ESCALON MEDICAL CORP
Form 10-Q
February 14, 2017

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

FORM 10-Q
QUARTERLY PERIOD PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period ended December 31, 2016
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)	(I.R.S. Employer Identification No.)

435 Devon Park Drive, Building 100, Wayne, PA 19087
(Address of principal executive offices, including 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 o

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 7,551,430 shares of common stock, $0.001 par value, outstanding as of February 13, 2017.

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Item 1. Condensed Consolidated Financial Statements
ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	December 31, 2016	June 30, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$ 538,284	$ 538,114
Accounts receivable, net	1,496,584	1,614,549
Inventory, net	2,214,790	2,107,148
Other current assets	332,044	278,830
Total current assets	4,581,702	4,538,641
Property and equipment, net	67,276	81,206
Goodwill	125,027	125,027
Trademarks and trade names	605,006	605,006
Patents, net	1,200	2,000
License, net	169,700	178,500
Total assets	$ 5,549,911	$ 5,530,380
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Current liabilities:		
Line of credit	$ 247,000	$—
Accounts payable	1,216,532	1,091,923
Accrued expenses	1,087,627	1,226,842
Related party note payable	545,000	275,000
Current portion of accrued post-retirement benefits	101,891	101,891
Liabilities of discontinued operations	84,285	88,660
Total current liabilities	3,282,335	2,784,316
Accrued post-retirement benefits, net of current portion	817,590	835,589
Total long-term liabilities	817,590	835,589
Total liabilities	4,099,925	3,619,905
Shareholders' equity:		
Common stock, $0.001 par value; 35,000,000 shares authorized; 7,551,430 issued and outstanding as of December 31, 2016 and June 30, 2016	7,551	7,551
Additional paid-in capital	69,701,907	69,701,907
Accumulated deficit	(68,259,472)	(67,798,983)
Total shareholders’ equity	1,449,986	1,910,475
Total liabilities and shareholders’ equity	$ 5,549,911	$ 5,530,380

See notes to condensed consolidated financial statements

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

	For the Three-month period ended December 31,		For the Six-month period ended December 31,	
	2016	2015	2016	2015
Net revenues:				
Product revenue	$3,162,565	$2,988,835	$5,494,553	$5,770,157
Revenues, net	3,162,565	2,988,835	5,494,553	5,770,157
Costs and expenses:				
Cost of goods sold	1,712,052	1,526,440	2,963,544	2,974,486
Marketing, general and administrative	1,206,888	1,344,746	2,362,303	2,611,482
Research and development	286,135	382,766	596,494	742,518
Total costs and expenses	3,205,075	3,253,952	5,922,341	6,328,486
Loss from operations	(42,510)	(265,117)	(427,788)	(558,329)
Other (expense)				
Interest	42	17	101	37
Interest expense	22,489	—	32,802	—
Total other (expense)	(22,447)	17	(32,701)	37
Net (loss)	$(64,957)	$(265,100)	$(460,489)	$(558,292)
Net (loss) per share				
Basic net (loss) per share	$(0.01)	$(0.04)	$(0.06)	$(0.07)
Diluted net (loss) per share	$(0.01)	$(0.04)	$(0.06)	$(0.07)
Weighted average shares—basic	7,551,430	7,541,013	7,551,430	7,541,013
Weighted average shares—diluted	7,551,430	7,541,013	7,551,430	7,541,013

See notes to condensed consolidated financial statements

ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
FOR THE SIX MONTHS ENDED DECEMBER 31, 2016
(UNAUDITED)

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Total Shareholders' Equity
	Shares	Amount			
Balance at June 30, 2016	7,551,430	$ 7,551	$69,701,907	$(67,798,983)	$ 1,910,475
Net loss	—	—	—	(460,489)	(460,489)
Balance at December 31, 2016	7,551,430	$ 7,551	$69,701,907	$(68,259,472)	$ 1,449,986

See notes to condensed consolidated financial statements

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

	For the six months ended December 31, 2016	2015
Cash Flows from Operating Activities:		
Net loss	$(460,489)	$(558,292)
Adjustments to reconcile net loss to cash (used in) operating activities:		
Depreciation and amortization	23,530	13,010
Compensation expense related to stock options	—	21,701
Change in operating assets and liabilities:		
Accounts receivable, net	117,965	437,231
Inventory, net	(107,642)	(225,294)
Other current assets	(53,214)	(40,341)
Accounts payable and accrued expenses	(14,606)	(278,118)
Change in accrued post-retirement benefits	(17,999)	35,360
Change in liabilities of discontinued operations	(4,375)	1,072
Net cash (used in) operating activities	(516,830)	(593,671)
Cash Flows from Investing Activities:		
Purchase of fixed assets	—	(62,228)
Net cash (used in) investing activities	—	(62,228)
Cash Flows from Financing Activities:		
Proceeds from related party note payable	270,000	—
Proceeds from line of credit	247,000	—
Net cash provided by financing activities	517,000	—
Net increase (decrease) in cash and cash equivalents	170	(655,899)
Cash and cash equivalents, beginning of period	538,114	1,516,761
Cash and cash equivalents, end of period	$538,284	$860,862

See notes to condensed consolidated financial statements

Escalon Medical Corp. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(UNAUDITED)

1. Basis of Presentation

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

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

Reclassification

Certain items in the June 30, 2016 consolidated balance sheet have been reclassified to conform to the current period presentation.

2. Stock-Based Compensation

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

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

As of December 31, 2016 and 2015 total unrecognized compensation cost related to non-vested share-based compensation arrangements granted to employees under the 2004 Equity Incentive Plan was $0 and $17,912, respectively. There is no remaining cost to be recognized as of December 31, 2016. For the three-month periods ended December 31, 2016 and 2015, $0 and $11,941 was recorded as compensation expense, respectively. For the six-month periods ended December 31, 2016 and 2015, $0 and $21,701 was recorded as compensation expense, respectively.

The Company did not receive any cash from share option exercises under stock-based payment plans for the six-month periods ended December 31, 2016 and 2015. The Company did not realize any tax effect, which would be a reduction in its tax rate, on options due to the full valuation allowances established on its deferred tax assets.

