ESCALON MEDICAL CORP
Form 10-Q
November 14, 2006

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

Mark One

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006

or

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number: 0-20127

ESCALON MEDICAL CORP.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

PENNSYLVANIA	33-0272839
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(IRS EMPLOYER IDENTIFICATION NO.)
565 EAST SWEDESFORD ROAD, SUITE 200 WAYNE, PA	19087
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)	(ZIP CODE)

(610) 688-6830
(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)
N/A
FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR, IF CHANGED SINCE LAST REPORT

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).
Large accelerated filer Yes [ ] No [ ] Accelerated filer Yes [ ] No [ ]
Non-accelerated filer 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]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 6,344,657 shares of common stock, $0.001 par value, outstanding as of November 6, 2006.

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ESCALON MEDICAL CORP.

FORM 10-Q QUARTERLY REPORT

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PART I. FINANCIAL STATEMENTS

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	SEPTEMBER 30, 2006
	(UNAUDITED)
ASSETS	
Current assets:	
Cash and cash equivalents	$ 2,149,040
Available for sale securities	59,130
Accounts receivable, net	4,252,165
Inventory, net	7,693,453
Other current assets	365,785
TOTAL CURRENT ASSETS	14,519,573
Furniture and equipment, net	925,750
Goodwill	21,072,260
Trademarks and trade names, net	620,106
Patents, net	289,355
Covenant not to compete and customer list, net	399,346
Other assets	545,284
TOTAL ASSETS	$ 38,371,674
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities:	
Current portion of long-term debt	$ 240,480
Accounts payable	1,702,095
Accrued expenses	2,627,314
TOTAL CURRENT LIABILITIES	4,569,889
Long-term debt, net of current portion	95,239
Accrued post-retirement benefits	1,087,000
TOTAL LIABILITIES	5,752,128
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 share authorized; 6,344,657 issued and outstanding at September 30, 2006 and June 30, 2006, respectively	6,345
Common stock warrants	1,601,346
Additional paid-in capital	65,797,782
Retained earnings	(34,836,544)
Accumulated other comprehensive income (loss)	50,617
TOTAL SHAREHOLDERS' EQUITY	32,619,546
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 38,371,674

See notes to condensed consolidated financial statements

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

	THREE MONTHS ENDED SEPTEMBER 30, 2006	2005
NET REVENUES:		
Product revenue	$ 6,543,586	$ 7,123,354
Other revenue	$ 624,574	670,180
REVENUES, NET	7,168,160	7,793,534
COSTS AND EXPENSES:		
Cost of goods sold	$ 3,630,380	4,105,653
Research and development	$ 713,605	756,160
Marketing, general and administrative	$ 3,555,900	3,284,051
TOTAL COSTS AND EXPENSES	7,899,885	8,145,864
LOSS FROM OPERATIONS	(731,725)	(352,330)
OTHER (EXPENSE) AND INCOME:		
Gain on sale of available for sale securities	0	1,157,336
Equity in Ocular Telehealth Management, LLC	(18,543)	(18,429)
Interest income	45,436	4,847
Interest expense	(9,285)	(10,677)
TOTAL OTHER INCOME	17,608	1,133,077
NET (LOSS) INCOME BEFORE TAXES	(714,117)	780,747
Provision for income taxes	0	66,400
NET (LOSS) INCOME	$ (714,117)	$ 714,347
BASIC NET (LOSS) INCOME PER SHARE	$ (0.11)	$ 0.12
DILUTED NET (LOSS) INCOME PER SHARE	$ (0.11)	$ 0.11
WEIGHTED AVERAGE SHARES - BASIC	6,344,657	5,964,292
WEIGHTED AVERAGE SHARES - DILUTED	6,344,657	6,372,742

See notes to condensed consolidated financial statements

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

	THR
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net (loss) income	$
Adjustments to reconcile net (loss) income to net cash (used in) operating activities:	
Depreciation and amortization	
Gain on sale of available for sale securities	
Loss on Ocular Telehealth Management, LLC	
Change in operating assets and liabilities:	
Accounts receivable, net	
Inventory, net	
Other current and long-term assets	
Accounts payable, accrued and other liabilities	
NET CASH (USED IN) OPERATING ACTIVITIES	(
CASH FLOWS FROM INVESTING ACTIVITIES:	
Proceeds from the sale of available for sale securities	
Purchase of fixed assets	
NET CASH PROVIDED BY/(USED IN) INVESTING ACTIVITIES	
CASH FLOWS FROM FINANCING ACTIVITIES:	
Principal payments on term loans	
Issuance of common stock - stock options	
Refund of income taxes related to exercise of stock options	
NET CASH PROVIDED BY/(USED IN) FINANCING ACTIVITIES	
Effect of exchange rate changes on cash and cash equivalents	
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(
Cash and cash equivalents, beginning of period	
Cash and cash equivalents, end of period	$
SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION:	
Interest paid	$
Income taxes paid	$
(Decrease)/increase in unrealized appreciation on available for sale securities	$

See notes to condensed consolidated financial statements

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2006
(UNAUDITED)

	COMMON STOCK		COMMON STOCK	ADDITIONAL PAID-IN	ACCUMULATED
	SHARES	AMOUNT	WARRANTS	CAPITAL	DEFICIT
BALANCE AT JUNE 30, 2006	6,344,657	$ 6,345	$ 1,601,346	$ 65,699,370	$ (34,122,427)
Net (loss)		0	0	0	(714,117)
Refund of income taxes related to exercise of stock options				98,412	
Change in unrealized gains on available for sale securities		0	0	0	0
Foreign currency translation		0	0	0	0
BALANCE AT SEPTEMBER 30, 2006	6,344,657	$ 6,345	$ 1,601,346	$ 65,797,782	$ (34,836,544)

See notes to condensed consolidated financial statements

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

	THREE MONTHS ENDED SEPTEMBER 30,	
	2006	2005
Net income (loss)	$ (714,117)	$ 714,347
Change in unrealized gains on available for sale securities	8,910	(1,163,187)
Foreign currency translation	126,234	(57,132)
COMPREHENSIVE (LOSS) INCOME	$ (578,973)	$ (505,972)

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 ("EME"), Escalon Digital Vision, Inc. ("EMI"), Escalon Pharmaceutical, Inc. ("Pharmaceutical"), Escalon Holdings, Inc. ("EHI") and Drew Scientific Company, Ltd ("Drew"), including its subsidiaries. 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") and other regulatory authorities. 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 2006 Annual Report on Form 10-KSB 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.

