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ESCALON MEDICAL CORP
Form 10KSB
September 28, 2006

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

FORM 10-KSB

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

For the fiscal year ended June 30, 2006

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.
(NAME OF SMALL BUSINESS ISSUER IN ITS CHARTER)

PENNSYLVANIA
(STATE OR OTHER JURISDICTION OF
INCORPORATION OR ORGANIZATION)

33-0272839
(I.R.S. EMPLOYER
IDENTIFICATION NO.)

565 EAST SWEDESFORD ROAD, SUITE 200, WAYNE, PA 19087
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICE'S INCLUDING ZIP CODE)

610 688-6830
(ISSUER'S TELEPHONE NUMBER)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:
NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
COMMON STOCK, \$0.001 PAR VALUE PER SHARE

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Indicate by check mark whether registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes No

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The revenues for the fiscal year ended June 30, 2006, the most recent fiscal year, were \$29,791,000.

The aggregate market value of the common voting stock held by non-affiliates of the Registrant was approximately \$27,710,483 as of September 20, 2006, based upon the closing sale price of the Common Stock as quoted on the NASDAQ Capital Market.

The number of shares of the Registrant's Common Stock outstanding as of September 20, 2006 is 6,344,657.

DOCUMENTS INCORPORATED BY REFERENCE

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Certain information required by Part III of this Annual Report on Form 10-KSB will be set forth in, and is incorporated by reference from the Registrant's Proxy Statement for the 2006 Annual Meeting of Stockholders.

Transitional Small Business Disclosure Format (Check one). Yes [] No [X]

ESCALON MEDICAL CORP.
ANNUAL REPORT ON FORM 10-KSB
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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PART I

ITEM 1. DESCRIPTION OF BUSINESS

COMPANY OVERVIEW

Escalon Medical Corp. ("Escalon") 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"), 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 Group, Plc ("Drew") and its subsidiaries. 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 in other jurisdictions. The FDA and other governmental authorities require 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.

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 since that date has acquired all of the Drew shares.

DREW BUSINESS

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.

DIABETES TESTING

Drew sells two diabetic testing products: the DS5 and the Hb-Gold. The DS5 instrument, dispenser and associated reagent kit measure long-term glucose control in diabetic patients. The system's small size and ease of use make it ideal for main laboratory, clinic or satellite laboratory settings. The Hb-Gold instrument and associated reagent kit provides for the in vitro measurement of certain genetic diseases of the blood. In the United States, this instrument is available for research only.

HEMATOLOGY

Drew offers a broad array of equipment for use in the field of human and veterinary hematology. Drew's Excell and HC product lines are for use in the field of human hematology, whereas the Hemavet product line is for use in the veterinary field.

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SONOMED BUSINESS

Sonomed develops, manufactures and markets ultrasound systems for diagnostic or biometric applications in ophthalmology. The systems are of four types: A-Scans, B-Scans, High Frequency B-Scans ("UBMs") and pachymeters.

A-SCANS

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The A-Scan provides information about the internal structure of the eye by sending a beam of ultrasound along a fixed axis through the eye and displaying the various echoes reflected from the surfaces intersected by the beam. The principal echoes occur at the cornea, both surfaces of the lens and the retina. The system displays the position and magnitudes of the echoes on an electronic display. The A-Scan also includes software for measuring distances within the eye. This information is primarily used to calculate lens power for implants.

B-SCANS

The B-Scan is primarily a diagnostic tool which supplies information to physicians where the media within the eye are cloudy or opaque. Whereas physicians normally use light, which cannot pass through such media, the ultrasound beam is capable of passing through the opacity and displaying an image of the internal structures of the eye. Unlike the A-Scan, the B-Scan transducer is not in a fixed position; it swings through a 60 degree sector to provide a two-dimensional image of the eye.

PACHYMETERS

The pachymeter uses the same principles as the A-Scan, but the system is tailored to measure the thickness of the cornea. With the advent of refractive surgery (where the cornea is actually cut and reshaped) this measurement has become critical. Surgeons must know the precise thickness of the cornea so as to set the blade to make a cut of approximately 20% of the thickness of the cornea.

UBM

A high frequency / high resolution ultrasound device, designed to provide highly detailed information of the anterior segment of the eye. The UBM is used for glaucoma evaluation, tumor evaluation and differentiation, pre-and post-intraocular lense implantation and corneal refractive surgery. The device allows the surgeons to do precise measurements.

VASCULAR BUSINESS

Vascular develops, manufactures and markets vascular access products. These products are Doppler-guided vascular access assemblies used to locate desired vessels for access. Primary specialty groups that use the device are cardiac catheterization labs and interventional radiologists. The Company's vascular products include the PD Access(TM) and SmartNeedle(TM) lines of monitors, Doppler-guided bare needles and Doppler-guided infusion needles.

PD ACCESS(TM) AND SMARTNEEDLE(TM) MONITORS, NEEDLES AND CATHETER PRODUCTS

These patented devices detect blood flow using Doppler ultrasound technology and differentiate between a venous and arterial vessel. The devices utilize a miniature Doppler ultrasound probe that is positioned within the lumen

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of a vascular access needle. When a Doppler-guided needle pierces the skin of a patient, the probe and monitor can determine if the user is approaching an artery or vein, guiding them to a successful access.

MEDICAL/TREK/EMI BUSINESS

Medical/Trek/EMI develops, manufactures and distributes ophthalmic surgical products under the Escalon Medical Corp. and/or Trek Medical Products names. Vitreoretinal ophthalmic surgeons primarily utilize the products. EMI markets a CFA (Color/Fluorescein Angiography) digital imaging system, designed specifically for ophthalmology. This diagnostic tool, ideal for use in detecting retinal problems in diabetic and elderly patients, provides a high-resolution image, far superior to conventional film in image quality, processing and capture. The instant image display provides users with the necessary clinical information that allows treatment to be performed while the patient is still in the office. 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.

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ADATOSIL(R) 5000 SILICONE OIL ("SILICONE OIL")

Silicone Oil is a specialty product used in worst-case detached retina surgery as a mechanical aid in the reattachment procedure. The Company distributed Silicone Oil until August 13, 1999, at which time the license and distribution rights for the product were sold to Bausch & Lomb Surgical, Inc. for \$2.1 million and additional cash consideration based on future sales through August 12, 2005. (See note 11 of the notes to consolidated financial statements for additional details.) Since August 12, 2005 the Company is no longer receiving any revenue from this product.

ISPAN INTRAOCULAR GASES

The Company distributes two intraocular gas products C3F8 and SF6, which are used by vitreoretinal surgeons as a temporary tamponade in detached retina surgery. Under a non-exclusive distribution agreement with Scott Medical Products ("Scott"), Escalon distributes packages of Scott gases in canisters containing up to 25 grams of gas. Along with the intraocular gases, the Company manufactures and distributes a patented disposable universal gas kit, which delivers the gas from the canister to the patient.

VISCOUS FLUID TRANSFER SYSTEMS

The Company markets viscous fluid transfer systems and related disposable syringe products, which aid surgeons in the process of injecting and extracting Silicone Oil. Adjustable pressures and vacuums provided by the equipment allow surgeons to manipulate the flow of Silicone Oil during surgery.

FIBER OPTIC LIGHT SOURCES

Light source and fiber optic products are widely used by vitreoretinal surgeons during surgery. The Company offers surgeons a complete line of light sources along with a variety of fiber optic probes and illuminated tissue manipulators.

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CFA CAMERA BACK AND MRP RETINAL IMAGING SYSTEMS

The images furnished by the CFA and MRP imaging systems provide a very high level of detail. The systems are being marketed to medical institutions, educational institutions and ophthalmologists for use in connection with the diagnosis of retinal disorders.

RESEARCH AND DEVELOPMENT

The Company conducts development of medical devices for the diagnosis and monitoring of medical disorders in the areas of diabetes, cardiovascular diseases and hematology at the Company's Dallas, Texas, Oxford, Connecticut and Barrow-in-Furness, United Kingdom facilities. The Company conducts medical device and vascular access product development at its New Berlin, Wisconsin facility located near Milwaukee. The development of ultrasound ophthalmic equipment is performed at the Company's Lake Success, New York facility on Long Island. Company-sponsored research and development expenditures for the fiscal years ended June 30, 2006, 2005 and 2004 were approximately \$2,828,000, \$1,893,000 and \$776,000, respectively.

MANUFACTURING AND DISTRIBUTION

The Company leases an aggregate of approximately 69,700 square feet of space at its facilities in Texas, Connecticut and the United Kingdom. These sites are currently used for engineering, product design and development and product assembly. All of the Company's medical devices and consumables for the diagnosis and monitoring of medical disorders in the areas of diabetes, cardiovascular diseases and hematology are distributed from the Company's Dallas, Texas, Oxford, Connecticut and Barrow-in-Furness, United Kingdom facilities (see Business Conditions in liquidity section for additional information).

The Company leases 13,500 square feet of space in New Berlin, Wisconsin, near Milwaukee, for its surgical products and vascular access operations. The facility is currently used for engineering, product

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design and development, manufacturing and product assembly. The Company subcontracts component manufacture, assembly and sterilization to various vendors. The New Berlin manufacturing facility includes a class 10,000 clean room. A class 10,000 clean room is a controlled environment for producing devices while avoiding any significant contaminants. The cleanliness provided by the clean room exceeds the requirements of the FDA. All of the Company's ophthalmic surgical products and vascular access products are distributed from the Company's Wisconsin facility.

The Company designs, develops and services its ultrasound ophthalmic products at its 12,000 square foot facility in Lake Success, New York. The Company has achieved ISO9001 certification at all of its manufacturing facilities for all medical devices, ultrasound devices and consumables the Company produces. ISO9001 requires an implemented quality system that applies to product design. These certifications can be obtained only after a complete audit of a company's quality system by an independent outside auditor. These certifications require that facilities undergo periodic reexamination. European Community ("CE") certification has been obtained for disposable delivery systems, fiber optic light probes, medical devices and consumables for the diagnosis and monitoring of medical disorders in the areas of diabetes,

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cardiovascular diseases and hematology, vascular access products and certain ultrasound models.

The manufacture, testing and marketing of each of the Company's products entails risk of product liability. Product liability insurance is carried by the Company to cover primary risk.

GOVERNMENTAL REGULATIONS

The Company's products are subject to stringent ongoing regulation by the FDA and similar health authorities, and if these governmental approvals or clearances of the Company's products are restricted or revoked the Company could face delays that would impair the Company's ability to generate funds from operations.

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

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

The Company has received CE approval on several of the Company's products that allows the Company to sell the products in the countries comprising the European community. In addition to the CE mark, however, some foreign countries may require separate individual foreign regulatory clearances.

MARKETING AND SALES

The Drew business unit sells its products through internal sales and marketing employees located in the United States and in the United Kingdom as well as through a large network of distributors, both domestic and international. The Sonomed product line is sold through internal sales employees as well as independent sales representatives located in the United States and Europe, to a large network of distributors and directly to medical institutions. Vascular business unit products are marketed domestically through internal sales and marketing employees located in the United States as well as through an independent sales representative in Europe and a network of domestic and foreign distributors that are managed by the Company's sales team. The Medical/Trek/EMI business unit sells its ophthalmic devices and instruments directly to end users through internal sales and marketing employees located at the Company's Wisconsin facility. Sales are primarily made to teaching institutions, key hospitals and eye surgery centers focusing

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primarily on physicians and operating room personnel performing vitreoretinal surgery. The EMI product line is sold through internal sales employees and independent sales representatives in the United States.

SERVICE AND SUPPORT

The Company maintains a full-service program for all products sold. Limited warranties are given on all products against defects and performance. Product repairs are made at the Wisconsin facility for surgical devices, vascular access products and EMI devices. Sonomed's products are serviced at the Company's New York facility. Drew's products are serviced at its Connecticut facility.

THIRD-PARTY REIMBURSEMENT

It is expected that physicians and hospitals will purchase certain of the Company's products and that they in turn will bill various third party payers for health care services provided to their patients using these products. These payers include Medicare, Medicaid and private insurers. Government agencies generally reimburse health care providers at a fixed rate based on the procedure performed. Third party payers may deny reimbursement if they determine that a procedure performed using any one of the Company's products was unnecessary, inappropriate, not cost-effective, experimental, or used for a non-approved indication.

PATENTS, TRADEMARKS AND LICENSES

The pharmaceutical and medical device communities place considerable importance on obtaining patent and trade secret protection for new technologies, products and processes for the purpose of strengthening the Company's position in the market place and protecting the Company's economic interests. The Company's policy is to protect its technology by aggressively obtaining patent protection for substantially all of its developments and products, both in the United States and in selected countries outside the United States. It is the Company's policy to file for patent protection in those foreign countries in which the Company believes such protection is necessary to protect its economic interests. The duration of the Company's patents, trademarks and licenses vary through 2020. The Company has 21 United States patents and 19 patents issued abroad that cover the Company's surgical products and pharmaceutical technology. With respect to the Company's ultrafast laser technology (licensed to IntraLase Corp. ("IntraLase")), 16 patents have been issued in the United States and 11 overseas. Vascular access products are covered by 18 patents, which provide protection in the United States, Europe, Japan and other countries overseas. Drew has approximately 60 patents related to its technology. The Company intends to vigorously defend its patents if the need arises.

