease was an increase in the percentage of sales during the period which were international sales. The Company historically

experiences a lower selling price per unit on its international product sales. Cost of goods sold in the Vascular business unit totaled $320,000, or 34.37% of product revenue, for the three-month period ended September 30, 2005 as compared to $320,000, or 46.04% of product revenue for the same period last fiscal year. The primary factor affecting the decrease in cost of goods sold as a percentage of product revenue was the increase in direct sales to end users and corresponding decrease in sales through the Company's distributor network where the Company generally experiences lower price per unit on its products. Cost of goods sold in the Medical/Trek/EMI business unit totaled $216,000, or 66.87% of product revenue, during the three-month period ended September 30, 2005 as compared to $242,000, or 61.58% of product revenue, during the same period last fiscal year. Fluctuations in Medical/Trek/EMI cost of goods sold primarily emanates from product mix, which was primarily controlled by market demand.

The following table presents consolidated marketing, general and administrative expenses as well as identifying trends in business segment marketing, general and administrative expenses for the three-month periods ended September 30, 2005 and 2004.

Three-Month Period Ended September 30,		
2005	2004	% Change

	(in thousands)	(in thousands)	
Marketing, general and administrative expenses:			
Drew	$ 1,399	$ 792	76.64%
Sonomed	516	324	59.26%
Vascular	420	339	23.89%
Medical/Trek/EMI	949	727	30.54%
	$ 3,284	$ 2,182	50.50%

Marketing, general and administrative expenses increased $1,102,000, or 50.5 %, to $3,284,000 during the three-month period ended September 30, 2005 as compared to the same period last fiscal year. While marketing, general and administrative expenses increased $1,102,000 between periods, it decreased as a percentage of product revenue to 46.1% for the three-month period ended September 30, 2005 from 47.1% in the corresponding prior year period.

Marketing, general and administrative expenses in the Drew business unit increased $ 607,000, or 76.64%, to $1,399,000 as compared to the same period last fiscal year. The increase is primarily due to higher personnel (approximately $308,000) and travel and trade show costs (approximately $99,000) related to improving the image of the Drew brand with both customers and distributors and improving the product distributor network, which ultimately contributed to the 138% increase in product revenue when compared to the corresponding prior year period. Marketing, general and administrative expenses in the Sonomed business unit increased $192,000, or 59.26%, to $516,000 as compared to the same period last fiscal year. Marketing and sales salaries, commissions and other personnel-related expenses, including amounts paid to independent agents utilized primarily in Europe, increased approximately $107,000 as a result of increased headcount related primarily to the Company's goal of increasing international revenues. Sales meeting and trade show expenses, travel and lodging, and advertising increased by a combined $34,000 related primarily to the focus on growing international sales. Rent and utilities expense increased $18,000 due to the relocation of Sonomed's facility and the corresponding new lease entered into during fiscal 2005. Legal expenses increased by $27,000 due fees incurred to resolve a dispute with a supplier and fees related to researching intellectual property ownership issues for intellectual property currently being evaluated for licensing for use in potential new products. Marketing, general and administrative expenses in the Vascular business unit increased $81,000, or 23.89%, to $420,000 as compared to the same period last fiscal year. Salaries and other personnel-related expenses increased $24,000 and the expense for customer samples increased by $17,000 when compared to the prior fiscal period. Both increases were related to supporting a higher volume of business during the current period as compared to the same period in the prior fiscal year. Marketing, general and administrative expenses in the Medical/Trek/EMI business unit increased $222,000, or 30.54%, to $949,000 as compared to the same period last fiscal year. Legal and accounting fees and personnel related costs increased by approximately $137,000 and $62,000, respectively. Legal fees increased due to litigation costs with Intralase, which the Company expects will

continue to impact earnings in the near term (see note 11 of the notes to the condensed consolidated financial statements for a description of Legal

Proceedings). Accounting fees increased due to increased auditor's fees in proportion to the increase in the Company's size due to the acquisition of Drew on July 23, 2004 and initial costs incurred related to compliance with the Sarbanes-Oxley Act of 2002. Personnel costs increased due to personnel additions to support the overall growth of the Company

Research and development expenses increased $440,000, or 139.24%, to $756,000 during the three-month period ended September 30, 2005 as compared to the same period last fiscal year. The increase in research and development expenses was attributed higher personnel, consultant and prototype costs related to planned introductions of new and or enhanced products in the Drew and Sonomed business units. In addition, approximately $92,000 of the increase was related to the addition of a senior level person involved in evaluating various technologies for potential use in new products or product enhancements.