In connection with the presentation of the current period condensed unaudited consolidated financial statements, certain prior period balances have been reclassified to conform with the current period presentation.

2. ACQUISITIONS

DREW ACQUISITION

On July 23, 2004, the Company acquired approximately 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. The results of Drew's operations have been included in the consolidated financial statements, and the Company has been operating Drew as an separate business unit 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 Company accounted for the purchase under FAS 141. Under FAS 141, the

Company paid a premium (i.e., goodwill) over the fair value of the net tangible and identified intangible assets. The Company acquired Drew as part of its strategy to diversify its business into the diagnostic medical devices

market. Drew afforded the Company a combined capital equipment product with a continuing revenue stream product in the form of disposables. The application of purchase accounting under FAS 141 requires that the total purchase price be allocated to the fair value of assets acquired and liabilities assumed based on their fair values at the acquisition date, with amounts exceeding the fair values being recorded as goodwill. The allocation process requires an analysis of acquired fixed assets, contracts, customer lists and relationships, trademarks, patented technology, service markets, contractual commitments, legal contingencies and brand value to identify and record the fair value of all assets acquired and liabilities assumed. The Company engaged a third-party to value the assets acquired and liabilities assumed. In valuing acquired assets and assumed liabilities, fair values were based on expected discounted cash flows, current replacement cost or other techniques as deemed appropriate.

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

MRP ACQUISITION

On January 30, 2006 EMI acquired substantially all of the assets of MRP Group, Inc. ("MRP") in exchange for 250,000 shares of the Company's common stock and approximately $47,000 in cash. The MRP business consists of ophthalmic technology solutions offering two retinal imaging systems. Approximately 200 of these systems have been installed at leading medical and retinal care centers. The operating results of MRP are included as part of the Medical/Trek/EMI business unit as of January 30, 2006.

The Company accounted for the purchase under FAS 141. Under FAS 141, the Company paid a premium (i.e., goodwill) over the fair value of the net tangible and identified intangible assets acquired to obtain a leading edge technology platform in the digital imaging marketplace. The application of purchase accounting under FAS 141 requires that the total purchase price be allocated to the fair value of assets acquired and liabilities assumed based on their fair

values at the acquisition date, with amounts exceeding the fair values being recorded as goodwill in the amount of $1,086,737. The allocation process requires an analysis of acquired fixed assets, contracts, customer lists and relationships, trademarks, patented technology, service markets, contractual commitments, legal contingencies and brand value to identify and record the fair value of all assets acquired and liabilities assumed. The values of certain assets and liabilities are based on preliminary valuations and are subject to adjustment as additional information is obtained. Business unit disclosures and pro forma statement of operations data for 2006 and 2005 do not include MRP operations and assets as they are not material in relation to the consolidated financial statements.

3. STOCK-BASED COMPENSATION

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 optionee provides service in exchange for the award. The Company was 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.

For the three months ended September 30, 2005, the Company accounted for its stock-based awards to employees using the intrinsic value method under Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees and related Interpretations. Stock-based awards to non-employees were recorded using the fair value method in accordance with SFAS No. 123, Accounting for Stock-Based Compensation .

If the computed fair value of the awards had been amortized to expense over the vesting period of the awards under SFAS No. 123, net income would have been as follows for the period ended:

	SEPTEMBER 30, 2005
Net income, as reported	$ 714,347
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(305,199)
PRO FORMA NET INCOME	$ 409,148
EARNINGS PER SHARE:	
BASIC - AS REPORTED	$ 0.12

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BASIC - PRO FORMA	$ 0.07
	==========
DILUTED - AS REPORTED	$ 0.11
	==========
DILUTED - PRO FORMA	$ 0.06
	==========

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 periods. No options were granted during the three-month period ended September 30, 2006.

The Company accelerated the vesting of all of its outstanding options effective June 30, 2006, as such, as of September 30, 2006, there was $0 of total unrecognized compensation cost related to non-vested share based compensation.

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, 2006	2005
NUMERATOR:		
Numerator for basic and diluted earnings per share NET (LOSS) INCOME	$ (714,117)	$ 714,347
DENOMINATOR:		
Denominator for basic earnings per share - weighted average shares	6,344,657	5,964,292
Effect of dilutive securities:		
Stock options and warrants	0	408,450
DENOMINATOR FOR DILUTED EARNINGS PER SHARE - WEIGHTED AVERAGE AND ASSUMED CONVERSION	6,344,657	6,372,742
BASIC (LOSS) EARNINGS PER SHARE	$ (0.11)	$ 0.12
DILUTED (LOSS) EARNINGS PER SHARE	$ (0.11)	$ 0.11

The impact of dilutive securities were omitted from the earnings per share calculation in 2006 as they would reduce the loss per share (anti-dilutive).

5. INVENTORY

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

	SEPTEMBER 30, 2006	JUNE 30, 2006
	(UNAUDITED)	
Raw materials	$ 4,964,886	$ 4,219,836
Work in process	848,434	809,807
Finished goods	2,177,986	2,345,985
	7,991,306	7,375,628
Valuation allowance	(297,853)	(252,712)
TOTAL INVENTORY	$ 7,693,453	$ 7,122,916

6. 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 $288,146 and $263,799 at September 30, 2006 and June 30, 2006, respectively. Amortization expense for the three-month periods ended September 30, 2006 and 2005 was $24,347 and $25,030, 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.