While in the aggregate the Company's patents are of material importance to its business taken as a whole, the patents, trademarks and licenses that are the most critical to the Company's ability to generate revenues are the following:

- The Escalon trademark is due for renewal on January 19, 2013, and the Company intends to renew the trademark. The Sonomed trademark was due for renewal on April 16, 2006 and the Company is in the process of renewing the trademark.
- In the Vascular business unit, the Company has two patents that are of material importance. The first patent is an apparatus for the cannulation of blood vessels. This patent will expire on February 23, 2011. The second patent is also an apparatus for the cannulation of blood vessels. This patent will expire on January 11, 2009. The Vascular unit has also one patent application pending for the cannulation of blood vessels with a hypodermic needle.

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- The Company licensed its ultrafast laser system technology to IntraLase. The material terms of the license of the Company's laser patents to IntraLase, which expires in 2013, provide that in exchange for the use of the Company's licensed laser patents, Escalon will receive a 2.5% royalty on product sales that are based on the licensed laser patents, subject to deductions for royalties payable to third parties up to a maximum of 50% of royalties otherwise due and payable to the Company 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 term of the license that is offset against the royalty payments. The material termination provisions of the license of the laser technology are as follows:

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1. Termination by the Company if IntraLase defaults in the payment of any royalty to the Company;
2. Termination by the Company if IntraLase makes any false report to the Company;
3. Termination by the Company if IntraLase defaults in the making of any required report to the Company;
4. Termination by either party due to the commission of any material breach of any covenant or promise by the other party under the license agreement; or
5. Termination of the license 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.

See note 9 of the notes to consolidated financial statements for a description of the Company's legal proceedings with IntraLase.

COMPETITION

There are numerous direct and indirect competitors of the Company in the United States and abroad. These companies include ophthalmic-oriented companies that market a broad portfolio of products including prescription ophthalmic pharmaceuticals, ophthalmic devices, consumer products (such as contact lens cleaning solution) and other eye care products; large integrated pharmaceutical companies that market a limited number of ophthalmic pharmaceuticals in addition to many other pharmaceuticals; and smaller specialty pharmaceutical and biotechnology companies that are engaged in the development and commercialization of prescription ophthalmic pharmaceuticals and products and, to some extent, drug delivery systems. The Company's competitors for medical devices and ophthalmic pharmaceuticals include, but are not limited to Bausch & Lomb, Inc., Alcon Laboratories, Inc., Paradigm Medical, Inc., Quantel, Inc. and Accutome, Inc.

Several large companies dominate the ophthalmic market, with the balance of the industry being highly fragmented. The Company believes that these large companies capture approximately 85% of the overall ophthalmic market. The balance of the market is comprised of smaller companies ranging from start-up entities to established market players. The ophthalmic market in general is intensely competitive, with each company eager to expand its market share. The Company's strategy is to compete primarily on the basis of technological

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innovation to which it has proprietary rights. The Company believes, therefore, that its success will depend in large part on protecting its intellectual property through patents and other governmental regulations. The Company recognizes that there are other innovative companies that may develop competitive strategies.

Sonomed's principal competitors are Alcon Laboratories, Inc, Quantel, Inc. and Accutome, Inc. Management believes that the Company is in a market leadership position. Sonomed has had a leading presence in the ophthalmic ultrasound industry for over 30 years. Management believes that this has helped the Company build a reputation as a long-standing operation that provides a quality product, which has enabled the Company to establish effective distribution coverage within the United States market. The Company seeks to preserve its position in the market through continued product enhancement. Various competitors offering similar products at a lower price could threaten Sonomed's market position. The development of laser technologies for ophthalmic biometrics and imaging may also diminish the Company's market position. This equipment can be used instead of ultrasound equipment in most, but not all, patients. Such equipment, however, is more expensive.

The Medical/Trek/EMI business sells a broad range of ophthalmic surgical and diagnostic products. The more significant products are ISPAN(R) gases and delivery systems. Medical/Trek/EMI also manufactures various ophthalmic surgical products for major ophthalmic companies to be sold under their names. To remain competitive, the Company needs to maintain a low cost operation. There are numerous other companies that can provide this manufacturing service. There are a variety of other devices that directly compete with the camera back marketed by Medical/Trek/EMI.

The Vascular access product line is comprised of disposable devices, and currently Vascular has no direct competition. However, a significantly higher priced non-disposable device that facilitates vascular access is currently being marketed. Vascular produces the only device that can be accommodated within a standard needle for assisting medical practitioners in gaining access to a vessel in the human vascular system. There are no similar devices in the market that enable medical practitioners in gaining access using their normal procedures. The only similar product utilizes a separate ultrasound monitor, but

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no disposables are utilized. When using the competing device, medical practitioners need to look at the monitor while advancing the needle into the patient. The perceived disadvantage of the Company's vascular product is that the retail price is substantially greater than the cost of a traditional needle.

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 the market for the physician office and veterinary office laboratories. Drew's principal competition is Beckman Coulter and Bayer Diagnostics in the human market and IDDEX in the veterinary market. Currently Drew has only a nominal share of these markets, and the Company will seek to increase Drew's market share. The Company's strategy is to market instruments and consumables that are competitive for the low volume users in the domestic and overseas markets. Drew's success will depend on its ability to enhance its current product range and control its production costs. Drew recognizes that other companies may adopt similar strategies which could hinder Drew's ability to increase market share.

HUMAN RESOURCES

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As of June 30, 2006, the Company employed 174 full-time employees and five part-time employees. 98 of the Company's employees are employed in manufacturing, 30 are employed in general and administrative positions, 42 are employed in sales and marketing and 9 are employed in research and development. Escalon's employees are not covered by a collective bargaining agreement, and the Company considers its relationship with its employees to be good.

CAUTIONARY FACTORS THAT MAY AFFECT FUTURE RESULTS

Certain statements contained in, or incorporated by reference in, this report are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, which provide current expectations or forecasts of future events. Such statements can be identified by the use of terminology such as "anticipate," "believe," "could," "estimate," "expect," "forecast," "intend," "may," "plan," "possible," "project," "should," "will," "would," 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, increased legal, accounting and Sarbanes-Oxley compliance costs, defending the Company in litigation matters and the Company's cost saving initiatives. The reader must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by assumptions that fail to materialize as anticipated. Consequently, no forward-looking statement can be guaranteed, and actual results may vary materially. It is not possible to foresee or identify all factors affecting the Company's forward-looking statements, and the reader therefore should not consider the following list of such factors to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions.

The Company cautions the reader to consider carefully these factors as well as the specific factors discussed with each specific forward-looking statement in this annual report and in the Company's other filings with the SEC. In some cases, these factors have impacted, and in the future (together with other unknown factors) could impact, the Company's ability to implement the Company's business strategy and may cause actual results to differ materially from those contemplated by such forward-looking statements. Any expectation, estimate or projection contained in a forward-looking statement may not be achieved.

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

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MARKET EXPECTATIONS.

In the normal course of business, the Company engages in discussions with third parties regarding possible acquisitions, strategic alliances, joint ventures and divestitures. As a result of any such transactions, the Company's financial results may differ from the investment community's expectations in a given quarter. In addition, acquisitions and alliances may require the Company to integrate a different company culture, management team, business infrastructure, accounting systems and financial reporting systems, although such acquisitions or alliances may not occur. The Company may have difficulty developing, manufacturing and marketing the products of a newly acquired company in a way that enhances the performance of the Company's combined businesses or product lines to realize the value from expected synergies. Depending on the size and complexity of an acquisition, the Company's successful integration of the entity depends on a variety of factors including the retention of key employees and the management of facilities and employees in separate geographical areas. These efforts require varying levels of management resources, which may divert the Company's attention from other business operations. The Company acquired Drew during the first quarter of fiscal 2005. Drew does not have a history of producing positive operating cash flows and, as a result, at the time of acquisition, was operating under financial constraints and was under-capitalized and has continued to negatively impact the Company's financial results. 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. The Company loaned approximately \$11,087,000 to Drew. The funds have been primarily used to procure components to build up inventory to support the manufacturing process, to pay off accounts payable and debt of Drew, and to expand the sales and marketing and research and development efforts, to fund new product development and underwrite operating losses since its acquisition. The Company anticipates that further working capital will likely be required by Drew. If the Company does not realize the expected benefits or synergies of such transactions, the Company's consolidated financial position, results of operations and stock price could be negatively impacted. Also, the Company's results may be adversely impacted because of acquisition-related costs, amortization costs for certain intangible assets and impairment losses related to goodwill in connection with such transactions. Finally, acquisitions or alliances by Escalon may not continue to occur, which could impair the Company's growth.

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

The Company is cognizant of the escalating legal expenses and costs associated with the IntraLase matter. The Company, however, is taking all necessary actions to protect its rights and interests under the License Agreement. The Company expects expenses associated with this litigation to adversely impact earnings in the near term.

THE COMPANY'S RESULTS FLUCTUATE FROM QUARTER TO QUARTER.

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

- Acquisitions, such as Drew, and subsequent integration of the acquired company, although such acquisitions may not occur;
- The timing and expense of new product introductions by the Company or its competitors, although the Company might not successfully develop new products and any such new products may not gain market acceptance;
- The cancellation or delays in the purchase of the Company's products;

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- Fluctuations in customer demand for the Company's products;
- Fluctuations in royalty income;
- The gain or loss of significant customers;
- Changes in the mix of products sold by the Company;
- Competitive pressures on prices at which the Company can sell its products; and
- Announcements of new strategic relationships by the Company or its competitors.

The Company sets its spending levels in advance of each quarter based, in part, on the Company's expectations of product orders and shipments during that quarter. A shortfall in revenue, therefore, in any particular quarter as compared to the Company's plan could have a material adverse impact on the

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Company's results of operations and cash flows. Also, the Company's quarterly results could fluctuate due to general market conditions in the healthcare industry or global economy generally, or market volatility unrelated to the Company's business and operating results.

COST SAVING INITIATIVES

The Company has initiated cost saving initiatives that may not be effective in returning the Company to profitability (see Business Conditions section in the liquidity section for information). If these initiatives are insufficient, additional measures may be necessary.

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

The Company's business and financial condition will depend in part upon the market acceptance of the Company's products. The Company's products may not achieve market acceptance. Market acceptance depends on a number of factors including:

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

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

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

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ABILITY TO GENERATE FUNDS FROM OPERATIONS.

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

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

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

The Company has received CE approval on several of the Company's products that allows the Company to sell the products in the countries comprising the European community. In addition to the CE mark, however, some foreign countries may require separate individual foreign regulatory clearances. The

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Company may not be able to obtain regulatory clearances for other products in the United States or foreign markets.

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

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

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

The Company faces intense competition in the medical device and pharmaceutical markets, which are characterized by rapidly changing technology, short product life cycles, cyclical oversupply and rapid price erosion. Many of the Company's competitors have substantially greater financial, technical,

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marketing, distribution and other resources. The Company's strategy is to compete primarily on the basis of technological innovation, reliability, quality and price of the Company's products. Without timely introductions of new products and enhancements, the Company's products will become technologically obsolete over time, in which case the Company's revenues and operating results would suffer. The success of the Company's new product offerings will depend on several factors, including the Company's ability to:

- Properly identify customer needs;
- Innovate and develop new technologies, services and applications;
- Establish adequate product distribution coverage;
- Obtain and maintain required regulatory approvals from the FDA and other regulatory agencies;
- Protect the Company's intellectual property;
- Successfully commercialize new technologies in a timely manner;
- Manufacture and deliver the Company's products in sufficient volumes on time;
- Differentiate the Company's offerings from the offerings of the Company's competitors;
- Price the Company's products competitively;
- Anticipate competitors' announcements of new products, services or technological innovations; and
- Anticipate general market and economic conditions.

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

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

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

If a court determines that any of the Company's products infringes, directly or indirectly, on a patent in a particular market, the court may enjoin the Company from making, using or selling the product.

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Furthermore, the Company may be required to pay damages or obtain a royalty-bearing license, if available, on acceptable terms.

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

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

THE COMPANY'S ABILITY TO MARKET OR SELL THE COMPANY'S PRODUCTS MAY BE ADVERSELY IMPACTED BY LIMITATIONS ON REIMBURSEMENTS BY GOVERNMENT PROGRAMS, PRIVATE INSURANCE PLANS AND OTHER THIRD PARTY PAYORS.

The Company's customers bill various third party payors, including government programs and private insurance plans, for the health care services provided to their patients. Third party payors may reimburse the customer, usually at a fixed rate based on the procedure performed, or may deny reimbursement if they determine that the use of the Company's products was elective, unnecessary, inappropriate, not cost-effective, experimental or used for a non-approved indication. Third party payors may deny reimbursement notwithstanding FDA approval or clearance of a product and may challenge the prices charged for the medical products and services. The Company's ability to sell the Company's products on a profitable basis may be adversely impacted by denials of reimbursement or limitations on reimbursement, compared with reimbursement available for competitive products and procedures. New legislation that further reduces reimbursements under the capital cost pass-through system utilized in connection with the Medicare program could also adversely impact the marketing of the Company's products.