Gain on sale of available for sale securities was approximately $1,157,000 in the three-month period ended September 30, 2005. The increase was due to the sale of 58,585 shares of IntraLase common stock in July 2005 (see note 15 of the notes to the condensed consolidated financial statements).

Escalon recognized a loss of $18,000 and $29,000 related to its investment in OTM during the three-month periods ended September 30, 2005, respectively. The share of OTM's loss recognized by the Company is in direct proportion to the Company's ownership equity in OTM. OTM began operations during the three-month period ended September 30, 2004. (See note 14 of the notes to the condensed consolidated financial statements).

Interest income was $5,000 and $32,000 for the three-month periods ended September 30, 2005 and 2004, respectively. The decrease relates to lower average cash balances due the repayment of approximately $6,348,000 of debt in the second quarter of fiscal 2005.

Interest expense was $11,000 and ($3,000) for the three-month periods ended September 30, 2005 and 2004, respectively. The Company paid off several of its debt facilities to several entities in advance of their maturities during the fiscal year ended June 30, 2005. Additionally, the Company reversed accrued loan commitment fees as a result of the satisfaction of the debt and the release by the lender of those fees. The fees were originally accrued based on contract terms. The increase in interest expense during the three-month period ended September 30, 2005 when compared to the same prior year period is due to the non-recurring reversal of loan commitment fees in the prior fiscal period.

LIQUIDITY AND CAPITAL RESOURCES

Changes in overall liquidity and capital resources from continuing operations during the three-month period ended September 30, 2005 are reflected in the following table:

(Dollars are in thousands)	September 30, 2005	June 30, 2005
Current assets	$ 17,257	$ 17,665
Less: Current liabilities	4,340	4,052
Working capital	$ 12,917	$ 13,613
Current ratio	4.0 to 1	4.4 to 1
Notes payable and current maturities	$ 233	$ 230
Long-term debt	330	392

Total debt	563	$ 622
Total equity	34,024	34,519
Total capital	$ 34,587	$ 35,141
Total debt to total capital	1.63%	1.77%

WORKING CAPITAL POSITION

Working capital decreased $696,000 as of September 30, 2005 and the current ratio decreased to 4.0 to 1 from 4.4 to 1 when compared to June 30, 2005. The decrease in working capital was caused primarily by the loss from operations of approximately $352,000 and cash used to fund fixed asset additions of approximately 145,000 during the three month period ended September 30, 2005.

CASH USED IN OPERATING ACTIVITIES

During the three-month periods ended September 30, 2005 and 2004, the Company used approximately $751,000 and $1,935,000 of cash for operating activities. The net decrease in cash generated from operating activities of approximately $1,184,000 for the three-month period ended September 30, 2005 as compared to the same period in the prior fiscal year is due primarily to the following factors:

- The Company employed significantly less cash to fund working capital requirements during the three months ended September 30, 2005 than it employed in the same period in the prior fiscal year. Total working capital employed was approximately $434,000 and $2,171,000, respectively, during the three-month periods ended September 30, 2005 and 2004, respectively. The decrease is due to the fact that in the prior year period, the Company utilized approximately $1,500,000 in cash to begin to alleviate the liquidity constraints that Drew was experiencing prior to its acquisition by the Company. The cash was utilized to support increases in inventory and receivables and reduce payables and outstanding draws on Drew's line of credit.

- The reduction in cash utilized to fund working capital was partially offset by a reduction in operating income of approximately $475,000 for the three-month period ended September 30, 2005 when compared to the same prior year period.

CASH FLOWS PROVIDED BY (USED IN) INVESTING AND FINANCING ACTIVITIES

Cash flows generated by investing activities were approximately $1,013,000 during the three-month period ended September 30, 2005 and relate primarily to the net proceeds of approximately $1,157,000 realized from the sale of a majority of the remaining shares of the IntraLase securities held by the Company as available for sale securities (see note 15 to the notes to the condensed consolidated financial statements). Partially offsetting the cash realized from the securities sale was cash utilized for fixed asset additions of approximately $145,000. Any necessary capital expenditures have generally been funded out of cash from operations, and the Company is not aware of any factors that would cause historical capital expenditure levels to not be indicative of capital expenditures in the future and, accordingly, does not believe that the Company will have to commit material resources to capital investment for the foreseeable future.