The Company measures compensation expense for non-employee stock-based compensation based on the fair value of the options issued, as this is more reliable than the fair value of the services received. Fair value is measured as the value of the Company's common stock on the date that the commitment for performance by the counterparty has been reached or the counterparty's performance is complete. The fair value of the equity instrument is charged directly to compensation expense and additional paid-in capital. There was $0 non-employee compensation expense for the six-month periods ended December 31, 2016 and 2015.

3. Net (Loss) earnings per Share

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

	For the Three-month period ended December 31,		For the Six-month period ended December 31,	
	2016	2015	2016	2015
Numerator:				
Numerator for basic and diluted earnings per share				
Net (loss)	$(64,957)	$(265,100)	$(460,489)	$(558,292)
Denominator:				
Denominator for basic earnings per share - weighted average shares	7,551,430	7,541,013	7,551,430	7,541,013
Effect of dilutive securities:				
Stock options and warrants	—	—	—	—
Shares reserved for future exchange	—	—	—	—
Denominator for diluted earnings per share - weighted average and assumed conversion	7,551,430	7,541,013	7,551,430	7,541,013
Net (loss) per share				
Basic net (loss) per share	$(0.01)	$(0.04)	$(0.06)	$(0.07)
Diluted net (loss) per share	$(0.01)	$(0.04)	$(0.06)	$(0.07)

4. Legal Proceedings

The Company, from time to time, is involved in various legal proceedings and disputes that arise in the normal course of business. These matters have previously and may in the future pertain to intellectual property disputes, commercial contract disputes, employment disputes, and other matters. The Company does not believe that the resolution of any of these matters has had or is likely to have a material adverse impact on the Company's business, financial condition or results of operations.

5. Recently Issued Accounting Standards

In May 2014 FASB issued Accounting Standards Update 2014-09 Revenue from Contracts with Customers (Topic 606). Under the new provision, an entity should apply five steps for revenue recognition to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. For a public entity, the amendments in this Update are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. In August 2015 FASB issued accounting Standards Update No. 2015-13 Revenue from Contracts with Customers (Topic 606) deferral of the effective date. The amendments in this Update defer the effective date of Update 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in Update 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within the reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within the reporting period. Management is evaluating the standard's impact on the consolidated financial statements.

In June 2014 FASB issued Accounting Standards Update 2014-11 Compensation-Stock Compensation (Topic 718) Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period. The amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. For all entities, the amendments in this Update are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.

In August 2014 FASB issued Presentation of Financial Statements-Going Concern (Subtopic 205-40) Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern. The amendments require management to assess an entity’s ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S.

auditing standards.The amendments in this Update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. The adoption of this standard is not expected to have a material impact to the Company’s consolidated financial statements.
In November 2014 FASB issued Derivatives and Hedging (Topic 815) Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity. For hybrid financial instruments issued in the form of a share, an entity should determine the nature of the host contract by considering the economic characteristics and risks of the entire hybrid financial instrument, including the embedded derivative feature that is being evaluated for separate accounting from the host contract.The amendments in this Update are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.
In January 2015, FASB issued Accounting Standards Update 2015-01 Income Statement - Extraordinary and Unusual Items Simplifying Income Statement presentation by eliminating the concept of extraordinary items. The amendment will be effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.
In February 2015, FASB issued Accounting Standards Update 2015-02 Consolidation Amendments to the Consolidation Analysis. The amendments affect those entities who are required to evaluate whether they should consolidate certain legal entities and affect the following areas: limited partnership and similar legal entities, evaluating fees paid to a decision maker or a service provider as a variable interest, the effect of fee arrangements on the primary beneficiary determination, the effect of related parties on the primary beneficiary determination, and certain investment funds. The amendments in this update are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the amendments in this Update are effective for fiscal year beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted. The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.
In April 2015, FASB issued Accounting Standards Update 2015-03 Interest-Imputation of Interest to simply the presentation of debt issuance costs. For public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal year. For all other entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15,2015, and interim periods within fiscal years beginning after December 15, 2016. The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.
In April 2015, FASB issued Accounting Standards Update 2015-04 Compensation-Retirement Benefits (Topic 715) to provide practical expedient for the measurement date of an employer’s defined benefit obligation and plan assets. The amendments in this Update are effective for public business entities for financial statements issued for fiscal year beginning after December 15, 2015, and interim periods within those fiscal year. For all other entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. Earlier adoption is permitted. The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.
In April 2015, FASB issued Accounting Standards Update 2015-05 Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40) to provide guidance to customers about whether a cloud computing arrangement includes a software license. For public business entities, the amendments will be effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. For all other entities, the amendments will be effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016. Early adoption is permitted for all entities. The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.
In April 2015, FASB issued Accounting Standards Update 2015-06 Earnings Per Share (Topic 260). The Amendments specify that for purposes of calculating historical earnings per unit under the two-class method, the earnings (losses) of a transferred business before the date of a dropdown transaction should be allocated entirely to the general partner. Qualitative disclosures about how the rights to the earnings (losses) differ before and after the dropdown transaction occurs for purposes of computing earnings per unit under the two-class method are required. The amendments are effective for fiscal year beginning after December 15, 2015, and interim periods within those

fiscal years. Earlier application is permitted. The adoption of this standard did not have a material impact to the Company's consolidated financial statements.

In May 2015, FASB issued Accounting Standards Update 2015-07 Fair Value Measurement (Topic 820). The amendments remove the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also remove the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. The amendments apply to reporting entities that elect to measure the friar value of an investment within the scope of paragraph 820-10-15-4 through 15-5 using the net asset value per share (or its equivalent) practical expedient in paragraph 820-35-59. The amendments in this Update are effective for public business entities for fiscal year beginning after December 15, 2015, and interim periods within those fiscal years. For all other entities, the amendments in this update are effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.

In May 2015, FASB issued Accounting Standard Update 2015-08 Business Combinations (Topic 805) as amendments to various SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115. The adoption of this standard is not expected to have a material impact to the Company’s consolidated financial statements.

In May 2015, FASB issued Accounting Standard Update 2015-09 Financial Services-Insurance (Topic 944). The amendments apply to all insurance entities that issue short-duration contracts as defined in Topic 944, Financial Service-Insurance. The amendments require insurance entities to provide additional disclosure for annual reporting periods about liability for unpaid claims and claim adjustment expenses. For public entities, the amendments in this Update are effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016. For all other entities, the amendments in this Update are effective for annual periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017. The adoption of this standard is not expected to have a material impact to the Company’s consolidated financial statements.