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

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

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

The testing and marketing of the Company's products entails an inherent risk of product liability, resulting in claims based upon injuries or alleged injuries or a failure to diagnose associated with a product defect. Some of these injuries may not become evident for a number of years. Although the Company is not currently involved in any product liability litigation, the Company may be party to litigation in the future as a result of an alleged claim. Litigation, regardless of the merits of the claim or outcome, could consume a great deal of the Company's time and attention away from the Company's

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core businesses. The Company maintains limited product liability insurance coverage of \$1,000,000 per occurrence and \$2,000,000 in the aggregate, with umbrella policy coverage of \$5,000,000 in excess of such amounts. A successful product liability claim in excess of any insurance coverage may adversely impact the Company's financial condition and results of operations. The Company's product liability insurance coverage may not continue to be available to the Company in the future on reasonable terms or at all.

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

The Company derives a portion of its revenue from sales outside the United States. Changes in the laws or policies of governmental agencies, as well as social and economic conditions, in the countries in which the Company operates could impact the Company's business in these countries and the Company's results of operations. Also, economic factors, including inflation and fluctuations in interest rates and foreign currency exchange rates, and competitive factors such as price competition, business combinations of competitors or a decline in industry sales from continued economic weakness, both in the United States and other countries in which the Company conducts business, could adversely impact the Company's results of operations.

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

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

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

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

- Any acquisitions, strategic alliances, joint ventures and divestitures that the Company effects, if any;
- Announcements of technological innovations;
- Changes in marketing, product pricing and sales strategies or new products by the Company's competitors;
- Changes in domestic or foreign governmental regulations or regulatory requirements; and

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- Developments or disputes relating to patent or proprietary rights and public concern as to the safety and efficacy of the procedures for which the Company's products are used.

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

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

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

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

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

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

ITEM 2. DESCRIPTION OF PROPERTY

The Company currently leases an aggregate of approximately 93,700 square feet of space for its (i) corporate offices in Wayne, Pennsylvania, (ii) administrative office and manufacturing facility in Barrow-in-Furness, United Kingdom, (iii) administrative office and manufacturing facility in Dallas, Texas, (iii) manufacturing facility in Lake Success, New York, (iv) manufacturing facility in New Berlin, Wisconsin, and (v) manufacturing facility in Oxford, Connecticut. The corporate offices in Pennsylvania cover approximately 7,100 square feet and expire in April 2008. The facility in the United Kingdom covers approximately 16,000 square feet and consists of three buildings whose leases expire in September 2006 and August 2007 and September 2009. The lease expiring in September 2006 will not be renewed and Drew will lease a smaller 6,000 square foot facility in its place, reducing overall square footage in Barrow by 7,000 square feet. The facility in Texas covers approximately 34,400 square feet and consists of three buildings whose leases expire in March 2007. Drew is renegotiating the lease on two of its Dallas facilities, one of the buildings will be closed and the remaining larger building will house the

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majority of Drew US operations (see footnote 1 of financial statements). The New York facility leases, covering approximately 12,200 square feet, and they expire in October 2011. The Wisconsin lease, covering approximately 13,500 square feet of space expires in April 2007. The Connecticut facility lease consists of two separate areas within the same building. The leases cover approximately 12,000 square feet and expire in January 2007 and 2008. Annual rent under all of the Company's lease arrangements was approximately \$772,000.

ITEM 3. LEGAL PROCEEDINGS

INTRALASE CORP. LEGAL PROCEEDINGS

In October 1997, the Company and IntraLase entered into a License Agreement wherein the Company granted IntraLase the exclusive right to use the Company'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 the Company 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, the Company gave IntraLase notice of its intention to terminate the License Agreement due to IntraLase's failure to pay certain royalties that the Company 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 the Company 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 the Company ("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 the Company filed cross-motions for summary judgment. On May 5, 2005, the District Court, having ruled on such motions, entered judgment in the First Action.

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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 the Company 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 the Company. 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 the Company royalties on IntraLase's accounts receivable. The court also held that IntraLase must give the Company 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 the Company 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.

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IntraLase has appealed the judgment to the United States Court of Appeals for the Ninth Circuit. The parties have submitted briefs to the court. The Company 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 the Company 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 the Company and a declaration concerning the Company'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. The Company, 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, the Company 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 lawsuitsought a ruling on issues already raised by the Company in the Company's Delaware Action. Accepting the Company'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, the Company, 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, the Company 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 the Company.

On February 21, 2006, the Company again gave IntraLase notice of its intention to terminate the License Agreement due to IntraLase's failure to pay certain royalties that the Company believed were due under the License Agreement as well as IntraLase's refusal to permit the Company 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 the Company to audit IntraLase's records and books of account and, instead, conditioned any inspection by the Company'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 the Company. On the same day, the Company filed its First Amended Complaint in the Delaware Action adding to its pending claims a claim for declaratory relief wherein the Company seeks a judgment declaring that the License Agreement terminated fifteen days after IntraLase received the Company's notice of defaults and intent to terminate and failed to cure said defaults.

On February 28, 2006, the Company agreed to suspend the cure periods applicable to the alleged breaches set out in its February 21, 2006 letter while

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the Company 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 independent auditor to IntraLase's headquarters in early September, 2006 to commence the audit review, which is continuing. The Company is desirous of concluding this audit in October, 2006.

Separately, on April 22, 2005, the Company, 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, the Company 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 November 8, 2006.

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

DREW LEGAL PROCEEDINGS

CARVER LITIGATION-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

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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.

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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 for 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.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II.

ITEM 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

Escalon's Common Stock trades on the Nasdaq SmallCap Market under the symbol "ESMC." The table below sets forth, for the periods indicated, the high and low sales prices as quoted on the Nasdaq SmallCap Market.

| | HIGH | LOW |
|----------------------------------|---------|--------|
| | ----- | ----- |
| FISCAL YEAR ENDED JUNE 30, 2006 | | |
| Quarter ended September 30, 2005 | \$ 9.08 | \$5.71 |
| Quarter ended December 31, 2005 | \$ 5.85 | \$4.54 |
| Quarter ended March 31, 2006 | \$ 5.99 | \$4.59 |
| Quarter ended June 30, 2006 | \$ 5.34 | \$4.40 |

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| | | |
|----------------------------------|---------|--------|
| FISCAL YEAR ENDED JUNE 30, 2005 | | |
| Quarter ended September 30, 2004 | \$15.43 | \$5.92 |
| Quarter ended December 31, 2004 | \$13.99 | \$7.70 |
| Quarter ended March 31, 2005 | \$ 9.08 | \$4.62 |
| Quarter ended June 30, 2005 | \$ 8.49 | \$3.70 |

As of September 20, 2006, there were 1,361 holders of record of the Company's Common Stock. On September 20, 2006 the closing price of Escalon's Common Stock as reported by the Nasdaq SmallCap Market was \$4.40 per share.

Escalon has never declared or paid a cash dividend on its common stock and presently intends to retain any future earnings to finance future growth and working capital needs.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

SELECTED FINANCIAL DATA

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The following selected financial data are derived from the consolidated financial statements of the Company. The data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included herein in Item 6 and the financial statements and related notes to consolidated financial statements thereto included herein in Item 7.

| | FOR THE YEARS ENDED JUNE 30, | | | | |
|---|--|--------------|--------------|--------------|--------------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| | (AMOUNTS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | | | | |
| STATEMENT OF OPERATIONS DATA: | | | | | |
| NET REVENUES: | | | | | |
| Product revenue | \$27,544 | \$23,864 | \$12,348 | \$11,191 | \$10,200 |
| Other revenue | 2,247 | 3,060 | 2,373 | 2,175 | 1,700 |
| | 29,791 | 26,925 | 14,721 | 13,366 | 12,000 |
| COSTS AND EXPENSES: | | | | | |
| Cost of goods sold | 16,004 | 13,158 | 5,476 | 4,896 | 4,600 |
| Marketing, general and administrative | 13,995 | 12,556 | 5,206 | 780 | 5,000 |
| Research and development | 2,828 | 1,893 | 776 | 5,034 | 5,000 |
| Writedown of license and distribution rights | 0 | 0 | 0 | 196 | 0 |
| | 32,827 | 27,607 | 11,458 | 10,906 | 10,200 |
| (LOSS) INCOME FROM OPERATIONS | (3,036) | (683) | 3,263 | 2,460 | 1,700 |
| OTHER (EXPENSE) AND INCOME: | | | | | |
| Gain on sale of available for sale securities | 1,157 | 3,412 | 0 | 0 | 0 |
| Loss from termination of joint venture | 0 | 0 | 0 | 0 | 0 |
| Equity in Ocular Telehealth Management, LLC | (174) | (64) | 0 | 0 | 0 |
| Interest income | 162 | 69 | 59 | 3 | 0 |
| Interest expense | (64) | (55) | (407) | (638) | (700) |
| | 1,157 | 3,412 | 0 | 0 | 0 |

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| | | | | | |
|---|------------|----------|----------|----------|-------|
| TOTAL OTHER (EXPENSE) AND INCOME | 1,081 | 3,362 | (347) | (635) | (8) |
| NET (LOSS) INCOME BEFORE TAXES | (1,956) | 2,680 | 2,915 | 1,825 | 9 |
| Provision for income taxes | 31 | 232 | 173 | 112 | |
| NET (LOSS) INCOME | \$ (1,987) | \$ 2,448 | \$ 2,742 | \$ 1,713 | \$ 9 |
| BASIC NET (LOSS) INCOME PER SHARE | \$ (0.32) | \$ 0.42 | \$ 0.70 | \$ 0.51 | \$ 0. |
| DILUTED NET (LOSS) INCOME PER SHARE | \$ (0.32) | \$ 0.39 | \$ 0.64 | \$ 0.48 | \$ 0. |
| WEIGHTED AVERAGE SHARES - BASIC USED IN PER SHARE CALCULATION | 6,152 | 5,832 | 3,897 | 3,365 | 3,3 |
| WEIGHTED AVERAGE SHARES - DILUTED USED IN PER SHARE CALCULATION | 6,152 | 6,231 | 4,304 | 3,573 | 3,3 |

AT JUNE 30,

| 2006 | 2005 | 2004 | 2003 | 2002 |
|------|------|------|------|------|
|------|------|------|------|------|

(AMOUNTS IN THOUSANDS)

BALANCE SHEET DATA:

| | | | | | |
|--|----------|----------|-----------|----------|----------|
| Cash and cash equivalents | \$ 3,380 | \$ 5,116 | \$ 12,602 | \$ 298 | \$ 221 |
| Working capital (deficit) | 10,616 | 13,613 | 13,966 | 889 | (240) |
| Total assets | 38,645 | 40,049 | 29,457 | 16,890 | 16,912 |
| Long-term debt, net of current portion | 163 | 392 | 2,396 | 4,080 | 5,191 |
| Total liabilities | 5,545 | 5,530 | 5,996 | 7,951 | 9,719 |
| Accumulated deficit | (34,122) | (32,136) | (34,585) | (37,326) | (39,039) |
| Total shareholders' equity | 33,100 | 34,519 | 23,461 | 8,939 | 7,193 |

No cash dividends were paid in any of the periods presented.

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The following discussion and analysis should be read together with the consolidated financial statements and notes thereto and other financial information contained elsewhere in this Form 10-KSB and the discussion under "Cautionary Factors that May Affect Future Results" included in Part I of this Form 10-KSB.

Escalon operates primarily in four reportable business segments: Drew, Sonomed, Vascular and Medical/Trek/EMI. 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. Sonomed develops, manufactures and markets ultrasound systems used for diagnosis or biometric applications in ophthalmology. Vascular develops, manufactures and markets vascular access products. Medical/Trek/EMI develops, manufactures and distributes ophthalmic surgical products under the Escalon Medical Corp. and/or Trek Medical Products

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names and manufactures and markets digital camera system for ophthalmic fundus photography. For a more complete description of these businesses and their products, see Item 1 - Description of Business.

EXECUTIVE OVERVIEW - FISCAL YEARS ENDED JUNE 30, 2006 AND 2005

The following highlights are discussed in further detail within this Form 10-KSB. The reader is encouraged to read this Form 10-KSB in its entirety to gain a more complete understanding of factors impacting Company 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 since that date has acquired all of the Drew shares. The Company has been operating Drew as a separate business unit since its acquisition, and Drew's results of its operations are included in the "Management's Discussion and Analysis or Plan of Operation" for all periods since the acquisition in July 2004. Prior to the acquisition, Drew's ability to obtain raw materials and components was severely restricted due to prolonged liquidity constraints. These constraints were pervasive throughout all of Drew's locations and affected all aspects of Drew's operations. The Company's operational priorities with respect to Drew have been to stabilize and increase Drew's revenue base and to infuse Drew with working capital in the areas of manufacturing, sales and marketing and product development in an effort to remove the pre-acquisition liquidity constraints (see "Business Conditions" in Liquidity and Capital Resource section).
- 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.
- Product revenue increased approximately 15.4% during fiscal year ended June 30, 2006 as compared to the prior fiscal year. The increase is primarily related to strong sales in the Company's Drew, Sonomed, Vascular and Medical/Trek/EMI business units. Sales at these business units increased approximately 26.2%, 1.0%, 14.5% and 10.8%, respectively, during the fiscal year ended June 30, 2006 when compared to the prior 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 16 to the notes to 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.
- Other revenue decreased approximately \$813,287 or 26.4% during the fiscal year ended June 30, 2006 as compared to the prior fiscal year. The decrease primarily relates to a decrease in royalty payments received from Bauch & Lomb in connection with the Silicone Oil product line. During the fiscal years ended June 30, 2006 and 2005, approximately .6% and 5.5%, respectively, of the Company's net revenue was received from the Bauch & Lomb contract, which expired in August

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2005. Accordingly, the Company will receive no additional revenue related to this contract. The decrease in royalties from Bauch & Lomb was partially offset by increases in royalties from IntraLase and Bio Rad.