Cash flows used in financing activities were approximately $49,000 during

the three month period ended September 30, 2005. During the period, the Company made scheduled long-term debt repayments of approximately $60,000. Partially offsetting the debt repayments was approximately $11,000 received by the Company from the exercise of stock options by employees of the Company.

DEBT HISTORY

On December 23, 2002, a lender acquired the Company's bank debt, which consisted of term debt of $5,850,000 and $1,475,000 outstanding on a $2,000,000 available line of credit. On February 13, 2003, the Company entered into an amended agreement with the lender. The primary amendments of the amended loan agreement were to reduce quarterly principal payments, extend the term of the repayments and to alter the covenants of the original bank agreement. On September 30, 2004, the Company paid off and terminated both the remaining term debt and the outstanding balance on the line of credit. In

November 2001, the Company issued 60,000 warrants to purchase the Company's common stock at $3.66 per share in connection with this debt. The warrants were exercised in December 2004.

On January 21, 1999, the Company's Vascular subsidiary and Endologix entered into an Assets Sale and Purchase Agreement. Pursuant to this agreement, the Company acquired for cash the assets of Endologix's vascular access business in exchange and also agreed to pay royalties to Endologix based on future sales of the vascular access business for a period of five years following the close of the sale, with a guaranteed minimum of $300,000 per year. On February 1, 2001, the parties amended the agreement to eliminate any future royalty payments to Endologix. Pursuant to this amendment, the Company paid $17,558 in cash to Endologix, delivered a short-term note in the amount of $64,884 that was satisfied in January 2002, delivered a note in the amount of $717,558 payable in eleven quarterly installments that commenced on April 15, 2002, and issued 50,000 shares of its common stock to Endologix. On September 30, 2004, the Company paid off the balance of the term debt.

At the time of the acquisition of Drew by Escalon, Drew had two lines of credit aggregating approximately $2,700,000, one of which was with a domestic financial institution, and one with a United Kingdom financial institution. At the time of the acquisition, outstanding draws on the lines aggregated approximately $1,643,000. The lines were paid off and terminated during the quarter ended December 31, 2004.

Drew has long-term debt facilities through the Texas Mezzanine Fund and through Symbiotics, Inc. The Texas Mezzanine Fund term debt is payable in monthly installments of $14,200, which includes interest at a fixed rate of 8.00%. The note is due in April 2008 and is secured by certain assets of Drew. The outstanding balance as of September 30, 2005 was $370,930. The Symbiotics, Inc. term debt, which originated from the acquisition of a product line from Symbiotics, Inc., is payable in monthly principal installments of $8,333 plus interest at a fixed rate of 5.00%. The outstanding balance as of September 30, 2005 was $191,688.

BALANCE SHEET

The components of the balance sheet of the Company were increased as of July 23, 2004 by the acquisition of Drew as follows:

Cash	$ 150,849
Accounts receivable	1,439,120

Inventory	2,069,146
Other current assets	351,505
Furniture and equipment	868,839
Goodwill	9,574,655
Patents	297,246
Other long-term assets	7,406
Line of credit	1,617,208
Current liabilities	3,392,286
Long-term debt	1,072,457
Exchange of common stock	7,430,439

These amounts represents approximately a $952,000 net difference from the amounts reported in the Company's Form 10-Q for the quarter ended September 30, 2004, which has been recorded as an increase in goodwill. The difference is the result of additional facts obtained since the acquisition which impacted the valuation of the assets acquired and liabilities assumed.

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

Escalon was not a party to any off-balance sheet arrangements as of and for the three-month periods ended September 30, 2005 and 2004.