In June 2015, FASB issued Accounting Standards Update 2015-10 Technical Correction and Update. The amendments affect wide variety of Topics in Codification in the following four categories: Amendments related to differences between original guidance and the codification, guidance clarification and reference corrections, simplification and minor improvements. The amendments in this Update that require transition guidance are effective for all entities for fiscal year, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted. The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.

In July 2015 FASB issued Accounting Standards Update No. 2015-11 Inventory Simplifying the Measurement of Inventory. Inventory measured using any method other than LIFO or the retail or average cost shall be measured at the lower of cost and net realizable value. For public business entities, the amendments in this update are effective for fiscal year beginning after December 15, 2016, including interim periods within those fiscal Years. The amendments should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The adoption of this standard is not expected to have a material impact to the Company’s consolidated financial statements.

In July 2015 FASB issued Accounting Standards Update No. 2015-12 (Part I) Plan Accounting: Defined Contribution Pension Plans (Topic 962) Health and Welfare Benefit Plans (Topic 965) to reduce the complexity in employee benefit plan accounting. Under the amendments, fully benefit-responsive investment contracts are measured, presented, and disclosed only at contract value. The amendments in Part I of this Update are effective for fiscal years beginning after December 15, 2015. Earlier application is permitted.The adoption of this standard did not have a material impact to the Company’s consolidated financial statements.

In August 2015 FASB issued Accounting Standard Update No. 2015-13 Derivatives and Hedging (Topic 815) Application of the Normal Purchases and Normal Sales Scope Exception to Certain Electricity Contracts within Nodal Energy Markets. The amendments apply to entities that enter into contracts for the purchase or sale of electricity on a forward basis and arrange for transmission through, or delivery to a location within, a nodal energy market whereby one of the contracting parties incurs charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) an independent system operator. The amendments specify that the use of locational marginal pricing by the independent system operator does not constitute the net settlement of the contract. If the physical delivery criterion is met, along with all of the other criteria of the normal purchase and normal scales scope exception, an entity may elect to designate that contract as a normal purchase or normal sale. The amendments in the Update are effective upon issuance and should be applied prospectively. The adoption of this standard is not expected to have a material impact to the Company’s consolidated financial statements.

In August 2015 FASB issued Accounting Standards Update No. 2015-15 Interest -Imputation of Interest (Subtopic 835-30). This update adds SEC paragraphs pursuant to the SEC Staff Announcement at the June 18, 2015 Emerging Issues Task Force (EIFF) meeting about the presentation of subsequent measurement of debt issuance costs associated with line-of-credit arrangements. Given the absence of authoritative guidance within Update 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance cots ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

In September 2015 FASB issued Accounting Standards Update No. 2015-16 Business Combinations (Topic 805) Simplifying the Accounting for Measurement-Period Adjustments. The amendments in this Update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments require that the acquirer record in the same period's financial statements the effect on earnings of changes in depreciation, amortization or other income effects, if any, as result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. Under this Update an entity must present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 2016, and interim periods within fiscal years beginning after December 15, 2017. The adoption of this standard did not have a material impact to the Company's consolidated financial statements.

In November 2015 FASB issued Accounting Standards Update No. 2015-17 Income Taxes (Topic 740) Balance Sheet Classification of Deferred Taxes to reduce complexity in accounting standards. The amendments require that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. For public business entities, the amendments in this Update are effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments in this Update are effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

In January 2016 FASB issued Accounting Standards Update No. 2016-01 Financial Instruments-Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities. Under the amendment, equity investments (with exceptions) must be evaluated at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. Qualitative assessment is required for impairment assessment of equity investments without readily determinable fair values to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value. Public business entities are required to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. An entity must present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. Financial assets and financial liabilities must be presented separately by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. All entities that are not public business entities may adopt the amendments in this Update earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

In February 2016 FASB issued Accounting Standards Update No. 2016-02 Leases (Topic 842) that changes the recognition of lease assets and lease liabilities by lessess for those leases classified as operating lease. The amendments in this Update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for a public business entity. Early adoption is permitted. The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements. Management is evaluating the standard's impact on the consolidated financial statements.

In March 2016 FASB issued Accounting Standards Update No. 2016-03 Intangibles-Goodwill and other (Topic 350), Business Combinations (Topic 805) Consolidation (Topic 810) and Derivatives and Hedging (Topic 815) The amendments in this Update could affect all private companies within the scope of Update 2014-02; Update 2014-03; Update 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements; or Update 2014-18, Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination. The amendments in this Update make the guidance in Updates 2014-02, 2014-03, 2014-07, and 2014-18 effective immediately by removing their effective dates. The amendments also include transition provisions that provide that private companies are able to forgo a preferability assessment the first time they elect the accounting alternatives within the scope of this Update. Any subsequent change to an accounting policy election requires justification that the change is preferable under Topic 250, Accounting Changes and Error Corrections. The amendments in this Update also extend the transition guidance in Updates 2014-02, 2014-03, 2014-07, and 2014-18 indefinitely. While this Update extends transition guidance for Updates 2014-07 and 2014-18, there is no intention to change how transition is applied for those two Updates. The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

In March 2016 FASB issued Accounting Standards Update No. 2016-07 Investments-Equity Method and Joint Ventures (Topic 323) The amendments in this Update affect all entities that have an investment that becomes qualified for the equity method of accounting as a result of an increase in the level of ownership interest or degree of influence. It eliminates the requirement to retroactively adopt the equity method of accounting for adjustment of the investment. The amendments in this Update are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Earlier application is permitted. The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

In March 2016 FASB issued Accounting Standards Update No. 2016-08 Revenue from Contracts with Customers (Topic) Principal vs. Agent Considerations. The amendments in this Update do not change the core principle of the guidance. The amendments clarify the implementation guidance on principal versus agent considerations. The amendments in this Update affect the guidance in Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements of Update 2014-09. Accounting Standards Update No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. The effective date is same as the date for Update No. 2014-09. The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