- Cost of goods sold as a percentage of product revenue increased to approximately 58.1% of revenues during the fiscal year ended June 30, 2006, as compared to approximately 55.1% of product revenue for the prior 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 fiscal year ended June 30, 2006 increased to approximately 51.0% of product revenue from approximately 44.6% in the prior fiscal year.

- Operating expenses increased approximately 16.4% during the fiscal year ended June 30, 2006 as compared to the prior fiscal year. During the fiscal year ended June 30, 2006, the Company incurred higher personnel costs to support the growth in the Company's business operations, higher advertising, sales and marketing salaries, travel and trade show costs related to the higher sales volumes and higher expenses associated with the integration of the MRP and existing EMI product lines. (The MRP acquisition closed on January 30, 2006. See note 12 of the notes to consolidated financial statements.) Research and development costs also increased to support introductions and planned introductions of new and or enhanced products, especially in the Drew and Sonomed business units. In addition, the Company continues to experience a high amount of legal and accounting fees primarily related to IntraLase litigation costs, increased auditors fees in proportion to the increase in the Company's size due to the acquisition of Drew and costs related to compliance with the Sarbanes-Oxley Act of 2002, which fees and costs exceeded \$500,000. While the Company expects these legal, accounting and compliance expenses to impact earnings in the near term, it does not believe that all of these expenses will continue in the future at such high levels.

RESULTS OF OPERATIONS

FISCAL YEARS ENDED JUNE 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 fiscal years ended June 30, 2006 and 2005. Table amounts are in thousands:

| | FISCAL YEARS ENDED JUNE 30, | | |
|------------------|-----------------------------|----------|----------|
| | 2006 | 2005 | % CHANGE |
| | ----- | ----- | ----- |
| PRODUCT REVENUE: | | | |
| Drew | \$14,253 | \$11,294 | 26.2% |
| Sonomed | 7,737 | 7,663 | 1.0% |
| Vascular | 3,640 | 3,180 | 14.5% |
| Medical/Trek/EMI | 1,914 | 1,727 | 10.8% |
| | ----- | ----- | ---- |
| TOTAL | \$27,544 | \$23,864 | 15.4% |
| | ===== | ===== | ===== |

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Product revenue increased approximately \$3,680,000, or 15.4%, to \$27,544,000 during the year ended June 30, 2006 as compared to the last fiscal year. In the Drew business unit, product revenue increased \$2,959,000, or 26.2% as compared to last fiscal year. The increase is primarily due to additional sales in the domestic and international markets of diabetics and hematology instruments. Sales of spare parts and reagents and controls, which are used to operate the instruments, also increased during the period to support the increase in the installed base of the related instruments.

Product revenue increased \$74,000, or 1%, to \$7,737,000 in the Sonomed business unit as compared to the last fiscal year. The increase in product revenue was primarily caused by an increase in sales of the Company's EZ AB scan ultrasound systems and an increase in export sales, which were partially offset by a decrease in domestic sales and in demand for the Company's pachymeter product. The domestic market for pachymeters had previously expanded due to enhanced techniques in glaucoma

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screening performed by optometrists, who had historically not been users of the pachymeter. Domestic demand for the pachymeter returned to historic levels during the fourth quarter of fiscal 2004 due to market saturation and increased price competition within the marketplace.

Product revenue increased \$460,000, or 14.5%, to \$3,640,000, at the Vascular business unit during the year ended June 30, 2006 as compared to last fiscal year. The increase in product revenue in the Vascular business unit was primarily caused by an increase in direct sales to end users by the Company's domestic sales team. These increases were partially offset by decreases in revenue from the Company's distributor network. The Company terminated its relationship with several of its distributors during fiscal year 2005. In the Medical/Trek/EMI business unit, product revenue increased \$187,000 or 10.8% to \$1,914,000 during the year ended June 30, 2006 as compared to the last fiscal year. The increase in Medical/Trek/EMI product revenue is primarily attributed to an increase in the Trek business unit revenue from Bausch & Lomb. Also contributing to the increase was an increase in EMI sales of digital imaging systems from the MRP acquisition. (See note 12 of the notes to consolidated financial statements.)

Other revenue decreased by approximately \$813,000, or 26.5%, to \$2,246,000 during the fiscal year ended June 30, 2006 as compared to the prior fiscal year. The decrease is primarily due to an approximately \$1,283,000 decrease in royalties received from Bausch & Lomb in connection with their sales of Silicone Oil. The Company's contract with Bausch & Lomb called for annual step-downs in the calculation of Silicone Oil revenue to be received by the Company from 64% from August 13, 2003 to August 12, 2004 to 45% from August 13, 2004 to August 12, 2005. The Company's contract with Bausch & Lomb ended in August 2005, and accordingly, the Company received no royalties after the termination date and will receive no future royalties under this agreement. (See note 11 of the notes to 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 increased by approximately \$51,000 to \$282,508 due to higher 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.

The following table presents consolidated cost of goods sold by reportable

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business unit and as a percentage of related unit product revenues for the fiscal years ended June 30, 2006 and 2005. Table amounts are in thousands:

| | FISCAL YEARS ENDED JUNE 30, | | | |
|---------------------|-----------------------------|-------|----------|-------|
| | 2006 | % | 2005 | % |
| COST OF GOODS SOLD: | | | | |
| Drew | \$ 9,225 | 64.7% | \$ 7,554 | 66.9% |
| Sonomed | 3,962 | 51.2% | 3,115 | 40.7% |
| Vascular | 1,535 | 42.2% | 1,432 | 45.0% |
| Medical/Trek/EMI | 1,282 | 67.0% | 1,058 | 61.3% |
| TOTAL | \$16,004 | 58.1% | \$13,159 | 55.1% |

Cost of goods sold totaled approximately \$16,004,000, or 58.1% of product revenue, for the fiscal year ended June 30, 2006 as compared to \$13,159,000 or 55.1% of product revenue, for the prior fiscal year. Cost of goods sold in the Drew business unit totaled \$9,225,000, or 64.7% of product revenue, for the fiscal year ended June 30, 2006 as compared to \$7,554,000, or 66.9% of product revenue, for the prior fiscal year. The decrease in the cost of goods sold as a percentage of revenue was due to a shift in the mix of products sold and a decrease in manufacturing gains experienced in the prior fiscal year. 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 \$3,962,000, or 51.2% of product revenue, for the fiscal year ended June 30, 2006 as compared to \$3,115,000, or 40.7% of product revenue, for prior fiscal year. The primary reason for the increase was an increase in the percentage of international sales during the period. The Company historically experiences a lower selling price per unit on its international product sales. In addition, the Company experienced a significantly higher margin in the prior year on pachymeters sales due to significant market demand. The demand returned to normal commencing

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in the fourth quarter of fiscal 2004. Cost of goods sold in the Vascular business unit totaled \$1,535,000, or 42.2% of product revenue, for fiscal year ended June 30, 2006 as compared to \$1,432,000, or 45.0% of product revenue, for the last fiscal year. The Company experienced lower overtime and higher production efficiencies in the current period as compared to the prior year. Cost of goods sold in the Medical/Trek/EMI business unit totaled \$1,282,000, or 67% of product revenue, for fiscal year ended June 30, 2006 as compared to \$1,058,000, or 61.3% of product revenue, during the same period last fiscal year. Fluctuations in Medical/Trek/EMI cost of goods sold primarily emanates from product mix, which was primarily controlled by market demand. Further contributing to the increase was the integration of MRP into the existing EMI product lines.

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 fiscal years ended June 30, 2006 and 2005. Table amounts are in thousands:

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| | FISCAL YEARS ENDED JUNE 30, | | |
|--|-----------------------------|----------|----------|
| | 2006 | 2005 | % CHANGE |
| MARKETING, GENERAL AND ADMINISTRATIVE: | | | |
| Drew | \$ 6,006 | \$ 4,104 | 46.4% |
| Sonomed | 2,098 | 1,608 | 30.5% |
| Vascular | 1,682 | 1,424 | 18.2% |
| Medical/Trek/EMI | 4,209 | 5,420 | -22.4% |
| TOTAL | \$13,995 | \$12,556 | 11.5% |

Marketing, general and administrative expenses increased \$1,439,000, or 11.5%, to 13,995,000 during the fiscal year ended June 30, 2006 as compared to the prior fiscal year. Marketing, general and administrative expenses in the Drew business unit increased \$1,902,000, or 46.4%, to \$6,006,000 as compared to the same period last fiscal year. The increase is primarily due to higher personnel and advertising costs related to improving the image of the Drew brand with both customers and distributors, improving the product distributor network and expanding the management team, which ultimately helped contribute to the 11.5% increase in product revenue when compared to the corresponding prior year period.

Marketing, general and administrative expenses in the Sonomed business unit increased by \$490,000, or 30.5%, to \$2,098,000 as compared to the prior fiscal year. The increase is due primarily to increased personnel, travel and advertising and trade show expenses related to the expansion into international markets and the roll out of Sonomed's new UBM Instrument.

Marketing, general and administrative expenses in the Vascular business unit increased \$258,000, or 18.2%, to \$1,682,000 as compared to the same period last fiscal year. Sales salaries and other personnel-related expenses increased approximately \$157,000, travel related expenses for sales personnel increased by approximately \$90,000, advertising increased by approximately \$9,000 and the expense for customer samples increased by approximately \$19,000 when compared to the prior fiscal year. All of the increases were related to supporting a higher volume of business during the current period as compared to the same period in the prior fiscal year. Legal expenses increased \$49,000 over the prior period due to additional patent applications, planning and review.

Marketing, general and administrative expenses in the Medical/Trek/EMI business unit decreased \$1,211,000 or 22.4% to \$4,209,000 as compared to last fiscal year. Of the decrease, \$1,087,000 is due to a one-time supplemental retirement benefit awarded in June 2005 to the Company's Chairman and CEO (see note 10 to the consolidated financial statements). EMI marketing, general and administrative expenses increased to \$560,000 from \$222,000 experienced last year due mainly to the integration of MRP with the EMI lines, and the joint marketing and integration of the Company's product line with Anka Systems. Legal expenses were \$754,000, a 22,000 increase over last year. The Company expects litigation costs due to Interlase and other matters to continue to impact earnings in the near term.

Research and development expenses increased \$935,000, or 49.4%, to \$2,828,000 during the fiscal year ended June 30, 2006 as compared to the prior fiscal year. Drew accounted for \$1,734,000 of the \$2,828,000 incurred for the year. These funds relate to the continued research on Drew's two new

instruments the Drew 360 and the XL22. Approximately \$510,000 was incurred during the period by Sonomed as it finalized the development of its new UBM Instrument. The remainder was incurred on various projects by legacy Escalon Companies to continue to enhance and improve their product lines.

Gain on sale of available for sale securities was approximately \$1,157,000 and \$3,412,000 for the fiscal years ended June 30, 2006 and 2005, respectively. The decrease was due to the sale of fewer shares of IntraLase common stock in July 2005. (See note 16 of the notes to consolidated financial statements.)

The Company recognized a loss of approximately \$174,000 and \$64,000 related to its investment in Ocular Telehealth Management ("OTM") during the fiscal years ended June 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 consolidated financial statements.)

Interest income was \$162,000 and \$69,000 for the fiscal years ended June 30, 2006 and 2005, respectively. The increase was due to higher cash balances and effective yields on investments.

Interest expense was \$64,000 and \$55,000 for the fiscal years ended June 30, 2006 and 2005 respectively. The Company paid off several of its debt facilities to several entities in advance of their maturities during the fiscal year ended June 30, 2005. Additionally, the Company reversed accrued loan commitment fees as a result of the satisfaction of the debt and the release by the lender of those fees. The fees were originally accrued based on contract terms.