COVENANT NOT TO COMPETE AND CUSTOMER LIST

The Company recorded the value of a covenant not to compete and a customer list as intangible assets as part of the acquisition of MRP (See note 2). The valuation was based on the fair market value of these assets at the time of acquisition. These assets are amortized over their estimate useful lives, not exceeding 5 years, on a straight-line basis from the date of acquisition. Accumulated amortization was $43,623 and $22,986 at September 30, 2006 and June 30, 2006, respectively. Amortization expense for the three-month period ended September 30, 2006 and 2005 was $20,637 and $0, respectively.

GOODWILL, TRADEMARKS AND TRADE NAMES

Goodwill, trademarks and trade names represent intangible assets obtained

from Escalon Opthalmics ("EOI"), Endologix, Inc. ("Endologix"), Sonomed, MRP (See note 2) 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 unit. 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, 2006 and June 30, 2006:

	SEPTEMBER 30, NET CARRYING AMOUNT	JUNE 30, 2006 NET CARRYING AMOUNT
	(UNAUDITED)	
GOODWILL		
Sonomed	$ 9,525,550	$ 9,525,550
Drew	9,574,655	9,574,655
Vascular	941,218	941,218
Medical/Trek/EMI	1,030,837	1,030,837
TOTAL	$21,072,260	$21,072,260

	SEPTEMBER 30, 2006 NET CARRYING AMOUNT	JUNE 30, 2006 NET CARRYING AMOUNT
	(UNAUDITED)	
UNAMORTIZED INTANGIBLE ASSETS		
Sonomed	$616,906	$616,906
Medical/Trek/EMI	3,200	3,200
TOTAL	$620,106	$620,106

The following table presents amortized intangible assets by business unit as of September 30, 2006:

	GROSS CARRYING AMOUNT	IMPAIRMENT	ADJUSTED GROSS CARRYING AMOUNT	ACCUMULATED AMORTIZATION	NET CARRYI VALUE
	(UNAUDITED)				
AMORTIZED INTANGIBLE ASSETS					
PATENTS					
Drew	$ 275,285	$ 0	$ 275,285	$(105,378)	$ 169,907
Vascular	36,915	0	36,915	(23,072)	13,843
Medical/Trek/EMI	265,301	0	265,301	(159,696)	105,605
TOTAL	$ 577,501	$ 0	$ 577,501	$(288,146)	$ 289,355
CUSTOMER LIST/COVENANT NOT TO COMPETE					
Medical/Trek/EMI	$ 442,969	$ 0	$ 442,969	$ (43,623)	$ 399,346
TOTAL	$ 442,969	$ 0	$ 442,969	$ (43,623)	$ 399,346

The following table presents amortized intangible assets by business unit as of June 30, 2006:

	GROSS CARRYING AMOUNT	IMPAIRMENT	ADJUSTED GROSS CARRYING AMOUNT	ACCUMULATED AMORTIZATION	NET CARRY VALUE
AMORTIZED INTANGIBLE ASSETS					
PATENTS					
Drew	$ 275,285	$ 0	$ 275,285	$ (90,955)	$ 184,33
Vascular (pending issuance)	36,915	0	36,915	0	36,91
Medical/Trek/EMI	265,301	0	265,301	(172,844)	92,45
TOTAL	$ 577,501	$ 0	$ 577,501	$(263,799)	$ 313,70
CUSTOMER LIST/COVENANT NOT TO COMPETE					
Medical/Trek/EMI	$ 442,969	$ 0	$ 442,969	$ (22,896)	$ 420,07
TOTAL	$ 442,969	$ 0	$ 442,969	$ (22,896)	$ 420,07

7. ACCRUED EXPENSES

The following table presents accrued expenses as of September 30, 2006 and June 30, 2006:

	SEPTEMBER 30, 2006 (UNAUDITED)	JUNE 30, 2006
Accrued compensation	$1,572,048	$1,260,139
Warranty accruals	255,740	255,740
Legal accruals	119,101	221,369
Other accruals	680,425	766,523
TOTAL ACCRUED EXPENSES	$2,627,314	$2,503,771

In addition to normal accruals, other accruals as of September 30, 2006 and June 30, 2006 relate to the remaining lease payments on a facility that ceased manufacturing operations 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 accruals.

8. 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 debt provided for interest at fixed rate of 8% per annum until July 1, 2005. The interest rate was then adjusted to the prime rate plus 4% per annum. Each June 1, the rate will be adjusted to the prime rate plus 4% per annum. The debt has a minimum interest rate of 8% per annum to a maximum interest rate of 18% per annum. The interest rate on the Texas Mezzanine Fund was 12.0% per annum and 10.25% per annum as of September 30, 2006 and June 30, 2006, respectively. Drew is required to pay the Texas Mezzanine Fund 1% of fiscal year revenues over $11,500,000 as defined in a revenue participation agreement. The note is due in June 2008 and is secured

by certain assets of Drew. The outstanding balance of the note was $244,056 and $278,717 as of September 30, 2006 and June 30, 2006, 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% per annum. The outstanding balance of this note was $91,663 and $116,671 as of September 30, 2006 and June 30, 2006, respectively.

The schedule below presents principal amortization for the next five years under each of the Company's loan agreements as of September 30, 2006:

TWELVE MONTHS ENDING SEPTEMBER 30,	TEXAS MEZZANINE	SYMBIOTICS	TOTAL (UNAUDITED)
2007	$148,817	$ 91,663	240,480

2008	95,239	0	95,239
TOTAL	$244,056	$ 91,663	335,719
		Current portion of long-term debt	240,480
		Long-term portion	$ 95,239

9. 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 laser technology; and

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

For the three-month periods ended September 30, 2006 and 2005, Silicone Oil revenue totaled $0 and $203,000, respectively, IntraLase royalties totaled approximately $555,000 and $392,000, respectively, and the Bio-Rad royalties totaled approximately $70,000 and $75,000, 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 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 diagnostic tests provided by Bio-Rad. If fewer 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 OEM 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.