In March 2016 FASB issued Accounting Standards Update No. 2016-09 Compensation-Stock Compensation -(Topic 718) Improvements to employee share-based payments accounting as part of simplicity initiatives. This update involve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Some of the areas for simplification apply only to nonpublic entities. For public business entities, the amendments in this Update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted for any entity in any interim or annual period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

In April 2016 FASB issued Accounting Standards Update No. 2016-10 Revenue from Contracts with Customers (Topic 606) Identifying Performance Obligations and Licensing. On May 2016 FASB issued Accounting Standards Update No. 2016-12 Revenue from Contracts with Customers (Topic 606) Narrow-Scope Improvements and Practical Expedients. The amendments in these two update do not change the the core principle of the guidance in Topic 606, which is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services, but they clarify the following two aspects of Topic 606: identifying performance obligations and the licensing implementation guidance and the Update affect only the narrow aspects of Topic 606. An entity should apply five steps to achieve the core principle. The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

In May 2016 FASB issued Accounting Standards Update No. 2016-11 Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815). This Accounting Standards Update rescinds SEC paragraphs pursuant to two SEC Staff Announcements at the March 3, 2016 Emerging Issues Task Force (EITF) meeting.The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

In June 2016 FASB issued Accounting Standards Update No. 2016-13 Financial Instruments—Credit Losses (Topic 326). The amendments in this Update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates.For public business entities that are U.S. Securities and Exchange Commission (SEC) filers, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other public business entities, the amendments in this Update are effective for fiscal years beginning

after December 15, 2020, including interim periods within those fiscal years.The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.
In August 2016 FASB issued Accounting Standards Update No. 2016-15 Statement of Cash Flows (Topic 230)Classification of Certain Cash Receipts and Cash Payments.The amendments in this Update provide guidance on the eight specific cash flow issues and apply to all entities, including both business entities and not-for-profit entities that are required to present a statement of cash flows under Topic 230.The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period.The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.
In October 2016 FASB issued Accounting Standards Update No. 2016-16 Income Taxes (Topic 740) Intra-Entity Transfers of Assets Other Than Inventory. The amendments in this Update requires that an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. Consequently, eliminating the exception for an intraentity transfer of an asset other than inventory. For public business entities, the amendments in this Update are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. For all other entities, the amendments are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual periods beginning after December 15, 2019.The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.
In November 2016 FASB issued Accounting Standards Update No. 2016-18 Statement of Cash Flows (Topic 230)Restricted Cash.Under the amendments in this update, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows.The amendments in this Update apply to all entities that have restricted cash or restricted cash equivalents and are required to present a statement of cash flows under Topic 230.The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. The company currently does not have restricted cash and the adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.The company currently does not have restricted cash and the adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.
In January 2017 FASB issued Account Standards Update No. 2017-04 Intangibles—Goodwill and Other (Topic 350)Simplifying the Test for Goodwill Impairment.Under the amendments in this udpate an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable.The amendments in this Update are required for public business entities and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill.A public business entity that is a U.S. Securities and Exchange Commission (SEC) filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A public business entity that is not an SEC filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020.The adoption of this standard is not expected to have a material impact to the Company's consolidated financial statements.

6. Fair Value Measurements
On July 1, 2008, the Company adopted the FASB-issued authoritative guidance for the fair value of financial assets and liabilities. This standard defines fair value and establishes a hierarchy for reporting the reliability of input

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

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

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

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

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

7. Discontinued Operations

BH Holdings, S.A.S ("BHH")

On January 12, 2012 BHH initiated the filing of an insolvency declaration with the Tribunal de Commerce de Rennes, France ("Commercial Court"). The Commercial Court on January 18, 2012 opened the liquidation proceedings with continuation of BHH's activity for 3 months and named an administrator to manage BHH. Since Drew no longer had a controlling financial interest in BHH it was deconsolidated in the December 31, 2011 quarterly condensed consolidated financial statements and prior period amounts were presented as discontinued operations.

Assets and liabilities of discontinued operations of BHH included in the condensed consolidated balance sheets are summarized as follows at December 31, 2016 and June 30, 2016 (in thousands):

	December 31, 2016	June 30, 2016
Assets		
Total assets	$ —	$—
Liabilities		
Accrued lease termination costs	84	89
Total liabilities	84	89
Net liabilities of discontinued operations	$ (84)	$(89)

During fiscal year 2015 the Company was informed by French Counsel that the total amount claimed by the BHH landlord in the liquidation of BHH was approximately $86,000. The Company did not have insight into the French liquidation process due to the Liquidator's reticence to communicate with the Company. As such, the Company had accrued the present value of the maximum amount potentially due under the lease guaranteed by the Company on behalf of BHH. The landlord's claim under liquidation of approximately $86,000 can not be revisited by the landlord and can only be potentially increased by interest or sundry expenses. Beginning in fiscal year end 2016 any changes to this liability are included in continuing operations. As of December 31, 2016 and June 30, 2016, the liability was approximately $84,000 and $89,000, respectively.

8. Related Party Transactions

During the year ended June 30, 2016, Richard J. DePiano, Sr., the Company’s Chairman, participated in an accounts receivable factoring program that was implemented by the Company. Under the program, Mr. DePiano advanced the Company $150,000 in February 2016, $125,000 in May 2016, $120,000 in October 2016 and $150,000 in November 2016. Interest on the transaction was 1.25% per month, which was equal to the best price offered by the Company’s usual factoring agent. The transaction excluded fees typically charged by the factoring agent and provided much needed liquidity to the Company. Related party interest expense for the three-month period ended December 31, 2016 and 2015 was $16,489 and $0, respectively. Related party interest expense for the six-month period ended December 31, 2016 and 2015 was $26,802 and $0, respectively. Repayment is due upon the Company receiving payment from the underlying receivables purchased by Mr. DePiano. In the near term Mr. DePiano will roll-over the original $545,000 investment as the receivables are collected and additional receivables will be assigned as collateral until such time as the Company no longer needs the liquidity.