The following table presents the Company's contractual obligations as of September 30, 2005 (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	$ 562,598	$ 233,033	$ 329,565	$ -	$ -
Operating lease agreements	3,024,462	889,749	1,132,264	577,325	425,124
	$ 3,587,060	$ 1,122,782	$ 1,461,829	$577,325	$ 425,124

FORWARD-LOOKING STATEMENT ABOUT SIGNIFICANT ITEMS LIKELY TO IMPACT LIQUIDITY

On July 23, 2004, the Company acquired approximately 67% of the outstanding ordinary shares of Drew, pursuant to the Company's exchange offer for all of the outstanding ordinary shares of Drew, and since that date has acquired all of the Drew shares. Drew does not have a history of producing positive operating cash flows and, as a result, at the time of acquisition, was operating under financial constraints and was under-capitalized. As Drew is integrated into the Company, management will be working to reverse the situation, while at the same time seeking to strengthen Drew's market position. As of September 30, 2005, Escalon has loaned approximately $6,891,000 to Drew. The funds have been primarily used to procure components to build up inventory to support the manufacturing process as well as to pay off accounts payable and debt of Drew. Escalon anticipates that further working capital will likely be required by Drew.

Escalon realized approximately 2.60% and 7.88%, of its net revenue during the three-month periods ended September 30, 2005 and 2004, respectively, from Bausch & Lomb's sale of Silicone Oil. This agreement expired in August 2005 and the Company will not receive any future royalties from this contract. Silicone

Oil revenue was based on sale of the product by Bausch & Lomb multiplied by a contractual factor that declines on an annual basis due to a contractual step-down provision through its expiration date which was August 12, 2005. As there were no costs associated with this revenue, the expiration of the agreement will negatively impact gross margins, operating income and cash flows in future periods. See Note 10 of the notes to the condensed consolidated financial statements for a description of the step-down provisions under the contract with Bausch & Lomb.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

The table below provides information about the Company's financial instruments, consisting primarily of fixed interest rate debt obligations. For debt obligations, the table represents principal cash flows and related interest rates by expected maturity dates. Interest rates as of September 30, 2005 were fixed at 8.00% on the Texas Mezzanine Fund term debt, and were fixed at 5.00% on the Symbiotics, Inc. term debt. See Note 9 of the notes to the condensed consolidated financial statements for further information regarding the Company's debt obligations.

	2006	2007	2008	Thereafter	Total
Texas Mezzanine Fund Note	$ 133,037	$ 156,868	$ 81,025	$ -	$ 370,930
Interest rate	8.00%	8.00%	8.00%	-	
Symbiotics, Inc. Note	$ 99,996	$ 91,672	-	-	$ 191,668
Interest rate	5.00%	5.00%	5.00%	-	
	$ 233,033	$ 248,540	$ 81,025	$ -	$ 562,598

EXCHANGE RATE RISK

During the three-month periods ended September 30, 2005 and 2004, approximately 37.2% and 35.9%, respectively, of the Company's consolidated net revenue was derived from international sales. Prior to the

acquisition of Drew, the price of all product sold overseas was denominated in United States Dollars and consequently the Company incurred no exchange rate risk on revenue. However, a portion of Drew's product revenue is denominated in United Kingdom Pounds and Euros. During the three-month period ended September 30, 200, Drew recorded approximately $411,000 and $96,000, respectively, of revenue denominated in United Kingdom Pounds respectively and Euros, respectively.

Drew incurs a portion of its expenses denominated in United Kingdom Pounds. During the three-month periods ended September 30, 2005 and 2004, Drew incurred approximately $1,368,000 and $632,000, respectively, of expense denominated in United Kingdom Pounds. The Company's Sonomed business unit incurs a portion of its marketing expenses in the European market, the majority of which are transacted in Euros. For the three-month periods ended September 30,

2005 and 2004, these expenses totaled $64,000 and $41,000, respectively. The Company's Vascular business unit began incurring marketing expenses in the European market during the second quarter of fiscal 2004, the majority of which are transacted in Euros. For the three-month periods ended September 30, 2005 and 2004, these expenses totaled $39,000 and $0, respectively.

The Company may begin to experience fluctuations, beneficial or adverse, in the valuation of currencies in which the Company transacts its business, namely the United States Dollar, the United Kingdom Pound and the Euro.