10. 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, 2006 are as follows:

TWELVE MONTHS ENDING	LEASE OBLIGATIONS
	(UNAUDITED)
2007	$ 720,916

2008	411,226
2009	284,615
2010	292,710
2011	308,770
Thereafter	116,354
TOTAL	$ 2,134,590

Rent expense charged to operations during the three-month periods ended September 30, 2006 and 2005 was $215,320 and $215,111, 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, as amended and restated on November 9, 2005, for the right to sell formulations or products of CDS, including reagents, controls and calibrators ("CDS products"), on a private label basis. The agreement has a term of 15 years, may be terminated by Drew at any time with 18 months written notice, and if not terminated 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.

11. LEGAL PROCEEDINGS

In October 1997, Escalon and IntraLase entered into a License Agreement wherein Escalon granted IntraLase the exclusive right to use Escalon's laser properties, including patented and non-patented technology, in exchange for shares of IntraLase common stock 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 Condensed 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 also held that IntraLase must give Escalon an accounting of third-party royalties. The court agreed with IntraLase that it is not required to pay royalties on research grants.

The court also 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 United States Court of Appeals for the Ninth Circuit. The parties have submitted briefs to the court. Escalon believes that a decision by the court is unlikely in 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 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. On June 3, 2005, after having been served with Escalon's Complaint filed in the Delaware Court of Chancery ("Delaware Action," described below), IntraLase filed an Amended Complaint in the Second Action. Escalon, not having been served with the Amended Complaint, filed a motion to dismiss the Complaint in the Second Action on jurisdictional and substantive grounds. On June 6, 2005, Escalon filed a Motion to Dismiss the Amended Complaint on grounds virtually identical to its first motion to dismiss. The court dismissed without prejudice the Second Action on the grounds that much of IntraLase's lawsuit sought a ruling on issues already raised by Escalon in Escalon's Delaware Action. Accepting Escalon's arguments for dismissal, the California Court held that retaining jurisdiction would likely result in duplicative litigation and an unnecessary entanglement between the federal and state court actions.

As referenced above, on May 15, 2005, Escalon, not having been served with IntraLase's Second Action, initiated the Delaware Action by filing a Complaint against IntraLase 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. In the 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 February 21, 2006, Escalon again 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 as well as IntraLase's refusal to permit Escalon to inspect IntraLase's records and books of account in accordance with paragraph 5.3 of the License Agreement. IntraLase

had steadfastly refused to permit inspections reasonably requested by Escalon to audit IntraLase's records and books of account and, instead, conditioned any inspection by Escalon's auditors on unreasonable and unnecessary

confidentiality restrictions and unilateral limitations on the scope of records and books of account that would be made available for inspection to Escalon. On the same day, Escalon filed its First Amended Complaint in the Delaware Action adding to its pending claims a claim for declaratory relief wherein Escalon seeks a judgment declaring that the License Agreement terminated fifteen days after IntraLase received Escalon's notice of defaults and intent to terminate and failed to cure said defaults.

On February 28, 2006, Escalon agreed to suspend the cure periods applicable to the alleged breaches set out in its February 21, 2006 letter while Escalon and IntraLase engaged in mediation efforts. Mediation before Vice Chancellor Donald F. Parsons, Jr. of the Delaware Court of Chancery, pursuant to Chancery Court Rule 174, took place on May 5, 2006 and was unsuccessful. However, in August 2006, the Parties entered into a Stipulation under which IntraLase agreed to allow an independent auditor, retained by the Company, to inspect certain of IntraLase's books and records as needed, in the opinion of the independent auditor, to verify that the Company received the full value of royalty payments to which it is entitled pursuant to the License Agreement. The Company sent its auditor to IntraLase's headquarters in early September 2006 to commence the audit. The auditor has informed the Company that it is awaiting responses and documents from Intralase that are necessary for the audit to be completed. The Company desires to conclude this audit in November 2006.

Separately, on April 22, 2005, Escalon, as beneficial 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. Shortly thereafter, Escalon Holdings, record holder of common stock of IntraLase, made the same written demand. IntraLase rejected both demands. Thereafter, Escalon and Escalon Holdings filed an action in the Delaware Court of Chancery against IntraLase seeking to enforce their shareholder rights to inspect IntraLase's books and records ("220 Action"). The 220 Case remains in the discovery stage and the Court has set a trial date of January 4, 2007.

Escalon is cognizant of the legal expenses and costs associated with the IntraLase matter. Escalon, however, is taking all necessary and appropriate 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 royalty payments based on its filings with the SEC and filings in connection with the First Action.

CARVER LITIGATION-CONNECTICUT ACTION

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 ("Connecticut Action"). 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 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.

CDC Acquisitions and IV Diagnostics and the plaintiffs in the Connecticut Action recently resolved their disputes as Acquisition Corp. paid the plaintiffs the outstanding judgment amount, eighty-three thousand dollars ($83,000.00). The Company's cross-claims against certain of the former principal shareholders of CDC Technologies, Inc. ("Technology Defendants") remain pending. The Technology

Defendants also have a cross-claim pending against CDC Acquisition Corp. However, even in the event that Technology Defendants would prevail, their damages are limited to the amount of their settlement, $50,000. Technology Defendants recently filed a Motion to Enforce Settlement Agreement with the trial court, asserting that there was an understanding that Technology Defendants would be included in a three-way agreement to resolve all claims associated with this litigation. The Company is opposing the Motion of the Technology Defendants and intends to preserve and proceed to enforce its rights against the Technology Defendants.

INSTITUTE OF CHILD HEALTH

Drew entered into a license agreement with the Institute of Child Health ("ICH") on May 10, 1993 to use ICH's intellectual property to manufacture, lease, sell, use and sublicense certain products and all related consumables used therein in the testing of blood and fluids. Under the license agreement Drew was to pay royalties to ICH on the products and consumables. On January 23, 2006, the Company received a letter from ICH alleging that Drew has failed to remit certain moneys due under the license agreement and has sought an accounting to determine such amount due. Drew is reviewing this matter with legal counsel and disputes the allegations of nonpayment.