LIQUIDITY AND CAPITAL RESOURCES

The following table presents overall liquidity and capital resources from continuing operations during the fiscal years ended June 30, 2006 and 2005. Table amounts are in thousands:

| | JUNE 30, | |
|--------------------------------------|-----------|-----------|
| | 2006 | 2005 |
| | ----- | ----- |
| CURRENT RATIO: | | |
| Current assets | \$ 14,911 | \$ 17,665 |
| Less: Current liabilities | 4,295 | 4,052 |
| | ----- | ----- |
| WORKING CAPITAL | \$ 10,616 | \$ 13,613 |
| | ===== | ===== |
| CURRENT RATIO | 3.5 TO 1 | 4.4 TO 1 |
| | ===== | ===== |
| DEBT TO TOTAL CAPITAL RATIO: | | |
| Notes payable and current maturities | \$ 233 | \$ 230 |
| Long-term debt | 163 | 392 |

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| | | |
|-----------------------------|-----------|-----------|
| Total debt | \$ 396 | \$ 622 |
| Total equity | 33,100 | 34,519 |
| TOTAL CAPITAL | \$ 33,496 | \$ 35,141 |
| TOTAL DEBT TO TOTAL CAPITAL | 1.2% | 1.8% |

WORKING CAPITAL POSITION

Working capital decreased \$2,997,000 as of June 30, 2006 and the current ratio decreased to 3.5 to 1 from 4.4 to 1 when compared to June 30, 2005. The decrease in working capital was caused primarily by a decrease in cash of \$1,736,000 from \$5,116,000 to \$3,380,000 in 2005 and 2006, respectively. Available for sale securities dropped \$1,157,000 from \$1,207,000 in 2005 to \$50,000 in 2006. Accounts receivable declined \$756,000 from \$4,752,000 in 2005 to \$3,996,000 in 2006. Overall total current assets decreased

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\$2,754,000 from \$17,645,000 in 2005 to \$14,911,000 in 2006. Total current liabilities which consist of current portion of long term debt, accounts payable and accrued expenses increased \$243,000, from \$4,052,000 in 2005 to \$4,295,000 in 2006.

CASH USED IN OPERATING ACTIVITIES

During fiscal 2006, the Company used approximately \$2,605,000 of cash for operating activities. In fiscal 2005, the Company used approximately \$3,350,000 in operating activities. The net increase in cash generated from operating activities of approximately \$745,000 in fiscal 2006 as compared to fiscal 2005 is due primarily to the following factors:

- Income/loss from operations decreased approximately \$4,434,000 in fiscal 2006 as compared to fiscal 2005, from net income in 2005 of \$2,448,000 to a net loss in 2006 of \$1,986,000. The net loss in 2006 was driven by net losses at our Drew division of approximately \$2,500,000 offset by net income in legacy Escalon companies of approximately \$600,000. The loss at Drew was primarily driven by increased marketing and advertising expenses, research and development and the compression of gross margins on instrument sales. The swing from net income of \$2,448,000 in 2005 to a net loss of \$1,985,000 in 2006 was offset by the following items:
- The Company, during fiscal 2005, utilized approximately \$1,882,000 of cash to fund planned increases in inventory, primarily at its Drew and Sonomed business units. Prior to its acquisition by Escalon, Drew's ability to obtain raw materials and components was severely restricted due to prolonged liquidity constraints. Escalon's operating priorities included injecting working capital into Drew to remove the pre-acquisition liquidity constraints. Inventories increased at the Sonomed business unit to support planned introduction of new products. The cash spent in 2006 for increases in inventory were \$1,189,000 or \$693,000 lower than in the prior year. In addition, during 2005, Escalon had a gain on sale of marketable securities of \$3,412,000 compared to \$1,157,000 in 2006.

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- The Company also utilized approximately \$2,169,000 of cash to fund increases primarily in Drew accounts receivable and reductions in Drew's accounts payable and accrued liabilities. The increase in receivables is due primarily to higher sales volume in the 4th quarter of fiscal 2005 and the reduction in payables and accruals is primarily due to the injection of working capital into Drew by Escalon to help remove Drew's pre-acquisition liquidity constraints. By contrast the changes in the accounts receivable and accounts payable accounts during 2006 resulted in a net increase in cash flow from operations of \$992,000 and compared to a net decrease in 2005 of \$2,169,000.

CASH FLOWS USED IN INVESTING AND FINANCING ACTIVITIES

Cash flows generated by investing activities for 2006 were approximately \$783,000. This amount is made up of sales of available for sale securities of \$1,157,000 (Interlase stock see note 16 of the consolidated financial statements) offset by purchases of fixed assets of \$327,000 and net cash used to purchase MRP of \$47,000.

Cash flows generated by investing activities of approximately \$2,187,000 during fiscal 2005 relate primarily to the net proceeds of approximately \$3,412,000 realized on the sale of a portion of the IntraLase securities held by the Company as available for sale securities and cash acquired as part of the Drew acquisition. The securities that were sold were originally acquired in connection with the license of intellectual laser properties to IntraLase (see note 16 to the consolidated financial statements). Partially offsetting the cash realized on the securities sale were costs related to the Drew acquisition of approximately \$1,015,000, the Company's \$256,000 investment in OTM and the purchase of fixed assets during 2005. During the fiscal year ended June 30, 2004, in addition to the Drew acquisition costs discussed above, the Company had approximately \$231,000 of expenditures related to the Drew acquisition that were classified as other current assets until the transaction was finalized in fiscal 2005. Otherwise, cash flows used in investing activities related solely to the purchase of fixed assets for the fiscal year ended June 30, 2004. Any necessary capital expenditures have generally been funded out of cash from operations, and the Company is not aware of any factors that would cause historical capital expenditure

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levels to not be indicative of capital expenditures in the future and, accordingly, does not believe that the Company will have to commit material resources to capital investment for the foreseeable future.

Cash flows provided by financing activities in the amount of \$147,000 during 2006 relate to repayment of debt of \$227,000, offset by the proceeds from the issuance of common stock options of \$374,000.

Cash flows used in financing activities were approximately \$6,318,000 during the fiscal year ended June 30, 2005. The Company paid off all of the Company's pre-acquisition debt as well as substantially all of the debt acquired from Drew. The Company paid off debt of approximately \$6,348,000 during the fiscal year ended June 30, 2005. See "Debt History" for more information regarding repayment of the Company's debt facilities.

BUSINESS CONDITIONS:

Due to Drew losing approximately \$2.5 million in fiscal 2006, management

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has re-evaluated the Drew business model and has devised a plan to enhance the ability of Drew to operate profitably. The following actions are currently under way and are expected to be completed by approximately November 7, 2006.

The Company is moving Drew's Connecticut manufacturing facility to its Dallas location. This move is expected to result in an annual savings of approximately \$391,000 in salaries and benefits, and facility savings of approximately \$149,000 for a total annual savings of approximately \$540,000. The implementation of this move to Texas began in August and is expected to be finished by approximately November 7, 2006.

The Drew Barrow, UK facility has been modified to reflect efficiencies we plan to achieve in our Dallas location. The elimination of redundant positions in Barrow is expected to result in salary reductions of approximately \$416,000. The lease on one of the Barrow properties has expired and will not be renewed, because the building was under utilized and is no longer needed. Total annual cash flow savings is expected to be approximately \$100,000. Finally, other savings related to the reduction of our footprint in the UK (IT, storage, vehicles, etc.) is estimated to be approximately \$51,000. Total annual cost reductions for Barrow is expected to be approximately \$567,000.

Concurrent with the move of Connecticut to Dallas we are implementing cost reductions in Dallas. The elimination of redundant positions is expected to result in a reduction of salaries and benefits by approximately \$294,000, these reductions were made in September 2006. In addition, Drew is renegotiating two of its leases in Dallas. The renegotiation allows Drew to close one of its buildings and renew a lease on the larger facility. The Dallas facility will house the majority of Drew US operations with a modest sales office located in Connecticut. The facility changes are expected to result in a reduction of approximately \$146,000 per year. Total reductions in Dallas are expected to be \$440,000 per year once fully implemented.

Summary of Drew anticipated reductions:

| | |
|----------------------------------|-------------|
| A. Connecticut | \$ 540,000 |
| B. Barrow | \$ 567,000 |
| C. Dallas | \$ 440,000 |
| | ----- |
| Total Anticipated Annual Savings | \$1,547,000 |
| | ===== |

Additionally, redundant or non-essential positions were identified at our corporate headquarters. These positions were eliminated in August and September of 2006 for anticipated savings in salaries and benefits of \$372,000, bringing total cost reductions when fully implemented to approximately \$1.9 million. Due to severance and other costs related to the plan approximately \$700,000 of these reductions are expected to be realized in fiscal 2007.

Management anticipates that these cuts combined with budgeted increased profits in legacy Escalon entities and the continued growth of our Interlase royalty revenue stream will return the Company to profitability.

DEBT HISTORY

Drew has long-term debt facilities through the Texas Mezzanine Fund and through Symbiotics, Inc. The Texas Mezzanine Fund debt provided for interest at

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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 June 30, 2006 and 2005, 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 June 30, 2006 was approximately \$278,717. 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 June 30, 2006 was approximately \$116,671.

On December 23, 2002, a lender acquired the Company's bank debt, which consisted of term debt of \$5,850,000 and \$1,475,000 outstanding on a \$2,000,000 available line of credit. On February 13, 2003, the Company entered into an amended agreement with the lender. The primary amendments of the amended loan agreement were to reduce quarterly principal payments, extend the term of the repayments and to alter the covenants of the original bank agreement. On September 30, 2004, the Company paid off and terminated both the remaining term debt and the outstanding balance on the line of credit. In November 2001, the Company issued 60,000 warrants to purchase the Company's common stock at \$3.66 per share in connection with this debt. The warrants were exercised in December 2004.

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

At the time of the acquisition of Drew by Escalon, Drew had two lines of credit aggregating approximately \$2,700,000, one of which was with a domestic financial institution, 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.

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 |

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| | |
|--------------------------|-----------|
| Line of credit | 1,617,208 |
| Current liabilities | 3,392,286 |
| Long-term debt | 1,072,457 |
| Exchange of common stock | 7,430,439 |

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

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

The Company was not a party to any off-balance sheet arrangements as of and for the fiscal years ended June 30, 2006 and 2005. The following table presents the Company's contractual obligations as of June 30, 2006 (interest is not included in the table as it is not material):

| | 2007 | 2008 | 2009 | THEREAFTER | TOTAL |
|---------------------------|---------------|---------------|---------------|------------|-----------|
| | ----- | ----- | ----- | ----- | ----- |
| Texas Mezzanine Fund Note | \$132,841 | \$145,876 | \$ 0 | \$ 0 | \$278,717 |
| Interest rate | Prime Plus 4% | Prime Plus 4% | Prime Plus 4% | 0.00% | |
| Symbiotics, Inc. Note | \$ 99,996 | \$ 16,675 | \$ 0 | \$ 0 | \$116,671 |
| Interest rate | 5.00% | 5.00% | 5.00% | 0.00% | |
| | ----- | ----- | ----- | ----- | ----- |
| TOTAL | \$232,837 | \$162,551 | \$ 0 | \$ 0 | \$395,388 |
| | ===== | ===== | ===== | ===== | ===== |

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 subsequently acquired the remaining shares during the fiscal year ended June 30, 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. Escalon loaned approximately \$11,276,000 to Drew. The funds have been primarily used to procure components to build up inventory to support the manufacturing process as well as to pay off accounts payable and debt of Drew. Escalon anticipates that further working capital will likely be required by Drew.

Escalon realized .6%, 5.5% and 13.2% of its net revenue during the fiscal years ended June 30, 2006, 2005 and 2004, respectively, from Bausch & Lomb's sales of Silicone Oil. Silicone Oil revenue is based on the 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. The contract expired on August 12, 2005. (See note 11 of the notes to consolidated financial statements for additional information regarding the contract with Bausch & Lomb.)

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ESCALON COMMON STOCK

The Company's common stock is currently listed on the Nasdaq Capital Market. In order to continue to be listed on the Nasdaq Capital Market, the following requirements must be met:

- Stockholders' equity of \$2,500,000 or market value of listed securities of \$35,000,000 or net income from continuing operations (in the latest fiscal year or two of the last three fiscal years) of \$500,000;
- 500,000 publicly held shares;
- \$1,000,000 market value of publicly held shares;
- A minimum bid price of \$1;
- 300 round lot shareholders;
- Two market makers; and
- Compliance with corporate governance standards.

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As of June 30, 2006, Escalon complied with these requirements.

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 Statement of Accounting Standards ("SFAS") No. 142 "Goodwill and Other Intangible Assets," discussed further in the notes to consolidated financial statements included in this Form 10-KSB. 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

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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

Escalon annually evaluates for impairment its intangible assets and goodwill in accordance with SFAS 142, "Goodwill and Other Intangible Assets," or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. These intangible assets include goodwill, trademarks and trade names. Factors the Company considers important that could trigger an impairment review include significant under-performance relative to historical or projected future operating results or significant negative industry or economic trends. If these criteria indicate that the value of the intangible asset may be impaired, an evaluation of the recoverability of the net carrying value of the asset is made. If this evaluation indicates that the intangible asset is not recoverable, the net carrying value of the related intangible asset will be reduced to fair value. Any such impairment charge could be significant and could have a material adverse impact on the Company's financial statements if 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.

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INCOME/(LOSS) PER SHARE

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

Under the provisions of SFAS 128 and SAB 98, basic and diluted net income/(loss) per share is computed by dividing the net income/(loss) for the period by the weighted average number of shares of common stock outstanding

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

In determining income/(loss) for financial statement purposes, management must make certain estimates and judgments. These estimates and judgments occur in the calculation of certain tax liabilities and in the determination of the recoverability of certain deferred tax assets, which arise from temporary differences between the tax and financial statement recognition of revenue and expense. SFAS 109 "Accounting for Income Taxes" also requires that the deferred tax assets be reduced by a valuation allowance, if based on the available evidence, it is more likely that not that all or some portion of the recorded deferred tax assets will not be realized in future periods.