ITEM 3. 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 Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rule 13a-15(e) and 15(d)-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and recording, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

(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 first fiscal quarter ended September 30, 2005 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

A control system, no matter how well-designed and operated, cannot provide absolute assurance that the objectives of the control systems are met, and no evaluation of internal control can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

INTRALASE CORP. LEGAL PROCEEDINGS

In October 1997, Escalon and IntraLase entered into a License Agreement wherein Escalon granted IntraLase the exclusive right to use Escalon's intellectual laser properties, including patented and non-patented technology, in exchange for an equity interest in IntraLase as well as royalties based on a percentage of net sales of future products. The shares of common stock were restricted for sale until April

6, 2005 and, according to a Fourth Amended Registration Right Agreement between Escalon and IntraLase, are now able to be sold. See Management's Discussion and Analysis of Financial Condition and Results of Operations and the Notes to Consolidated Financial Statements for discussions on the Company's sales of IntraLase common stock.

On June 10, 2004, Escalon gave IntraLase notice of its intention to terminate the License Agreement due to IntraLase's failure to pay certain

royalties that Escalon believed were due under the License Agreement. On June 21, 2004, IntraLase sought a preliminary injunction and temporary restraining order with the United States District Court for the Central District of California, Southern District against Escalon to prevent termination of the License Agreement. Contemporaneously, IntraLase filed an action for declaratory relief asking the Court to validate its interpretation of certain terms of the License Agreement relating to the amount of royalties owed to Escalon ("First Action"). The parties mutually agreed to the entry of a temporary restraining order which was entered by the Court shortly thereafter. At the close of discovery, IntraLase and Escalon filed cross-motions for summary judgment. On May 5, 2005, the District Court, having ruled on such motions, entered judgment in the First Action.

The Court, in ruling on the parties' cross-motions for summary judgment, did not agree with IntraLase's interpretation of certain terms and declared that, under the terms of the License Agreement, IntraLase must pay Escalon royalties on revenue from maintenance contracts and one-year warranties. Further, the Court rejected IntraLase's argument that it is entitled to deduct the value of non-patented components of its ophthalmic products, which it sells as an integrated unit, from the royalties due Escalon. Non-patented components of the products include computer monitors, joysticks, keyboards, universal power supplies, microscope assemblies, installation kits and syringes. In addition, the Court rejected IntraLase's assertion that accounts receivable are not "consideration received" under the License Agreement and expressly ruled that IntraLase must pay Escalon royalties on IntraLase's accounts receivable. The Court agreed with IntraLase, however, holding that IntraLase is not required to pay royalties on research grants. The Court also held that IntraLase must give Escalon an accounting of third-party royalties.

Further, the Court agreed with Escalon in finding that royalties are "monies" and the default in the payment of royalties must be remedied within 15 days of written notice of the default. The Court rejected IntraLase's position concerning the effective date of the Amended and Restated License Agreement holding that the effective date of such Agreement was dated October 17, 2000. IntraLase has appealed the judgment to the Ninth Circuit Court of Appeals. Currently, briefing is scheduled to occur in February/March, 2006.

Intralase, after entry of the Court's ruling, attempted to cure its default under the License Agreement, but underpaid based upon a purported interpretation of "accounts receivable" that discounts the receivables recorded on the sales substantially, and in a manner that appears to directly contradict Intralase's own published financial statements.

In May, 2005, IntraLase also filed a second suit against Escalon in the Central District of California, case number SAVC 05-440-AHS ("Second Action"), again for declaratory relief as well as for reformation of the License Agreement. In this action, IntraLase has asked the Court to, among other things, validate its interpretation of certain other terms of the License Agreement relating to the amount of royalties owed to Escalon and a declaration concerning Escalon's audit rights under the License Agreement. Escalon filed a motion to dismiss the Second Action on jurisdictional and substantive grounds. The motion has been fully briefed and is currently under consideration by the Court for the Central District of California.

On May 15, 2005, Escalon, not having been served with IntraLase's Second Action, filed a Complaint against IntraLase in the Delaware Court of Chancery for, among other things, breach of contract, breach of fiduciary duty arising out of IntraLase's bad faith conduct under, and multiple breaches of, the License Agreement ("Delaware Action"). Escalon seeks declaratory relief, specified damages, and specific performance of its rights under the License Agreement, including its express right under the

Agreement to have independent certified accountants audit the books and records of IntraLase to verify and compute payments due Escalon.