OTHER LEGAL PROCEEDINGS

The Company, from time to time is involved in various legal proceedings and disputes that arise in the normal course of business. These matters have 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, 2006 and 2005, the Company operations were classified into four principal reportable business units that provide different products or services.

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

SEGMENTAL STATEMENTS OF OPERATIONS (IN THOUSANDS) - THREE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005

	DREW		SONOMED		VASCULAR		MEDICAL
	2006	2005	2006	2005	2006	2005	2006
REVENUES, NET:							
Product revenue	$ 2,785	$ 4,071	$ 2,293	$ 1,798	$ 817	$ 931	$ 648
Other revenue	70	75	0	0	0	0	555
TOTAL REVENUE, NET	2,855	4,146	2,293	1,798	817	931	1,203
COSTS AND EXPENSES:							
Cost of goods sold	1,759	2,594	1,187	976	313	320	372
Operating expenses	1,841	1,792	884	1,040	552	529	992
TOTAL COSTS AND EXPENSES	3,600	4,386	2,071	2,016	865	849	1,364
(LOSS) INCOME FROM OPERATIONS	(745)	(240)	222	(218)	(48)	82	(161
OTHER (EXPENSE) AND INCOME:							
Gain on sale of available for sale securities	0	0	0	0	0	0	0
Equity in OTM	0	0	0	0	0	0	(19
Interest income	0	0	0	0	0	0	45
Interest expense	(8)	(10)	0	0	0	(1)	0
TOTAL OTHER (EXPENSE) AND INCOME	(8)	(10)	0	0	0	(1)	26
(LOSS) AND INCOME BEFORE TAXES	(753)	(250)	222	(218)	(48)	81	(135
Income taxes	0	0	0	0	0	0	0
NET (LOSS) INCOME	$ (753)	$ (250)	$ 222	$ (218)	$ (48)	$ 81	$ (135
Depreciation and amortization	$ 86	$ 55	$ 6	$ 5	$ 49	$ 17	$ 18
Assets	$ 17,404	$ 15,295	$ 13,784	$ 13,623	$ 3,944	$ 2,208	$ 3,092
Expenditures for long-lived assets	$ 35	$ 88	$ 0	$ 0	$ 1	$ 13	$ 9

13. SHAREHOLDERS' EQUITY

WARRANTS TO PURCHASE COMMON STOCK

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. The fair market value of the warrants was determined under the Black Scholes model and recorded to additional paid-in capital in accordance with Emerging Issues Task Force Issue Number 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19").

14. RELATED-PARTY TRANSACTIONS

The Company and a member of the Company's Board of Directors are founding and equal members of 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, 2006, the Company had invested $256,000 in OTM. As of September 30, 2006, 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 its membership interest back to OTM at fair market value. The Company provides administrative support functions to OTM. From inception through September 30, 2006, OTM had revenue of approximately $16,200 and incurred expenses of approximately $213,500. This investment is accounted for under the equity method of accounting and is included in other assets.

Two relatives of a senior executive officer have provided legal services as either an employee or a consultant to the Company. Richard DePiano, Jr. (son of the Chief Executive Officer ("CEO")) is General Counsel to the Company, Mr. DePiano's salary plus bonus for the three-month periods ended September 30, 2006 and 2005 were $31,364 and $30,900, respectively. Caryn Lindsey (daughter-in-law of the CEO) acted as a consultant and employee for the Company in 2005. For the three-month periods ended September 30, 2006 and 2005 Ms. Lindsey received consulting fees and salary of $0 and $16,250, respectively.

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 as having 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 held by the Company 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.

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 common stock at September 30, 2006 are classified as available-for-sale securities and had a market value of $59,130.

16. ANKA CO-MARKETING AGREEMENT

On October 11, 2005 the Company signed a non-exclusive co-marketing agreement with privately held 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. The co-marketing agreement will enable the Company to jointly market its existing 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.

In connection with the co-marketing agreement, Company extended a $300,000 loan in October 2005 and an additional loan of $100,000 in January 2006, pursuant to demand notes, to Anka. Under the terms of these notes, repayment is due within six months after written demand or immediately upon an event of default. On February 16, 2006, the Company demanded repayment in accordance with the terms of the notes. The loan was paid in full in April 2006.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD LOOKING STATEMENTS

Certain statements contained in, or incorporated by reference in, this report are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, which provide current expectations or forecasts of future events. Such statements can be identified by the use of terminology such as "anticipate," "believe," "could," "estimate," "expect," "forecast," "intend," "may," "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 FDA, acquisitions, the development of joint venture opportunities, intellectual property and patent protection and infringement, the loss of revenue due to the expiration on termination of certain agreements, the effect of competition on the structure of the markets in which the Company competes 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 list of such factors contained in its periodic report on Form 10-KSB for the year ended June 30, 2006 to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions.

EXECUTIVE OVERVIEW - THREE-MONTH PERIOD ENDED SEPTEMBER 30, 2006

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 the Company's performance and financial condition.

- On July 23, 2004, the Company 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 acquired all of the Drew shares during the fiscal year ended June 30, 2005. The Company has been operating Drew as a separate business unit since its acquisition, and

Drew's results of operations are included in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" 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. The Company's operational priorities with respect to Drew is 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 six- month period ended December 31, 2004. The balance of the shares were issued in the six-month period ended June 30, 2005.

- Revenue decreased approximately 8% during the three-month period ended September 30, 2006 as compared to the same period last fiscal year. The decrease is primarily related to decreases in the Drew and Vascular business units. Revenue at Drew and Vascular decreased 32% and 12%, respectively, during the three-month period ended September 30, 2006 when compared to the same period last fiscal year. These decreases were offset by strong sales in the Company's Sonomed and Medical/Trek/EMI business units. Sales at Sonomed and Medical/Trek/EMI increased approximately 28% and 100%, respectively, during the three-month period ended September 30, 2006 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 by the Company in connection with the license of its laser properties to IntraLase in 1997. (See note 15 of 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.