9. Inventory

(In thousands)	December 31, 2016	June 30, 2016

Inventories, net:

Raw Material	$ 841	$917
Work-In-Process	344	363
Finished Goods	1,030	827
Total	$ 2,215	$2,107

10. Continuing Operations and Nasdaq Listing

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has incurred recurring operating losses and negative cash flows from operating activities and these conditions raise substantial doubt about the Company’s ability to continue as a going concern. These consolidated financial statements do not include any adjustments relating to the realization of the carrying value of assets or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. The Company's continuance as a going concern is dependent on its future profitability and on the on-going support of its shareholders, affiliates and creditors. In order to mitigate the going concern issues, the Company is actively pursuing business partnerships, managing our continuing operations and seeking to sell certain assets. The Company may not be successful in any of these efforts.

If the Company is unable to achieve the mitigating factors mentioned above in the near term, it is likely that our existing cash and cash flow from operations will not be sufficient to fund activities without curtailing certain business activities.

On March 2, 2016, NASDAQ notified the Company that the bid price of its listed security had closed at less than $1 per share over the previous 30 consecutive business days, and, as a result, did not comply with Listing Rule 5550(a)(2) (the "Rule"). In accordance with Listing Rule 5810(c)(3)(A), the Company was provided 180 calendar days, or until August 29, 2016, to regain compliance with the Rule. The Company received a letter from NASDAQ dated August 30, 2016 stating that the NASDAQ staff determined that the Company did not meet the terms of the extension. The Company had previously requested an appeal of the staff's determination of the Company's failure to comply with the minimum $2,500,000 stockholders’ equity requirement for continued listing. Therefore, both issues were addressed at the requested hearing with the Hearings Panel. The Company presented its plan for compliance with the NASDAQ continued listing standards on October 13, 2016. The Company's plan for compliance was unsuccessful and on November 16, 2016 Nasdaq notified the Company that the Panel had determined to delist the Company's shares from the Nasdaq Stock Market. Suspension of trading in the Company's shares on the Nasdaq Stock Market was effective at the open of business on November 18, 2016. The Company's securities are now trading on the OTCQB marketplace, which became effective at the open of business on November 18, 2016.
The Company’s forecast of the period of time through which its financial resources will be adequate to support its operations is a forward-looking statement and involves risks and uncertainties, and actual results could vary as a result of a number of factors, including the factors discussed in “Risk Factors” included in the Company's Form 10-K for the year ended June 30, 2016. If the Company raises funds in the future, the Company may be required to raise those funds through public or private financings, strategic relationships or other arrangements at prices and other terms that may not be as favorable as they would without such qualification. The sale of additional equity and debt securities may result in additional dilution to the Company’s shareholders. Additional financing may not be available in amounts or on terms acceptable to the Company or at all.

11. Line of credit

On December 29, 2016, the Company entered into a credit agreement providing the Company up to an aggregate of $250,000 in cash, secured by the Company’s inventory. The Company, and its wholly owned subsidiary Sonomed, Inc., entered into an Inventory Advance Agreement as of December 29, 2016 (the "Agreement"), with CDS Business Services, Inc., doing business as Newtek Business Credit ("Newtek"). Newtek may in its discretion make loans against the Company’s Eligible Inventory in an aggregate amount outstanding at any time up to the lesser of (i) fifty percent (50%) of the Inventory Value or (ii) the Inventory Advance Limit, as those terms are defined in the Agreement, which is currently $250,000. The credit agreement renews annually and can be terminated upon 90 days written notice from the Company or 30 days written notice from NewTek.

If, at any time and for any reason, the aggregate amount of the outstanding advances under the Agreement exceeds the Inventory Advance Limit or percentage limitation contained in the preceding sentence, then Company must, upon demand by Newtek, immediately pay to Newtek, in cash, the amount of such excess, or at Newtek’s option Newtek may charge such excess against any reserves held by Newtek.

Newtek will maintain reserves against Company’s availability for advances and may maintain reserves against the Company’s accounts and/or ineligible inventory as well, or maintain a cash collateral deposit account, as NewTek in its discretion deems appropriate. Newtek may also increase such reserves or reduce its advance percentages based on eligible inventory without declaring an event of default and without prior notice, if it determines, in its discretion, that such increase in reserves or reduction is necessary, including, without limitation, to protect its interest in the collateral and/or against diminution in the value of any collateral, and/or to insure the prospect of payment or performance by Company of its obligations to Newtek are not impaired.

Interest will accrue on the daily balance at the per annum rate of 5.00% above the Prime Rate (currently 3.75%), but not less than 5.0%. The current annual interest rate is 8.75% as of December 29, 2016. The Company’s obligations will, at the option of Newtek, (i) from and after the occurrence of an event of default, or (ii) if the Company’s obligations are not paid in full by the termination date, bear interest at the per annum rate of 10.00% above the prime rate. All interest payable by under the financing documents will be computed on the basis of a 360 day year for the actual number of days elapsed on the daily balance.

The Company is obligated to pay to Newtek a closing fee equal to 1.00% of the Advance Limit. Upon any renewal of the Agreement, an annual fee will be due from Company equal to 1.00% of the Advance Limit. In consideration of monitoring, ledgering and other administrative functions undertaken by Newtek in connection with the Company’s inventory, and the merchant processor, Company is obligated pay Newtek a monthly collateral monitoring fee calculated by multiplying (i) seventy basis points (0.70%) (except during the existence of an Event of Default at which time it shall be 1%) by (ii) the amount of the average daily balances during the calendar month preceding the month for which the calculation is made.

The foregoing description of the Agreement does not purport to be complete and is qualified in its entirety by reference to the Agreement, a copy of which is attached to the Form 8-K report dated December 29, 2016. As of December 31, there is $3,000 overpayment of a transaction fee, reducing the debt balance to $247,000.

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,” “wi
words or expressions. The

Company's forward-looking statements include certain information relating to general business strategy, growth strategies, financial results, liquidity, discontinued operations, research and development, product development, the introduction of new products, the potential markets and uses for the Company's products, the Company's ability to increase its sales campaign effectively, the Company's regulatory filings with the FDA, acquisitions, dispositions, the development of joint venture opportunities, intellectual property and patent protection and infringement, the loss of revenue due to the expiration on termination of certain agreements, the effect of competition on the structure of the markets in which the Company competes, increased legal, accounting and Sarbanes-Oxley compliance costs, compliance with Nasdaq continued listing qualifications, defending the Company in litigation matters and the Company's cost saving initiatives. The reader must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by assumptions that fail to materialize as anticipated. Consequently, no forward-looking statement can be guaranteed, and actual results may vary materially. It is not possible to foresee or identify all factors affecting the Company's forward-looking statements, and the reader therefore should not consider the list of such factors contained in its periodic report on Form 10-K for the year ended June 30, 2016 and this Form 10-Q quarterly report to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions.