On June 3, 2005, IntraLase, after having been served with Escalon's Complaint, filed its First Amended Complaint in the Second Action adding new matters that had already been raised by Escalon in its Delaware Action. IntraLase also filed a motion to dismiss Escalon's Delaware Action. In July, 2005, the parties agreed to postpone briefing on IntraLase's motion until after the California Court has ruled on Escalon's motion to dismiss the Second Action.

Separately, on April 22, 2005, Escalon, as record holder of common stock of IntraLase, made a formal written demand to inspect certain of IntraLase's books and records pursuant to Section 220 of the Delaware General Corporation Law. IntraLase rejected Escalon's demand. Escalon recently filed an action in the Delaware Court of Chancery against IntraLase seeking to enforce its shareholder rights to inspect IntraLase's books and records. The 220 Case is currently in the discovery stage.

Escalon is cognizant of the legal expenses and costs associated with the IntraLase matter. Escalon, however, is taking all necessary actions to protect its rights and interests under the License Agreement. Escalon expects expenses associated with this litigation to adversely impact earnings in the near term. Escalon believes that IntraLase has sufficient funds to support such payments based on its filings with the SEC and filings in connection with the First Action.

DREW LEGAL PROCEEDINGS

CARVER LITIGATION

On December 17, 2002, Edward Carver, David DeCava and Diane Carver, former principal shareholders of CDC Technologies, Inc., filed a complaint in the State of Connecticut, Superior Court, Judicial District of Waterbury at Waterbury against CDC Acquisition, IV Diagnostics and certain other principal shareholders of CDC Technologies seeking a total of approximately $420,000 for, among other things, repayment of loans made to CDC Technologies, payment of past wages and reimbursement of business expenses. The Plaintiffs' claims arose out of a certain asset purchase for stock transaction in which CDC Acquisition, a wholly owned subsidiary of Drew, acquired the assets of CDC Technologies and IV Diagnostics. CDC Acquisition and IV Diagnostics, also a subsidiary of Drew, asserted counterclaims against the plaintiffs for, among other things, breach of fiduciary duty, unfair trade and conversion. In addition, CDC Acquisition and IV Diagnostics asserted cross-claims against its co-defendants for indemnification pursuant to the transaction agreements. A bench trial was held in June, 2005. In August, 2005 the Court rendered a decision resulting in the Court's award of only $76,000 to Plaintiffs. CDC Acquisition and IV Diagnostics filed a motion for reconsideration of certain issues ruled upon by the Court. The motion was denied. Plaintiffs' counsel filed a motion for attorneys' fees seeking over $181,000. The Court recently granted such motion but awarded only $3,000 to plaintiffs' counsel. On November 1, 2005, CDC Acquisition and IV Diagnostics timely appealed the Court's ruling that CDC Acquisitions and IV Diagnostics are liable to the plaintiffs. Further, CDC Acquisition and IV Diagnostics are presently negotiating with co-defendants over the companies' indemnification claims.

On December 30, 2002, Source One, a distributor of CDC Technologies, Inc. filed suit in state court in Minnesota, later removed to the United States District Court in Minnesota, against CDC Technologies, Edward Carver and CDC Acquisition, Inc. and IV Diagnostics, as successors in interest to CDC

Technologies. CDC Acquisition and IV Diagnostics asserted cross-claims against Carver for indemnification. The court granted summary judgment to the plaintiff against defendants and awarded plaintiff approximately $185,000 plus interest and costs. The Court also found Carver liable to CDC Acquisition for indemnification. Plaintiff agreed to accept $140,000 from CDC Acquisition in settlement of its claims. CDC Acquisition settled its indemnification claim against Carver for $75,000.

The Company does not believe that these matters have, had or are likely to have a material adverse impact on the Company's business, financial condition or future results of operations.

OTHER LEGAL PROCEEDINGS

Escalon, from time to time is involved in various legal proceedings and disputes that arise in the normal course of business. These matters have included intellectual property disputes, 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.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 6. EXHIBITS

31.1 Certificate of Chief Executive Officer under Rule 13a-14(a).

31.2 Certificate of Chief Financial 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 Chief Financial Officer under Section 1350 of Title 18 of the United States Code.

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: November 14, 2005 By: /s/ Richard J. DePiano

Richard J. DePiano
Chairman and Chief
Executive Officer

Date: November 14, 2005 By: /s/ Mark H. Karsch

Mark H. Karsch
CFO

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