- Cost of goods sold as a percentage of product revenue decreased to approximately 55.4% of revenues during the three-month period ended September 30, 2006, as compared to approximately 57.6% of product revenue for the same period last fiscal year. Gross margins in the Drew business unit 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, 2006 remained steady at approximately 50.0% of product revenue in the same period last fiscal year.

- Operating expenses increased approximately 5.5% during the three-month period ended September 30, 2006 as compared to the same period in the prior fiscal year. During the three-month period ended September 30, 2006, the Company continued to experience a high amount of legal and accounting fees primarily related to IntraLase litigation costs. While the Company expects these legal and accounting 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.

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 ultra fast laser systems designed for the treatment of ophthalmic disorders. As a result of the EOI acquisition, the Company changed its market focus and ceased 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 notes 9 and 15 of the notes to the condensed consolidated financial statements for further information.) The Company is in dispute with IntraLase over royalty payments owed to the Company. (See note 11 of the notes to the 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, the Company 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 acquired all of the Drew shares during fiscal 2005. 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 2 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

The Company annually evaluates for impairment its intangible assets and goodwill in accordance with SFAS 142, "Goodwill and Other Intangible Assets," or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. 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 and 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.

(LOSS)/INCOME PER SHARE

The Company computes net (loss)/income 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 (loss)/income per share is computed by dividing the net (loss)/income for the period by the weighted average number of shares of common stock outstanding during the period. The calculation of diluted net (loss)/income per share excludes potential common shares if the effect is anti-dilutive. Basic earnings per share are computed by dividing net (loss)/income 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 (loss)/income 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, 2006, 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 carry forwards. 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, 2006 AND 2005

The following table shows consolidated product revenue by business unit as well as identifying trends in business unit product revenues for the three-month periods ended September 30, 2006 and 2005. Table amounts are in thousands:

	THREE-MONTH PERIOD ENDED SEPTEMBER 30,		
	2006	2005	% CHANGE
PRODUCT REVENUE:			
Drew	$ 2,785	$ 4,071	-31.6%
Sonomed	2,293	1,798	27.5%
Vascular	817	931	-12.2%
Medical/Trek/EMI	648	323	100.6%
TOTAL	$ 6,543	$ 7,123	-8.1%

Product revenue decreased approximately $584,000, or 8%, to $6,543,000 during the three-month period ended September 30, 2006 as compared to the same period last fiscal year. In the Drew business unit, product revenue decreased $1,280,000, or 32%, as compared to the same period last fiscal year. The decrease is primarily due to the aging of Drew's product line and delays in bringing its new products to market. Drew anticipates that it will release a new product for sale in each of the second and third quarters of the current fiscal year.

Product revenue increased $495,000, or 28%, at the Sonomed business unit 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 new Vumax II ultrasound systems and an increase in export sales, which were partially offset by a decrease in domestic sales and in demand for the Company's pachymeter product.

Product revenue decreased $114,000, or 12%, to $817,000 in the Vascular business unit during the three-month period ended September 30, 2006 as compared to the same period last fiscal year. The decrease in product revenue in the Vascular business unit was primarily caused by an decrease in direct sales to end users by the Company's domestic sales team. The Company also saw a decrease 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 increased $325,000, or 100%, to $648,000 during the three-month period ended September 30, 2006 as compared to the same period last fiscal year. The increase in Medical/Trek/EMI product revenue is primarily attributed to an increase in the EMI sales of digital imaging systems.

Other revenue decreased by approximately $45,000, or 6.7%, to $625,000 during the three-month period ended September 30, 2006 as compared to the same period last fiscal year. The decrease is primarily due to a decrease in royalties received from Bausch & Lomb from $203,000 in the prior fiscal period to $0 for the three-month period ended September 30, 2006. The Company's contract with Bausch & Lomb ended in August 2005, and accordingly, the Company received no royalties in the three-month period ended September 30, 2006 and

will receive no future royalties under this agreement. (See note 9 of the notes to the condensed consolidated financial statements for a description of the step-down provisions under the contract with Bausch & Lomb.) Royalties from Bio-Rad related to an OEM agreement between Bio-Rad and Drew decreased by approximately $5,000 to $70,000 due to lower sales of Drew's products in

covered areas. 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. Offsetting these decreases was an increase in royalties received from Interlase of approximately $163,000 from $392,000 in the prior fiscal period to $555,000 in the three-month period ended September 30, 2006. The Company continues to challenge the method of calculating its royalty payments to the Company by Intralase and this issue remains a subject of litigation. (See notes 9 and 11 of the notes to the condensed consolidated financial statements.)

The following table presents consolidated cost of goods sold by reportable business unit and as a percentage of related unit product revenues for the three-month periods ended September 30, 2006 and 2005. Table amounts are in thousands:

	THREE-MONTH PERIOD ENDED SEPTEMBER 30,			
	2006	%	2005	%
COST OF GOODS SOLD:				
Drew	$ 1,759	63.2%	$ 2,594	63.7%
Sonomed	1,187	51.8%	976	54.3%
Vascular	313	38.3%	320	34.4%
Medical/Trek/EMI	372	57.4%	216	66.9%
TOTAL	$ 3,631	55.5%	$ 4,106	57.6%

Cost of goods sold totaled approximately $3,631,000, or 55% of product revenue, for the three-month period ended September 30, 2006 as compared to $4,106,000, or 57.6% of product revenue, for the same period last fiscal year. Cost of goods sold in the Drew business unit totaled $1,759,000, or 63% of product revenue, for the three-month period ended September 30, 2006 as compared to $2,594,000, or 64% of product revenue, for the same period last fiscal year. The decrease in the cost of goods sold of 32% corresponds to a like decrease in sales of 32%. Drew's instrument and OEM 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 $1,187,000, or 52% of product revenue, for the three-month period ended September 30, 2006 as compared to $976,000, or 54% of product revenue, for the same period last fiscal year. The primary reason for the decrease in cost of goods sold as a percentage of product revenue was an increase in sales of higher margin Vumax II's during the three months ended September 30, 2006.