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

Through June 30, 2006, the Company has recorded a full valuation allowance against the Company's 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 would reduce (increase) the income tax expense (benefit) in the period such determination is made by the Company.

QUANTITATIVE AND QUALITATIVE DISCLOSURE 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 June 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 6 of the notes to consolidated financial statements for further information regarding the Company's debt obligations.)

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| | 2007 | 2008 | 2009 | THEREAFTER | TOTAL |
|---------------------------|---------------|---------------|---------------|------------|-----------|
| | ----- | ----- | ----- | ----- | ----- |
| Texas Mezzanine Fund Note | \$132,841 | \$145,876 | \$ 0 | \$ 0 | \$278,717 |
| Interest rate | Prime Plus 4% | Prime Plus 4% | Prime Plus 4% | 0.00% | |
| Symbiotics, Inc. Note | \$ 99,996 | \$ 16,675 | \$ 0 | \$ 0 | \$116,671 |
| Interest rate | 5.00% | 5.00% | 5.00% | 0.00% | |
| | ----- | ----- | ----- | ----- | ----- |
| TOTAL | \$232,837 | \$162,551 | \$ 0 | \$ 0 | \$395,388 |
| | ===== | ===== | ===== | ===== | ===== |

ITEM 7. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements of the Company are filed under this Item 7, beginning on page F-2 of this report.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

ITEM 8A. 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 June 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 quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

A control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control systems are met, and no evaluation of internal controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. The Company's disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives and the chief executive officer and the principal financial and accounting

officer concluded that the Company's disclosure controls and procedures are effective at that reasonable assurance level.

ITEM 8B. OTHER INFORMATION

None.

PART III.

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT AND EXECUTIVE OFFICERS OF THE REGISTRANT.

The information required by this Item 9 is incorporated by reference to the Company's proxy statement for the Company's 2006 Annual Meeting of Shareholders to be filed with the SEC.

ITEM 10. EXECUTIVE COMPENSATION

The information required by this Item 10 is incorporated by reference to the Company's proxy statement for the Company's 2006 Annual Meeting of Shareholders to be filed with the SEC.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED SHAREHOLDER MATTERS

The information required by this Item 11 is incorporated by reference to the Company's proxy statement for the Company's 2006 Annual Meeting of Shareholders to be filed with the SEC.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

See note 14 of the notes to the consolidated financial statements.

ITEM 13. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

CONSOLIDATED FINANCIAL STATEMENTS

See index to Consolidated Financial Statements on Page F-1.

CONSOLIDATED FINANCIAL STATEMENT SCHEDULES

All schedules have been omitted because they are not applicable, or not required, or the information is shown in the financial statements or notes to consolidated financial statements therein.

EXHIBITS

The following is a list of exhibits filed as part of this Annual Report on Form 10-KSB, where so indicated by footnote, exhibits, which were previously filed, are incorporated by reference. For exhibits incorporated by reference, the location of the exhibit in the previous filing is indicated parenthetically,

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followed by the footnote reference to the previous filing.

- 3.1 (a) Restated Articles of Incorporation of Registrant. (8)
- (b) Agreement and Plan of Merger dated as of September 28, 2001 between Escalon Pennsylvania, Inc. and Escalon Medical Corp. (8)
- 3.2 Bylaws of Registrant. (8)
- 4.5 (a) Warrant Agreement between Registrant and U.S. Stock Transfer Corporation. (1)
- (b) Amendment to Warrant Agreement between the Registrant and U.S. Stock Transfer Corporation. (2)
- (c) Amendment to Warrant Agreement between the Registrant and American Stock Transfer Corporation. (3)
- 4.6 Securities Purchase Agreement, dated as of December 31, 1997 by and among the Registrant and Combination. (4)
- 4.7 Registration Rights Agreement, dated as of December 31, 1997 by and among the Registrant and Combination. (4)
- 4.8 Warrant to Purchase Common Stock issued December 31, 1997 to David Stefansky. (4)
- 4.9 Warrant to Purchase Common Stock issued December 31, 1997 to Combination. (4)
- 4.10 Warrant to Purchase Common Stock issued December 31, 1997 to Richard Rosenblum. (4)
- 4.11 Warrant to Purchase Common Stock issued December 31, 1997 to Trautman, Kramer & Company. (4)
- 10.6 Employment Agreement between the Registrant and Richard J. DePiano dated May 12, 1998. (6)**
- 10.7 Non-Exclusive Distributorship Agreement between Registrant and Scott Medical Products dated October 12, 2000. (9)
- 10.9 Assets Sale and Purchase Agreement between the Registrant and Endologix, Inc. dated January 21, 1999. (5)
- 10.13 Supply Agreement between the Registrant and Bausch & Lomb Surgical, Inc. dated August 13, 1999. (5)
- 10.15 Registrant's Amendment and Supplement Agreement and Release between the Registrant and Endologix, Inc. dated February 28, 2001. (10)
- 10.29 Registrant's amended and restated 1999 Equity Incentive Plan. (13)
**
- 10.30 Securities Purchase Agreement dated as of March 16, 2004 (the "Securities Purchase Agreement") between the Company and the Purchasers signatory thereto. (14)
- 10.31 Registration Rights Agreement dated as of March 16, 2004 between

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- the Company and the Purchasers signatory thereto. (14)
- 10.32 Form of Warrant to Purchase Common Stock issued to each Purchaser under the Securities Purchase Agreement. (14)
- 10.33 Manufacturing Supply and Distribution Agreement between Sonomed, Inc. and Ophthalmic Technologies, Inc. dated as of March 11, 2004. (15)
- 10.34 Supplemental Executive Retirement Benefit Agreement for Richard DePiano dated June 23, 2005. (16)**
- 10.35 2004 Equity Incentive Plan. (17)**
- 21 Subsidiaries. (*)
- 23.1 Consent of Independent Registered Public Accounting Firm. (*)

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- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Richard J. DePiano (*)
- 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Robert M. O'Connor(*)
- 32.1 Certification pursuant to Section 1350 of Title 18 of the United States Code - Richard J. DePiano. (*)
- 32.2 Certification pursuant to Section 1350 of Title 18 of the United States Code - Robert M. O'Connor. (*)

* Filed herewith.

** Management contract of compensatory plan.

- (1) Filed as an exhibit to Pre-Effective Amendment No. 2 to the Company's Registration Statement on Form S-1 dated November 9, 1993 (Registration No. 33-69360).
- (2) Filed as an exhibit to the Company's Form 10-KSB for the year ended June 30, 1994.
- (3) Filed as an exhibit to the Company's Form 10-KSB for the year ended June 30, 1995.
- (4) Filed as an exhibit to the Company's Registration Statement on Form S-3 dated January 20, 1998 (Registration No. 333-44513).
- (5) Filed as an exhibit to the Company's Form 10-KSB for the year ended June 30, 1999.
- (6) Filed as an exhibit to the Company's Form 8-K/A, dated March 31, 2000.

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- (7) Intentionally omitted.
- (8) Filed as an exhibit to the Company's Proxy Statement on Schedule 14A, as filed by the Company with the SEC on September 21, 2001.
- (9) Filed as an exhibit to the Company's Form 10-KSB for the year ended June 30, 2001.
- (10) Intentionally omitted.
- (11) Intentionally omitted.
- (12) Intentionally omitted.
- (13) Filed as an exhibit to the Company's Form 10-Q for the quarter ended December 31, 2003.
- (14) Filed as an exhibit to the Company's Registration Statement on Form s_3 dated April 8, 2004 (Registration No. 333-114332).
- (15) Filed as an exhibit to the Company's Form 10-Q for the quarter ended March 31, 2004.
- (16) Filed as an exhibit to the Company's Form 8-K, dated June 23, 2005.
- (17) Filed with the Definitive Proxy Statement on October 27, 2004.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item 14 is incorporated by reference to the Company's proxy statement for the Company's 2006 Annual Meeting of Shareholders to be filed with the SEC.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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)

By: /s/ Richard J. DePiano

Richard J. DePiano
Chairman and Chief Executive Officer

Dated: September 28, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

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| | | |
|---|---|--------------------|
| By: /s/ Richard J. DePiano ----- Richard J. DePiano | Chairman and Chief Executive Officer (Principal Executive Officer) and Director | September 28, 2006 |
| By: /s/ Robert M. O'Connor ----- Robert M. O'Connor | Chief Financial Officer (Principal Financial Officer) | September 28, 2006 |
| By: /s/ Anthony Coppola ----- Anthony Coppola | Director | September 28, 2006 |
| By: /s/ Jay L. Federman ----- Jay L. Federman | Director | September 28, 2006 |
| By: /s/ William L.G. Kwan ----- William L.G. Kwan | Director | September 28, 2006 |
| By: /s/ Lisa Napolitano ----- Lisa Napolitano | Director | September 28, 2006 |
| By: /s/ Fred Choate ----- Fred Choate | Director | September 28, 2006 |

ESCALON MEDICAL CORP.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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| Consolidated Balance Sheets at June 30, 2006 and 2005 | F-4 |
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| Consolidated Statements of Cash Flows for the Years Ended June 30, 2006 and 2005 | F-7 |
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Escalon Medical Corp.
Wayne, Pennsylvania

We have audited the accompanying consolidated balance sheets of Escalon Medical Corp. and subsidiaries (the "Company") as of June 30, 2006, and the related consolidated statement of income, shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Escalon Medical Corp. and subsidiaries as of June 30, 2006, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Mayer Hoffman McCann P.C.

Plymouth Meeting, Pennsylvania
September 20, 2006

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Escalon Medical Corp.
Wayne, Pennsylvania

We have audited the accompanying consolidated balance sheet of Escalon Medical Corp. and subsidiaries (the "Company") as of June 30, 2005, and the related consolidated statements of income, shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal

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control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Escalon Medical Corp. and subsidiaries as of June 30, 2005, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

BDO Seidman, LLP

Philadelphia, Pennsylvania
September 22, 2005

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ESCALON MEDICAL CORP. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

| | JUNE 30, 2006 | JUNE 30, 2005 |
|--|------------------|------------------|
| | ----- | ----- |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 3,379,710 | \$ 5,115,772 |
| Available for sale securities | 50,220 | 1,207,317 |
| Accounts receivable, net | 3,996,243 | 4,752,310 |
| Inventory, net | 7,122,916 | 5,856,285 |
| Notes receivable | 0 | 100,000 |
| Other current assets | 362,160 | 633,214 |
| | ----- | ----- |
| TOTAL CURRENT ASSETS | 14,911,249 | 17,664,898 |
| | ----- | ----- |
| Furniture and equipment, net | 969,956 | 911,700 |
| Goodwill | 21,072,260 | 20,166,450 |
| Trademarks and trade names | 620,106 | 616,906 |
| Patents, net | 313,702 | 402,814 |
| Covenant not to compete and customer list, net | 420,073 | 0 |
| Other assets | 337,421 | 286,568 |
| | ----- | ----- |
| TOTAL ASSETS | \$ 38,644,767 | \$ 40,049,336 |
| | ===== | ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ 232,837 | \$ 230,344 |
| Accounts payable | 1,558,501 | 1,135,680 |
| Accrued expenses | 2,503,771 | 2,685,670 |
| | ----- | ----- |
| TOTAL CURRENT LIABILITIES | 4,295,109 | 4,051,694 |

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| | | |
|---|---------------|---------------|
| Long-term debt, net of current portion | 162,551 | 391,793 |
| Accrued post-retirement benefits | 1,087,000 | 1,087,000 |
| | ----- | ----- |
| TOTAL LIABILITIES | 5,544,660 | 5,530,487 |
| | ----- | ----- |
| 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 and 5,963,477 issued and outstanding at June 30, 2006 and June 30, 2005, respectively | 6,345 | 5,964 |
| Common stock warrants | 1,601,346 | 1,601,346 |
| Additional paid-in capital | 65,699,370 | 63,898,190 |
| Accumulated (deficit) | (34,122,427) | (32,136,487) |
| Accumulated other comprehensive (loss) income | (84,527) | 1,149,836 |
| | ----- | ----- |
| TOTAL SHAREHOLDERS' EQUITY | 33,100,107 | 34,518,849 |
| | ----- | ----- |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 38,644,767 | \$ 40,049,336 |
| | ===== | ===== |

See notes to consolidated financial statements

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ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

| | FOR THE YEARS ENDED JUNE 30 | |
|---|-----------------------------|--------------|
| | 2006 | 2005 |
| | ----- | ----- |
| NET REVENUES: | | |
| Product revenue | \$27,543,785 | \$23,864,322 |
| Other revenue | 2,246,913 | 3,060,300 |
| | ----- | ----- |
| REVENUES, NET | 29,790,698 | 26,924,622 |
| | ----- | ----- |
| COSTS AND EXPENSES: | | |
| Cost of goods sold | 16,003,904 | 13,158,061 |
| Marketing, general and administrative | 13,994,788 | 12,556,374 |
| Research and development | 2,828,196 | 1,892,706 |
| | ----- | ----- |
| TOTAL COSTS AND EXPENSES | 32,826,888 | 27,607,141 |
| | ----- | ----- |
| (LOSS) INCOME FROM OPERATIONS | (3,036,190) | (682,519) |
| | ----- | ----- |
| OTHER (EXPENSE) AND INCOME: | | |
| Gain on sale of available for sale securities | 1,157,336 | 3,411,761 |
| Equity in Ocular Telehealth Management, LLC | (173,844) | (63,613) |
| Interest income | 161,588 | 69,262 |
| Interest expense | (63,521) | (55,116) |
| | ----- | ----- |