Executive Overview—Six-Months Ended December 31, 2016 and 2015.

The following highlights are discussed in further detail within this Form 10-Q. The reader is encouraged to read this Form 10-Q in its entirety to gain a more complete understanding of factors impacting Company performance and financial
condition.

• Consolidated product revenue decreased approximately $275,000, or 4.8%, to $5,495,000 during the six-months ended December 31, 2016 as compared to same period of the last fiscal year. The decrease in revenue is attributed to a decrease of $144,000 in surgical products and a decrease of $168,000 in digital imaging cameras and AXIS image management systems offset by an increase of $37,000 in ultrasound products .

• Consolidated cost of goods sold totaled approximately $2,964,000, or 53.9%, of product revenue for the six months ended December 31, 2016, as compared to $2,974,000, or 51.5%, of product revenue for the same period of the prior fiscal year. The increase of 2.4% in cost of goods sold as a percentage of revenue is due mainly to decreased high margin Axis image management sales.

• Total operating expenses decreased approximately $395,000, or 11.8%, during the six-month period ended December 31, 2016 as compared to the same period of prior fiscal year. This decrease was due to decreased marketing, general and administrative expenses of $249,000, or 9.5% and a decrease of $147,000 or 19.8%, in research and development expenses.

• Net loss was approximately $460,000 for the six-months ended December 31, 2016.

Company Overview

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

The Company operates in the healthcare market specializing in the development, manufacture, marketing and distribution of medical devices and pharmaceuticals in the area of ophthalmology. 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. Sonomed-Escalon develops, manufactures and markets ultrasound systems used for diagnosis or biometric applications in ophthalmology, develops, manufactures and distributes ophthalmic surgical products under the Trek Medical Products name, and manufactures and markets digital camera systems for ophthalmic fundus photography and image management systems.

Critical Accounting Policies

The preparation of financial statements requires management to make estimates and assumptions that impact amounts reported therein. The most significant of those involve the application of FASB-issued authoritative guidance concerning Revenue Recognition, Goodwill and Other Intangible Assets, discussed further in the notes to consolidated financial statements included in the Form 10-K for the year ended June 30, 2016. The financial statements are prepared in conformity with accounting principles generally accepted in the United States of America, and, as such, include amounts based on informed estimates and judgments of management. For example, estimates are used in determining valuation allowances for deferred income taxes, uncollectible receivables, obsolete inventory, sales returns and rebates, warranty liabilities and valuation of 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 upon wholesale prices and to the balance of its customers at set retail prices. Distributors can receive discounts for accepting high volume shipments. The discounts are reflected immediately in the net invoice price, which is the basis for revenue recognition. No further material discounts are given.

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

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

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, and as circumstances require, evaluates for impairment its intangible assets and goodwill in accordance with FASB guidance related to 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. Recoverability of these assets is measured by comparison of their carrying amounts to future discounted cash flows the assets are expected to generate. If identifiable intangibles are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds its fair market value. The Company does not amortize intangible assets with indefinite useful lives, rather, such assets are required to be tested for impairment at least annually or sooner whenever events or changes in circumstances indicate that the assets may be impaired. The Company performs its intangible asset impairment tests on or about June 30, of each year. Any such impairment charge could be significant and could have a material adverse impact on the Company's financial statements if and when an impairment charge is recorded.

Income/(Loss) Per Share

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

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 tax will be for the year. Since judgment is involved, there is a risk that the tax rate may increase or decrease in any period.

In determining income/(loss) for financial statement purposes, management must make certain estimates and judgments. These estimates and judgments occur in the calculation of certain tax liabilities and in the determination of the recoverability of certain deferred tax assets, which arise from temporary differences between the tax and financial statement recognition of revenue and expense. FASB issued authoritative guidance concerning accounting for income taxes also requires that the deferred tax assets be reduced by a valuation allowance if, based on the available evidence, it is more likely 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 December 31, 2016, the Company has recorded a valuation allowance against the Company's deferred tax assets arising from net operating losses due to uncertainty of their realization as a result of the Company's earnings history, the number of years the Company's net operating losses and tax credits can be carried forward, the existence of taxable temporary differences and near-term earnings expectations. The amount of the valuation allowance could decrease if facts and circumstances change that materially increase taxable income prior to the expiration of the loss carryforwards. Any reduction in the valuation allowance would result in an income tax benefit in the period such determination is made by the Company.

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

Stock-Based Compensation

Stock-based compensation expense for all stock-based compensation awards granted after July 1, 2006 is based on the grant-date fair value estimate in accordance with the provisions of the FASB issued guidance. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award. Valuations are based on highly subjective assumptions about the future, including stock price volatility and exercise patterns. The fair value of share-based payment awards was estimated using the Black-Scholes option pricing model. Expected volatilities are based on the historical volatility of the Company's stock. The Company uses historical data to estimate option exercise and employee terminations. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

Results of Operations

Three-month and six-month periods Ended December 31, 2016 and 2015

The following table shows consolidated product revenue, as well as identifying trends in revenues for the three-month and six-month periods ended December 31, 2016 and 2015.

Table amounts are in thousands:

	For the Three-month period ended December 31,	For the Six-month period ended December 31,

	2016	2015	% Change		2016	2015	% Change	
Product Revenue:								
Sonomed-Escalon	$3,163	$2,989	5.8	%	$5,495	$5,770	(4.8	)%
Total	$3,163	$2,989	5.8	%	$5,495	$5,770	(4.8	)%

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Consolidated product revenue increased approximately $174,000, or 5.8%, to $3,163,000 during the three months ended December 31, 2016 as compared to same period of the last fiscal year. The increase in revenue is attributed to an increase of $239,000 in ultrasound products, offset by a decrease of $54,000 in surgical products and a decrease of $11,000 in digital imaging cameras and AXIS image management systems.
Consolidated product revenue decreased approximately $275,000, or 4.8%, to $5,495,000 during the six months ended December 31, 2016 as compared to same period of the last fiscal year. The decrease in revenue is attributed to a decrease of $144,000 in surgical products and a decrease of $168,000 in digital imaging cameras and AXIS image management systems offset by an increase of $37,000 in ultrasound products .