Cost of goods sold in the Vascular business unit totaled $313,000, or 38%

of product revenue, for the three-month period ended September 30, 2006 as compared to $320,000, or 34% of product revenue, for the same period last fiscal year. The Company experienced higher overtime and lower production efficiencies in the current period as compared to the prior period.

Cost of goods sold in the Medical/Trek/EMI business unit totaled $372,000, or 57% of product revenue, during the three-month period ended September 30, 2006 as compared to $216,000, or 67% of product revenue, during the same period last fiscal year. Fluctuations in Medical/Trek/EMI cost of goods sold primarily emanates from product mix. The large increase in high margin EMI products in the current year accounts for the decrease in cost of goods sold as a percent of product revenue.

The following table presents consolidated marketing, general and administrative expenses as well as identifying trends in business unit marketing, general and administrative expenses for the three-month periods ended September 30, 2006 and 2005. Table amounts are in thousands:

	THREE-MONTH PERIOD ENDED SEPTEMBER 30,		
	2006	2005	% CHANGE
MARKETING, GENERAL AND ADMINISTRATIVE:			
Drew	$ 1,841	$ 1,792	2.7%
Sonomed	884	1,040	-15.0%
Vascular	552	529	4.4%
Medical/Trek/EMI	992	679	46.1%
TOTAL	$ 4,269	$ 4,040	5.7%

Marketing, general and administrative expenses increased $260,000, or 8%, to $3,551,000 during the three-month period ended September 30, 2006 as compared to the same period last fiscal year. Marketing, general and administrative expenses in the Drew business unit increased $14,000 or 1%, to $1,383,000 as compared to the same period last fiscal year. The increase is primarily due to increased legal fees related to the ICH matter in the United Kingdom (see footnote 11).

Marketing, general and administrative expenses in the Sonomed business unit decreased by $47,000, or 6%, to $797,000 as compared to the same period last fiscal year. This decrease is related to higher expenses in the prior year for marketing and travel expenses related to the Company's focus on increasing domestic and foreign revenues and exhibits and brochures advertising the Company's Ultrasound Biomicrosopes instrument.

Marketing, general and administrative expenses in the Vascular business unit increased $37,000, or 8%, to $530,000 as compared to the same period last fiscal year. The increase is related primarily to an increase of $11,000 in legal fees for logo and patent registrations and $18,000 in administrative and sales salaries incurred in the three month period ended September 30, 2006.

Marketing, general and administrative expenses in the Medical/Trek/EMI business unit increased $256,000, or 44% to $841,000 as compared to the same period last fiscal year. Legal fees, related mainly to the Interlase litigation, increased by $281,000 in the period ended September 30, 2006 as compared to the same period last year. The Company still anticipates these litigation costs 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.) The remainder of the increase is related to sales and marketing expenses related to the EMI product lines, and the joint marketing and integration of the Company's product line with Anka Systems as part of a co-marketing agreement.

Research and development expenses decreased $31,000, or 4%, to $718,000 during the three-month period ended September 30, 2006 as compared to the same period last fiscal year. Research and development expenses were primarily expenses associated with the planned introduction of new and or enhanced products in the Drew and EMI business units. Research and development expenses in the Drew business unit increased $35,000, or 8%, to $458,000 as compared to the same period last fiscal year. The increase is primarily due to additional salaries and benefits and consulting fees associated with the development of several new hematology and diabetic instruments. Research and development expenses in the Medical/Trek/EMI business unit increased $57,000 to $151,000 as compared to the same period last fiscal year. The increase is primarily due to higher prototype expenses (approximately $13,000) and salary expenses (approximately $40,000) for the development of the Company's new digital ophthalmic platform.

Gain on sale of available for sale securities was decreased approximately $1,157,000 in the three-month period ended September 30, 2006. The decrease 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.) There were no sales of available for sale securities during the three-month period ended September 30, 2006.

The Company recognized a loss of $19,000 and $18,000 related to its investment in OTM during the three-month periods ended September 30, 2006 and 2005, respectively. Commencing July 1, 2005, the Company began recognizing all of the losses of OTM in its consolidated financial statements. OTM is an early stage privately held company. Prior to July 1, 2005, the share of OTM's loss recognized by the Company was 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 $45,000 and $5,000 for the three-month periods ended September 30, 2006 and 2005, respectively. The increase was due to a combination of higher effective yields on investments and higher investable balances.

Interest expense was $9,000 and $11,000 for the three-month periods ended September 30, 2006 and 2005, respectively. The decrease reflects the reduction in outstanding debt balance as of September 30, 2006 as compared to the prior period.

LIQUIDITY AND CAPITAL RESOURCES

Changes in overall liquidity and capital resources from continuing operations during the three-month period ended September 30, 2006 are reflected in the following table (in thousands):

	SEPTEMBER 30, 2006	JUNE 30, 2006
CURRENT RATIO:		
Current assets	$ 14,520	$ 14,911
Less: Current liabilities	4,570	4,295
WORKING CAPITAL	$ 9,950	$ 10,616
CURRENT RATIO	3.2 TO 1	3.5 TO 1
DEBT TO TOTAL CAPITAL RATIO:		
Notes payable and current maturities	$ 240	$ 233
Long-term debt	1,182	1,250
Total debt	$ 1,422	$ 1,483
Total equity	32,620	33,100
TOTAL CAPITAL	$ 34,042	$ 33,100
TOTAL DEBT TO TOTAL CAPITAL	4.2%	4.5%

WORKING CAPITAL POSITION

Working capital decreased approximately $666,000 as of September 30, 2006 and the current ratio decreased to 3.2 to 1 from 3.5 to 1 when compared to June 30, 2006. The decrease in working capital was caused primarily by the loss from operations of approximately $714,000 and cash used to fund fixed asset additions of approximately $60,000. Partially offsetting these uses of working capital were proceeds of

approximately $98,000 realized by the Company for the income tax benefit from the exercise of stock options.