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| | | |
|-------------------------------------|----------------|--------------|
| TOTAL OTHER (EXPENSE) AND INCOME | 1,081,559 | 3,362,294 |
| NET (LOSS) INCOME BEFORE TAXES | (1,954,631) | 2,679,775 |
| Provision for income taxes | 31,309 | 231,664 |
| NET (LOSS) INCOME | \$ (1,985,940) | \$ 2,448,111 |
| BASIC NET (LOSS) INCOME PER SHARE | \$ (0.323) | \$ 0.420 |
| DILUTED NET (LOSS) INCOME PER SHARE | \$ (0.323) | \$ 0.393 |
| WEIGHTED AVERAGE SHARES - BASIC | 6,152,455 | 5,831,564 |
| WEIGHTED AVERAGE SHARES - DILUTED | 6,152,455 | 6,231,024 |

See notes to consolidated financial statements

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ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

| | COMMON STOCK | | COMMON STOCK | ADDITIONAL | ACCUMULATED |
|---|--------------|---------|--------------|-----------------|-----------------|
| | SHARES | AMOUNT | WARRANTS | PAID-IN CAPITAL | DEFICIT |
| BALANCE AT JUNE 30, 2004 | 5,017,122 | \$5,018 | \$1,601,346 | \$56,438,903 | \$ (34,584,598) |
| Comprehensive Income: | | | | | |
| Net income | 0 | 0 | 0 | 0 | 2,448,111 |
| Change in unrealized gains on available for sale securities | 0 | 0 | 0 | 0 | 0 |
| Foreign currency translation | 0 | 0 | 0 | 0 | 0 |
| TOTAL COMPREHENSIVE INCOME | 0 | 0 | 0 | 0 | 2,448,111 |
| Acquisition of Drew | 900,000 | 900 | 0 | 7,429,538 | 0 |
| Exercise of common stock purchase warrants | 32,855 | 33 | 0 | (33) | 0 |
| Exercise of stock options | 13,500 | 13 | 0 | 29,782 | 0 |
| BALANCE AT JUNE 30, 2005 | 5,963,477 | \$5,964 | \$1,601,346 | \$63,898,190 | \$ (32,136,487) |
| Comprehensive Income: | | | | | |
| Net (loss) | 0 | 0 | 0 | 0 | (1,985,940) |
| Change in unrealized gains on available for sale securities | 0 | 0 | 0 | 0 | 0 |
| Foreign currency translation | 0 | 0 | 0 | 0 | 0 |
| TOTAL COMPREHENSIVE INCOME | 0 | 0 | 0 | 0 | (1,985,940) |
| Exercise of stock options | 131,180 | 131 | 0 | 296,123 | 0 |
| Income tax benefit from exercise of stock options | | | | 77,807 | |
| Purchase of assets of MRP | 250,000 | 250 | 0 | 1,427,250 | 0 |

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| | | | | | |
|--------------------------|-----------|---------|-------------|--------------|----------------|
| BALANCE AT JUNE 30, 2006 | 6,344,657 | \$6,345 | \$1,601,346 | \$65,699,370 | \$(34,122,427) |
|--------------------------|-----------|---------|-------------|--------------|----------------|

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ESCALON MEDICAL CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | YEARS ENDED JUNE 30, | |
|--|----------------------|--------------|
| | 2006 | 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net (loss) income | \$ (1,985,940) | \$ 2,448,111 |
| Adjustments to reconcile net (loss) income to net cash (used in) operating activities: | | |
| Depreciation and amortization | 440,952 | 387,651 |
| Post retirement benefits | 0 | 1,087,000 |
| Gain on sale of available for sale securities | (1,157,336) | (3,411,761) |
| Reserve on notes receivable | 100,000 | 50,000 |
| Loss on Ocular Telehealth Management, LLC | 173,844 | 63,613 |
| Abandonment of leasehold improvement | 0 | 12,458 |
| Change in operating assets and liabilities: | | |
| Accounts receivable, net | 761,834 | (838,624) |
| Inventory, net | (1,189,207) | (1,882,149) |
| Other current and long-term assets | 19,880 | 63,750 |
| Accounts payable, accrued and other liabilities | 230,643 | (1,330,009) |
| NET CASH (USED IN) OPERATING ACTIVITIES | (2,605,330) | (3,349,960) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of Drew, net of cash acquired | 0 | 151,459 |
| Acquisition costs related to Drew | | (1,015,362) |
| Purchase of MRP, net of cash acquired | (47,060) | 0 |
| Proceeds from the sale of available for sale securities | 1,157,336 | 3,411,761 |
| Investment in Ocular Telehealth Management, LLC | 0 | (256,000) |
| Purchase of fixed assets | (327,340) | (104,396) |
| NET CASH PROVIDED BY/(USED IN) INVESTING ACTIVITIES | 782,936 | 2,187,462 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Line of credit borrowing | 0 | 0 |
| Line of credit repayment | 0 | (1,905,822) |
| Principal payments on term loans | (226,749) | (4,441,761) |
| Issuance of common stock - private placement | 0 | 0 |
| Issuance of common stock - stock options | 374,061 | 29,795 |
| NET CASH PROVIDED BY/(USED IN) FINANCING ACTIVITIES | 147,312 | (6,317,788) |
| Effect of exchange rate changes on cash and cash equivalents | (60,980) | (5,913) |
| NET (DECREASE) IN CASH AND CASH EQUIVALENTS | (1,736,061) | (7,486,199) |
| Cash and cash equivalents, beginning of period | 5,115,772 | 12,601,971 |

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| | | |
|---|----------------|--------------|
| Cash and cash equivalents, end of period | \$ 3,379,711 | \$ 5,115,772 |
| ===== | | |
| SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION: | | |
| Interest paid | \$ 37,586 | \$ 198,647 |
| ===== | | |
| Income taxes refund (paid) | \$ (1,133) | \$ 327,176 |
| ===== | | |
| Issuance of common stock for Drew acquisition | \$ 0 | \$ 7,430,438 |
| ===== | | |
| Issuance of common stock for MRP acquisition | \$ 1,427,500 | \$ 0 |
| ===== | | |
| (Decrease)/increase in unrealized appreciation on available for sale securities | \$ (1,157,097) | \$ 1,207,317 |
| ===== | | |

See notes to consolidated financial statements

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ESCALON MEDICAL CORP. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND DESCRIPTION OF BUSINESS AND BUSINESS CONDITIONS

Escalon Medical Corp. ("Escalon") 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"), 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 Group, Plc ("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"). 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 connection with the presentation of the current period consolidated financial statements, certain prior period balance have been reclassified to conform with current period presentation.

The Drew business unit has experienced significant losses and negative cash flow from operations in the last two years. Management has begun to implement cost reductions in each of Drew's three locations in order to bring Drew's cost structure in line with anticipated revenues. Management anticipates that these cuts combined with budgeted profits in legacy Escalon entities and the continued IntraLase royalty revenue stream will provide sufficient liquidity in the coming fiscal year.

2. SIGNIFICANT ACCOUNTING POLICIES

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PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Sonomed, Vascular, EME, EMI, Pharmaceutical, EHI and Drew. All intercompany accounts and transactions have been eliminated.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that impact the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

CASH AND CASH EQUIVALENTS

For the purposes of reporting cash flows, the Company considers all cash accounts, which are not subject to withdrawal restrictions or penalties, and highly liquid investments with original maturities of 90 days or less to be cash and cash equivalents.

FAIR VALUE OF FINANCIAL INSTRUMENTS

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The Company follows Statement of Financial Accounting Standards No. 107 ("SFAS" 107), "Disclosure about Fair Value of Financial Instruments". The carrying amounts for cash and cash equivalents, accounts receivable, line of credit, accounts payable and accrued liabilities approximate their fair value because of their short-term maturity. The carrying value of available for sale securities approximates market based-upon market arms-length transactions in the underlying security. The carrying amounts of long-term debt approximate fair value since the Company's interest rates approximate current interest rates. While we believe the carrying value of the assets and liabilities is reasonable, considerable judgment is used to develop estimates of fair value; thus the estimates are not necessarily indicative of the amounts that could be realized in a current market exchange.

MARKETABLE SECURITIES

The Company reports debt and marketable securities in accordance with Statement of Financial Accounting Standards No. 115 ("SFAS 115"), "Accounting for Certain Investments in Debt and Equity Securities." All of the equity securities held by the Company at June 30, 2006 and 2005 are classified as available for sale securities. Accordingly, amounts are reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity.

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

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or sales incentives 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 policy and procedures related to the buyer's (distributor's) creditworthiness. Based on this determination, the Company believes that collectibility is reasonably assured.

With respect to additional consideration related to the sale of Silicone Oil by Bausch & Lomb and the licensing of the Company's intellectual laser technology, revenue is recognized upon notification from the other parties of amount earned or upon receipt of royalty payments.

Provision has been made for estimated sales returns based on historical experience.

SHIPPING AND HANDLING REVENUES AND COSTS

Shipping and handling revenues are included in product revenue and the related costs are included in cost of goods sold.

INVENTORIES

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Raw materials, work in process and finished goods are recorded at lower of cost (first-in, first-out) or market. The composition of inventories is as follows:

| | JUNE 30, | |
|-----------------|-------------|-------------|
| | 2006 | 2005 |
| Raw materials | \$4,219,836 | \$3,476,493 |
| Work in process | 809,807 | 473,252 |
| Finished goods | 2,345,985 | 2,073,208 |

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| | | |
|---------------------|-------------|-------------|
| | 7,375,628 | 6,022,953 |
| | ----- | ----- |
| Valuation allowance | (252,712) | (166,668) |
| | ----- | ----- |
| TOTAL INVENTORY | \$7,122,916 | \$5,856,285 |
| | ===== | ===== |

Valuation allowance activity for the years ended June 30 was as follows:

| | JUNE 30, | |
|-----------------------------------|-----------|-----------|
| | 2006 | 2005 |
| | ----- | ----- |
| BALANCE, JULY 1 | \$166,668 | \$ 5,125 |
| Provision for valuation allowance | 87,475 | 161,543 |
| Write-off's | (1,431) | 0 |
| | ----- | ----- |
| BALANCE, JUNE 30 | \$252,712 | \$166,668 |
| | ===== | ===== |

ACCOUNTS RECEIVABLE

Accounts receivable are recorded at net realizable value. The Company performs ongoing credit evaluations of customers' financial condition and does not require collateral for accounts receivable arising in the normal course of business. The Company maintains allowances for potential credit losses based on the Company's historical trends, specific customer issues and current economic trends. Accounts are written off when they are determined to be uncollectible based on management's assessment of individual accounts. Credit losses, when realized, have been within the range of management's expectations. Allowance for doubtful accounts activity for the years ended June 30 was as follows:

| | JUNE 30, | |
|-------------------------|------------|-----------|
| | 2006 | 2005 |
| | ----- | ----- |
| BALANCE, JULY 1 | \$ 490,465 | \$121,212 |
| Provision for bad debts | 347,968 | 202,446 |
| Write-off's | (188,856) | (41,208) |
| Other (a) | 0 | 208,015 |
| | ----- | ----- |
| BALANCE, JUNE 30 | \$ 649,577 | \$490,465 |
| | ===== | ===== |

(a) Acquired as part of the Drew acquisition in July 2004

PROPERTY AND EQUIPMENT

Property and equipment is recorded at cost. Leasehold improvements are amortized on a straight-line basis over the lesser of the estimated useful life of the asset or lease term. Depreciation on property and equipment is recorded using the straight-line method over the estimated economic useful life of the related assets. Estimated useful lives are generally 3 to 5 years for computer

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equipment and software, 5 to 7

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years for furniture and fixtures and 5 to 10 years for production and test equipment. Depreciation expense for the years ended June 30, 2006 and 2005 was \$324,458 and \$321,142, respectively.

Property and equipment consist of the following at:

| | JUNE 30, | |
|---|--------------|--------------|
| | 2006 | 2005 |
| Equipment | \$ 2,289,994 | \$ 1,921,731 |
| Furniture and Fixtures | 65,891 | 120,460 |
| Leasehold Improvements | 128,866 | 121,193 |
| | ----- | ----- |
| | 2,484,751 | 2,163,384 |
| | ----- | ----- |
| Less: Accumulated depreciation and amortization | (1,514,795) | (1,251,684) |
| | ----- | ----- |
| | \$ 969,956 | \$ 911,700 |
| | ===== | ===== |

LONG-LIVED ASSETS

Long-lived assets and certain identifiable intangibles to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. An asset's value is impaired if management's estimate of the aggregate future cash flows, undiscounted and without interest charges, to be generated by the asset are less than the carrying value of the asset. Such cash flows consider factors such as expected future operating income and historical trends, as well as the effects of demand and competition. To the extent impairment has occurred, the loss will be measured as the excess of the carrying amount of the asset over the fair value of the asset. Such estimates require the use of judgment and numerous subjective assumptions, which if actual experience varies, could result in material differences in the requirements for impairment charges.