The following table presents consolidated cost of goods sold as a percentage of product revenues for the three months ended December 31, 2016 and 2015. Table amounts are in thousands:

	For the Three-month period ended December 31,				For the Six-month period ended December 31,			
	2016	%	2015	%	2016	%	2015	%
Cost of Goods Sold:								
Sonomed-Escalon	$1,712	54.1%	$1,526	51.1%	$2,964	53.9%	$2,974	51.5%
Total	$1,712	54.1%	$1,526	51.1%	$2,964	53.9%	$2,974	51.5%

Consolidated cost of goods sold totaled approximately $1,712,000, or 54.1%, of product revenue for the three-months ended December 31, 2016, as compared to $1,526,000, or 51.1%, of product revenue, for the same period of the prior fiscal year. The increase of 3.0% in cost of goods sold as a percentage of revenue is due mainly to an increase in lower margin ultrasound product sales.

Consolidated cost of goods sold totaled approximately $2,964,000, or 53.9%, of product revenue for the six-months ended December 31, 2016, as compared to $2,974,000, or 51.5%, of product revenue for the same period of the prior fiscal year. The increase of 2.4% in cost of goods sold as a percentage of revenue is due mainly to a decrease in high margin Axis image management sales.

The following table presents consolidated marketing, general and administrative expenses as well as identifying trends in marketing, general and administrative expenses for the three months and six-months ended December 31, 2016 and 2015. Table amounts are in thousands:

	For the Three-month period ended December 31,			For the Six-month period ended December 31,		
	2016	2015	% Change	2016	2015	% Change
Marketing, General and Administrative:						
Sonomed-Escalon	$1,207	$1,345	(10.3)%	$2,362	$2,611	(9.5)%
Total	$1,207	$1,345	(10.3)%	$2,362	$2,611	(9.5)%

Consolidated marketing, general and administrative expenses decreased $138,000, or 10.3% , to $1,207,000 during the three-months ended December 31, 2016, as compared to the same period of the prior fiscal year. The decrease is due to the decreased hiring expense, consulting expenses, health insurance and stock option expenses.
Consolidated marketing, general and administrative expenses decreased $249,000, or 9.5%, to $2,362,000 during the six-months ended December 31, 2016, as compared to the same period of the prior fiscal year. The decrease is due to the decreased travel expense, meeting and exhibit expense, health insurance, hiring expense offset by increased legal expense in the current period.
The following table presents consolidated research and development expenses for the three-months and six-months ended December 31, 2016 and 2015. Table amounts are in thousands:

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	For the Three-month period ended December 31,			For the Six-month period ended December 31,		
	2016	2015	% Change	2016	2015	% Change
Research and Development:						
Sonomed Escalon	$286	$383	(25.3)%	$596	$743	(19.8)%
Total	$286	$383	(25.3)%	$596	$743	(19.8)%

Consolidated research and development expenses decreased $97,000, or 25.3%, to $286,000 during the three-months ended December 31, 2016, as compared to the same period of the prior fiscal year.

Consolidated research and development expenses decreased $147,000, or 19.8%, to $596,000 during the six-months ended December 31, 2016, as compared to the same period of the prior fiscal year. Research and development expenses were primarily expenses associated with the planned introduction of new or enhanced products. The decrease is mainly related to the decrease in headcount and consulting expense.

Discontinued Operations

During fiscal year 2015 the Company was informed by French Counsel that the total amount claimed by the BHH landlord in the liquidation of BHH was approximately $86,000. The Company did not have insight into the French liquidation process due to the Liquidator's reticence to communicate with the Company. As such, the Company had accrued the present value of the maximum amount potentially due under the lease guaranteed by the Company on behalf of BHH. The landlord's claim under liquidation of approximately $86,000 can not be revisited by the landlord and can only be potentially increased by interest or sundry expenses. Beginning in fiscal year end 2016 any changes to this liability are included in continuing operations. As of December 31, 2016 and June 30, 2016, the liability was approximately $84,000 and $89,000, respectively.

Other Income (expense)

The Company did not have significant other income during the three-months and six-months ended December 31, 2016 and 2015.

The Company incurred related party interest expense of $16,489 and $0 for the three-months periods ended December 31, 2016 and 2015, respectively. The Company incurred related party interest expense of $26,802 and $0 for the six-months periods ended December 31, 2016 and 2015, respectively. The expense expense for short-term debt is $6,000 and $0 for the three-months period and six-months period ended December 31, 2016. See Note 8 to Consolidated Financial Statements for further details.

Liquidity and Capital Resources

The following table presents overall liquidity and capital resources as of December 31, 2016 and June 30, 2016. Table amounts are in thousands:

	December 31, 2016	June 30, 2016
Current Ratio:		
Current assets	$ 4,582	$4,539
Less: Current liabilities	3,282	2,784
Working capital	$ 1,300	$1,755
Current ratio	1.40 to 1	1.63 to 1
Debt to Total Capital Ratio:		
Note payable and line of credit	$ 792	$275
Total debt	792	275
Total equity	1,450	1,910
Total capital	$ 2,242	$2,185
Total debt to total capital	35.3 %	12.6 %

Working Capital Position

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Working capital decreased $455,000 as of December 31, 2016, and the current ratio changed from 1.63 to 1 to 1.40 to 1 when compared to June 30, 2016.
Debt to Total Capital Ratio was 35.3% and 12.6% as of December 31, 2016 and June 30, 2016, respectively.