CASH USED IN OPERATING ACTIVITIES

During the three-month periods ended September 30, 2006 and 2005, the Company used approximately $1,282,000 and $751,000 of cash for operating activities. The net increase in cash used for operating activities of approximately $531,000 for the three-month period ended September 30, 2006 as compared to the same period in the prior fiscal year is due primarily to the following factors:

The Company had a net loss of $714,000 and experienced net cash out flows from increases in accounts receivable, inventory and other current and long-term assets of approximately $238,000, $554,000 and $181,000, respectively. These cash out flows were partially offset by and increase in accounts payable of $251,000 and non-cash expenditures on depreciation and amortization of $135,000.

In the prior fiscal period the cash used in operating activities of $531,000 was related to net income in the prior year of $714,000 offset by a gain on sale of marketable securities in the amount of $1,157,000.

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

Cash flows used in investing activities of $40,000 is related to fixed asset purchases during the three-month period ended September 30, 2006. The decrease in cash flows from investing activities from the prior fiscal period was $1,013,000. The change relates 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 of 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.

Cash flows provided by financing activities were approximately $39,000 during the three-month period ended September 30, 2006. During the period, the Company made scheduled long-term debt repayments of approximately $60,000 and received an income tax benefit of $98,000 by amending its fiscal 2006 state tax returns to deduct the exercise of stock options during fiscal 2006.

DEBT HISTORY

At the time of the acquisition of Drew by the Company, 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 debt provides for interest at fixed rate of 8% per annum until July 1, 2005. The interest rate was then adjusted to the prime rate plus 4% per annum. Each June 1, the rate will be adjusted to the prime rate plus 4% per annum. The debt has a minimum interest rate of 8% per annum to a maximum interest rate of 18% per annum. The interest rate on the Texas Mezzanine Fund was 10.25% per annum and 8% per annum as of September 30, 2006 and June 30, 2006, respectively. Drew is required to pay the Texas Mezzanine Fund 1% of fiscal year revenues over $11,500,000 as defined in a revenue participation agreement. The note is due in June 2008 and is secured by certain assets of Drew. The outstanding balance as of September 30, 2006 was approximately $244,000. 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% per annum. The outstanding balance as of March 31, 2006 was approximately $92,000.

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 $113,000 net difference from the amounts reported in the Company's Form 10-Q for the quarter ended December 31, 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

The Company was not a party to any off-balance sheet arrangements during the three-month periods ended September 30, 2006 and 2005.

The following table presents the Company's contractual obligations as of September 30, 2006 (interest is not included in the table as it is immaterial):

	TOTAL	LESS THAN 1 YEAR	1-3 YEARS	4-5 YEARS
Long-term debt	$ 335,719	$ 240,480	$ 95,239	$ 0
Operating lease agreements	2,134,590	720,916	988,550	425,124
TOTAL	$2,470,309	$ 961,396	$1,083,789	$ 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 acquired all of the Drew shares during 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. 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, 2006, the Company has loaned approximately $11,023,000 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, to fund new product development and underwrite operating losses incurred since acquisition. The Company anticipates that further working capital will likely be required by Drew.

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. The Company has incurred and anticipates continuing to incur higher than normal legal expenses related primarily to protecting its rights and interests in intellectual property licensed to IntraLase. (See note 11 of the notes to the condensed consolidated financial statements.) These higher costs are likely to unfavorably impact operating income and cash flows in future periods.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

The table below provides information about the Company's financial instruments consisting of both variable and 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, 2006 were variable at prime plus 4%, currently 10.25% per annum, on the Texas Mezzanine Fund debt, and were fixed at 5.00% per annum, on the Symbiotics, Inc. term debt. (See note 8 of the notes to the condensed consolidated financial statements for further information regarding the Company's debt obligations.)

	2006	2007
Texas Mezzanine Fund Note	$ 148,817	$ 95,239
Interest rate	10.25%	Prime Plus 4%
Symbiotics, Inc. Note	$ 91,663	$ 0
Interest rate	5.00%	5.00%
TOTAL	$ 240,480	$ 95,239

EXCHANGE RATE RISK

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 periods ended September 30, 2006 and 2005, Drew recorded approximately $321,000 and $87,000 respectively, of revenue denominated in United Kingdom Pounds and Euros, respectively.

Drew incurs a portion of its expenses denominated in United Kingdom Pounds. During the three-month periods ended September 30, 2006 and 2005, Drew incurred approximately $1,265,000 and $1,368,000, respectively, of expense denominated in United Kingdom Pounds. The Company's Sonomed and Vascular business units incur an immaterial portion of their marketing expenses in the European market, the majority of which are transacted in Euros.

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 4. CONTROLS AND PROCEDURES

(A) EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

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

Based on their evaluation of the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2006, the Chief Executive Officer and Principal Financial and Accounting Officer of the Company have concluded that such disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its Chief Executive Officer and Principal Financial and Accounting Officer, to allow timely decisions regarding required disclosure.

(B) INTERNAL CONTROL OVER FINANCIAL REPORTING

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act, during the first fiscal quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See note 11 of the notes to the condensed consolidated financial statements for further information regarding the Company's legal proceedings.

ITEM 1A. RISK FACTORS

There are no material changes from the risks previously disclosed in our Annual Report on Form 10-K for the period ended June 30, 2006.

ITEM 6. EXHIBITS

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

31.2 Certificate of Principal Financial and Accounting Officer under Rule 13a-14(a).

32.1 Certificate of Chief Executive Officer under Section 1350 of Title 18 of the United Stat

32.2 Certificate of Principal Financial and Accounting Officer under Section 1350 of Title 18

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, 2006

By: /s/ Richard J. DePiano

Richard J. DePiano
Chairman and Chief
Executive Officer

Date: November 14, 2006

By: /s/ Robert O'Connor

Robert O'Connor
Chief Financial Officer