Cash Used In or Provided By Operating Activities

During the six-month periods ended December 31, 2016 and 2015, the Company experienced cash outflows from operating activities of $517,000 and $594,000, respectively. The net decrease in cash used in operating activities of approximately $77,000 for the six-month period ended December 31, 2016, as compared to the same period in the prior fiscal year is due primarily to the following factors:

For the six-month period ended December 31, 2016, the Company had a net loss of $460,000, experienced net cash out-flows from a decrease in post-retirement benefits of $18,000, a change in liabilities of discontinued operations of $4,000, a decrease in accounts payable and accrued expense of $15,000, an increase in inventory of $108,000 and an increase in other current assets of $53,000. The cash outflows were partially offset by a decrease in accounts receivable of $118,000, and an increase in non-cash expenditures on depreciation and amortization of approximately $24,000.

For the six-month period ended December 31, 2015, the Company had a net loss of $558,000, and experienced net cash in flows from a decrease in accounts receivable of $437,000, an increase in post-retirement benefits of $35,000 and an increase in non-cash expenditures on depreciation and amortization and compensation expense related to stock options of approximately $13,000 and $22,000, respectively. These cash in-flows were offset by a decrease in accounts payable and accrued expense and an increase in inventory of $278,000 and $225,000, respectively, and an increase in other current assets of $40,000.

Cash Flows Used In Investing and Financing Activities

There was no cash flows used in or provided by investing activities during the six-month periods ended December 31, 2016.

Cash flows used in investing activities of $62,000 were due to the purchase of an injection mold for the new hand held GoVu pachymeter during the six-month period ended December 31, 2015.

Cash flows provided by financing captivities during the six-month periods ended December 31, 2016 includes $270,000 of related party note payable and $247,000 of short-term debt.

There were no cash flows used in or provided by financing activities during the six-month periods ended December 31, 2015.

Debt History

On December 29, 2016, the Company entered into a credit agreement providing the Company up to an aggregate of $250,000 in cash, secured by the Company’s inventory. The Company, and its wholly owned subsidiary Sonomed, Inc., entered into an Inventory Advance Agreement as of December 29, 2016 (the "Agreement"), with CDS Business Services, Inc., doing business as Newtek Business Credit ("Newtek"). Newtek may in its discretion make loans against the Company’s Eligible Inventory in an aggregate amount outstanding at any time up to the lesser of (i) fifty percent (50%) of the Inventory Value or (ii) the Inventory Advance Limit, as those terms are defined in the Agreement, which is currently $250,000. The credit agreement renews annually and can be terminated upon 90 days written notice from the Company or 30 days written notice from NewTek.

If, at any time and for any reason, the aggregate amount of the outstanding advances under the Agreement exceeds the Inventory Advance Limit or percentage limitation contained in the preceding sentence, then Company must, upon demand by Newtek, immediately pay to Newtek, in cash, the amount of such excess, or at Newtek’s option Newtek may charge such excess against any reserves held by Newtek.

Newtek will maintain reserves against Company's availability for advances and may maintain reserves against the Company's accounts and/or ineligible inventory as well, or maintain a cash collateral deposit account, as NewTek in its discretion deems appropriate. Newtek may also increase such reserves or reduce its advance percentages based on eligible inventory without declaring an event of default and without prior notice, if it determines, in its discretion, that such increase in reserves or reduction is necessary, including, without limitation, to protect its interest in the collateral and/or against diminution in the value of any collateral, and/or to insure the prospect of payment or performance by Company of its obligations to Newtek are not impaired.

Interest will accrue on the daily balance at the per annum rate of 5.00% above the Prime Rate (currently 3.75%), but not less than 5.0%. The current annual interest rate is 8.75% as of December 29, 2016. The Company's obligations will, at the option of Newtek, (i) from and after the occurrence of an event of default, or (ii) if the Company's obligations are not paid in full by the termination date, bear interest at the per annum rate of 10.00% above the prime rate. All interest payable by under the financing documents will be computed on the basis of a 360 day year for the actual number of days elapsed on the daily balance.

The Company is obligated to pay to Newtek a closing fee equal to 1.00%of the Advance Limit. Upon any renewal of the Agreement, an annual fee will be due from Company equal to 1.00% of the Advance Limit. In consideration of monitoring, ledgering and other administrative functions undertaken by Newtek in connection with the Company's inventory, and the merchant processor, Company is obligated pay Newtek a monthly collateral monitoring fee calculated by multiplying (i) seventy basis points (0.70%) (except during the existence of an Event of Default at which time it shall be 1%) by (ii) the amount of the average daily balances during the calendar month preceding the month for which the calculation is made.

The foregoing description of the Agreement does not purport to be complete and is qualified in its entirety by reference to the Agreement, a copy of which is attached to the Form 8-K report dated December 29, 2016. As of December 31, there is $3,000 overpayment of a transaction fee, reducing the debt balance to $247,000.

Off-Balance Sheet Arrangements and Contractual Obligations

The Company was not a party to any off-balance sheet arrangements during the six-month periods ended December 31, 2016 and 2015.

The following table presents the Company's contractual obligations as of December 31, 2016 (excluding interest):

	Total	Less than 1 Year	2-3 Years	3-5 Years	More than 5 Years
Operating lease agreements	$1,542,513	$1,189,204	$314,762	$38,547	$ —
Line of credit	247,000	247,000	—	—	—
Related party note payable	545,000	545,000	—	—	—
Total	$2,334,513	$1,981,204	$314,762	$38,547	$ —

Item 3. Quantitative and Qualitative Disclosures About Market Risk

None

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 December 31, 2016, 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.

Management determined that there was a material weakness in the internal controls over Equity for the 12 month period ended June 30, 2016. During the prior year 25,000 shares were issued in lieu of cash to a consultant of the Company. In July 2015, 12,500 shares were issued and not timely recorded in the accounting records, in addition, there was no evidence in the Board of Directors minutes that these shares were authorized. The minutes have been updated to reflect that the shares were authorized by the Board of Directors. The Company has implemented enhanced controls to ensure this material weakness does not reoccur in fiscal year 2017.

(B) Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act), during the second fiscal quarter ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 1. Legal Proceedings

See footnote 4 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 the Company's Annual Report on Form 10-K for the year ended June 30, 2016.

Item 6. Exhibits

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

Signatures

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

	Escalon Medical Corp. (Registrant)	
Date: February 14, 2017	By:	/s/ Richard J. DePiano, Jr. Richard J. DePiano, Jr. Chief Executive Officer
Date: February 14, 2017	By:	/s/ Robert O'Connor Robert O'Connor Chief Financial Officer