INTANGIBLE ASSETS

The Company follows Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets," which discontinues the amortization of goodwill and identifiable intangible assets that have indefinite lives. In accordance with SFAS 142, these assets are tested for impairment on an annual basis.

ACCRUED WARRANTIES

The Company provides a limited one year warranty against manufacturer's defects on its products sold to customers. The Company's standard warranties require the Company to repair or replace, at the Company's discretion, defective parts during such warranty period. The Company accrues for its product warranty liabilities based on estimates of costs to be incurred during the warranty

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period, based on historical repair information for warranty costs.

BUSINESS COMBINATIONS

The Company allocates the purchase price of acquired companies to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values. When acquisitions are deemed material by management, the Company engages independent third-party appraisal firms to assist in determining the fair values of assets acquired and liabilities assumed. Such a valuation requires management to make significant estimates and assumption, especially with respect to intangible assets.

STOCK-BASED COMPENSATION

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

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

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

| | 2006 ----- | 2005 ----- |
|---|----------------|---------------|
| Net (loss) income, as reported | \$(1,985,940) | \$2,448,111 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (288,848) | (539,026) |
| PRO FORMA NET (LOSS) INCOME | \$ (2,274,788) | \$1,909,085 |
| | ===== | ===== |
| (LOSS) EARNINGS PER SHARE: | | |
| BASIC - AS REPORTED | \$ (0.323) | \$ 0.420 |
| | ===== | ===== |
| BASIC - PRO FORMA | \$ (0.370) | \$ 0.327 |
| | ===== | ===== |
| DILUTED - AS REPORTED | \$ (0.323) | \$ 0.393 |
| | ===== | ===== |
| DILUTED - PRO FORMA | \$ (0.370) | \$ 0.306 |
| | ===== | ===== |

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 these Black-Scholes option pricing method.

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For the purposes of pro forma disclosures, the estimated fair value of the equity awards is amortized to expense over the options' vesting period. For the purposes of applying SFAS 123, the estimated per share value of the options granted during the fiscal years ended June 30, 2006, 2005 and 2004 was \$5.52, \$4.93, and \$6.94, respectively. The fair value was estimated using the following assumptions: dividend yield of 0.0%; volatility ranging between 0.60 and 2.51; risk free interest ranging between 3.30% and 4.5%; and expected life of 10 years. The volatility assumption is based on volatility seen in the Company's stock over the last five years. This assumption was made according to the guidance of SFAS 123. There is no reason to believe that future volatility will compare to historic volatility.

RESEARCH AND DEVELOPMENT

All research and development costs are charged to operations as incurred.

ADVERTISING COSTS

Advertising costs are charged to operations as incurred. Advertising expense for the two years ended June 30, 2006 and 2005 was \$279,670 and \$190,963, respectively.

NET INCOME PER SHARE

The Company follows Financial Accounting Standard 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:

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| | 2006 | 2005 |
|--|----------------|--------------|
| | ----- | ----- |
| NUMERATOR: | | |
| Numerator for basic and diluted earnings per share | | |
| NET (LOSS) INCOME | \$ (1,985,940) | \$ 2,448,111 |
| | ----- | ----- |
| DENOMINATOR: | | |
| Denominator for basic earnings per share - weighted average shares | 6,152,455 | 5,831,564 |
| Effect of dilutive securities: | | |
| Stock options and warrants | 0 | 399,460 |
| | ----- | ----- |
| DENOMINATOR FOR DILUTED EARNINGS PER SHARE - WEIGHTED AVERAGE AND ASSUMED CONVERSION | 6,152,455 | 6,231,024 |
| | ----- | ----- |
| BASIC (LOSS) EARNINGS PER SHARE | \$ (0.323) | \$ 0.420 |
| | ===== | ===== |
| DILUTED (LOSS) EARNINGS PER SHARE | \$ (0.323) | \$ 0.393 |
| | ===== | ===== |

As of June 30, 2006, the impact of all dilutive securities were omitted from the diluted earnings per share calculation as they reduce the loss per

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share (anti-dilutive). As of June 30, 2005, and 2004, 120,000 warrants, which were issued in March 2004 (see note 7), to purchase shares of Escalon common stock were outstanding. These warrants were excluded from the calculation of diluted earnings per share as the exercise price of the warrants exceeded the average share price of the Company's common stock for of the year ended June 30, 2005 making the warrants anti-dilutive.

INCOME TAXES

The Company accounts for income taxes using the asset and liability method. Under this method, deferred tax assets and liabilities are recognized based on the difference between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted rates in effect in the years when those temporary differences are expected to reverse. The impact on deferred taxes of a change in tax rates, should a change occur, is recognized in income in the period that include the enactment date.

COMPREHENSIVE INCOME

The Company reports comprehensive income in accordance with the provision of SFAS No.130, "Reporting Comprehensive Income," which establishes standards for reporting comprehensive income and its component in financial statements. Comprehensive income, as defined, includes all changes in equity during a period from non-owner sources.

FOREIGN CURRENCY TRANSLATION

The Company translates the assets and liabilities of international subsidiaries into U.S. dollars at the current rates of exchange in effect as of each balance sheet date. Revenues and expenses are translated using average rates in effect during the period. Gains and losses from translation adjustments are included in accumulated other comprehensive income on the consolidated balance sheet. Foreign currency transaction gains or losses are recognized in current operations and have not been significant to the Company's operating results in any period. In addition, the effect of foreign currency rate changes on cash and cash equivalents has not been significant in any period.

NEW ACCOUNTING PRONOUNCEMENTS

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In December 2004, the FASB issued SFAS No.123R ("SFAS No.123R"), (revised 2004), "Share-Based Payments" SFAS No. 123R is a revision of SFAS No. 123 and supersedes ABP Opinion No. 25 which requires the Company to expense share-based payments, including employee stock options. With limited exceptions, the amount of compensation costs will be measured based on the grant date fair value of the equity or liability instrument issued. Compensation cost will be recognized over the period that the employee provides service in exchange for the award. The Company is required to adopt this standard in its fiscal year beginning July 1, 2005. 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 can not 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.

3. INTANGIBLE ASSETS

GOODWILL, TRADEMARKS AND TRADE NAMES

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

The Company adopted SFAS 142 effective July 1, 2001. Under SFAS 142, goodwill and identified intangible assets that have indefinite lives are no longer amortized but reviewed for impairment annually or more frequently if certain indicators arise.

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

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

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| | 2006 NET CARRYING AMOUNT | 2005 NET CARRYING AMOUNT |
|------------------|-----------------------------------|-----------------------------------|
| | ----- | ----- |
| GOODWILL | | |
| Sonomed | \$ 9,525,550 | \$ 9,525,550 |
| Drew | 9,574,655 | 9,574,655 |
| Vascular | 941,218 | 941,218 |
| Medical/Trek/EMI | 1,030,837 | 125,027 |
| | ----- | ----- |
| TOTAL | \$21,072,260 | \$20,166,450 |
| | ===== | ===== |

| | 2006 NET CARRYING AMOUNT | 2005 NET CARRYING AMOUNT |
|---------------------------|-----------------------------------|-----------------------------------|
| | ----- | ----- |
| TRADEMARKS AND TRADENAMES | | |
| Sonomed | \$616,906 | \$616,906 |
| Medical/Trek/EMI | 3,200 | 0 |
| | ----- | ----- |

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| | | |
|-------|-----------|-----------|
| TOTAL | \$620,106 | \$616,906 |
| | ===== | ===== |

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 \$263,799 and \$188,649 at June 30, 2006 and 2005, respectively. Amortization expense for the years ended June 30, 2006 and 2005 was \$75,150 and \$66,509, respectively.

Amortization expense, relating entirely to 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 12). 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 \$22,986 and \$0 at June 30, 2006 and 2005, respectively. Amortization expense for the years ended June 30, 2006 and 2005 was \$22,896, and \$0, respectively.

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

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| | GROSS CARRYING AMOUNT | IMPAIRMENT | ADJUSTED GROSS CARRYING AMOUNT | ACCUMULATED AMORTIZATION | NET CARRYING VALUE |
|---|-----------------------------|------------|---|-----------------------------|-----------------------|
| | ----- | ----- | ----- | ----- | ----- |
| AMORTIZED INTANGIBLE ASSETS | | | | | |
| PATENTS | | | | | |
| Drew | \$275,284 | \$0 | \$275,284 | \$ (90,955) | \$184,329 |
| Vascular | 36,916 | 0 | 36,916 | (18,458) | 18,458 |
| Medical/Trek/EMI | 265,301 | 0 | 265,301 | (154,386) | 110,915 |
| | ----- | --- | ----- | ----- | ----- |
| TOTAL | \$577,501 | \$0 | \$577,501 | \$ (263,799) | \$313,702 |
| | ===== | === | ===== | ===== | ===== |
| COVENANT NOT TO COMPETE/ CUSTOMER LIST | | | | | |
| Medical/Trek/EMI | \$442,969 | \$0 | \$442,969 | \$ (22,896) | \$420,073 |
| | ----- | --- | ----- | ----- | ----- |
| TOTAL | \$442,969 | \$0 | \$442,969 | \$ (22,896) | \$420,073 |
| | ===== | === | ===== | ===== | ===== |

Amortization expense, relating entirely to covenant not to compete and the

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customer list, is estimated to be approximately \$93,350 per year for each of the next five fiscal years.

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

| | GROSS CARRYING AMOUNT | IMPAIRMENT | ADJUSTED GROSS CARRYING AMOUNT | ACCUMULATED AMORTIZATION | NET CARRYING VALUE |
|-----------------------------|-----------------------------|------------|---|-----------------------------|-----------------------|
| | ----- | ----- | ----- | ----- | ----- |
| AMORTIZED INTANGIBLE ASSETS | | | | | |
| PATENTS | | | | | |
| Drew | \$297,246 | \$0 | \$297,246 | \$ (55,908) | \$241,338 |
| Vascular (pending issuance) | 36,916 | 0 | 36,916 | 0 | 36,916 |
| Medical/Trek/EMI | 257,301 | 0 | 257,301 | (132,741) | 124,560 |
| | ----- | --- | ----- | ----- | ----- |
| TOTAL | \$591,463 | \$0 | \$591,463 | \$ (188,649) | \$402,814 |
| | ===== | === | ===== | ===== | ===== |

4. NOTE RECEIVABLE

Escalon entered into an agreement with an individual who was involved in the development of the Company's Ocufit SR(R) drug delivery system. The Company holds a note receivable from the individual in the amount of \$150,000 that was due in May 2005. The note was not paid when due and the individual is currently in default. The Company intends to aggressively pursue collection, is currently evaluating collection alternatives and has recorded a reserve of \$150,000 and \$50,000 as of June 30, 2006 and 2005, respectively.

In connection with a co-marketing agreement with Anka Systems, Inc. ("Anka"), in October 2005, the Company extended a \$400,000 loan to Anka (See note 17). Anka is an early stage privately held company. Under the terms of this note, repayment was 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 note. The note was paid in full in April 2006.

5. ACCRUED EXPENSES

The following table presents accrued expenses:

| | JUNE 30, 2006 | JUNE 30, 2005 |
|----------------------|---------------|---------------|
| | ----- | ----- |
| Accrued compensation | \$1,260,139 | \$1,276,639 |
| Warranty accruals | 255,740 | 201,413 |
| Severance accruals | 0 | 195,263 |
| Legal accruals | 221,369 | 251,000 |
| Other accruals | 766,523 | 761,355 |
| | ----- | ----- |

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| | | |
|------------------------|-------------|-------------|
| TOTAL ACCRUED EXPENSES | \$2,503,771 | \$2,685,670 |
| | ===== | ===== |

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

In addition to normal accruals, other accruals as of June 30, 2006 and 2005 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.

Accrued compensation as of June 30, 2006 and 2005 primarily relates to payroll, bonus and vacation accruals, and payroll tax liabilities.

6. 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 10.25% per annum and 8% per annum as of June 30, 2006 and 2005, respectively. Drew is required to pay an additional interest payment to the Texas Mezzanine Fund of 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 \$278,717 and \$405,471 as of June 30, 2006 and 2005, respectively. The Symbiotics, Inc. term debt, which originated from the acquisition of a product line from Symbiotics, Inc., is payable in monthly installments of \$8,333 with interest at a fixed rate of 5% per annum. The outstanding balance of this note was \$116,671 and \$216,666 as of June 30, 2006 and 2005, respectively.

On December 23, 2002, a privately held fund (the "Lender") acquired the Company's bank debt, which consisted of outstanding term debt of \$5,850,000 and \$1,475,000 outstanding on a \$2,000,000 line of credit (the "Term Loan and Line of Credit"). On February 13, 2003, the Company entered into an Amended Loan Agreement with the Lender. The primary amendments of the Amended Loan Agreement were to reduce quarterly principal payments, extend the term of the repayments and alter the covenants of the original loan agreement.

As of June 30, 2004, the amount outstanding under the Term Loan and Line of Credit were \$3,896,019 and \$250,000, respectively. At June 30, 2004, the variable interest rates applicable to the term loan and line of credit were 5.75% and 5.50%, respectively. The lender's prime rate at June 30, 2004 was 4.00%. On September 30, 2004, the Company paid off Term Loan and Line of Credit.

On January 21, 1999, the Company's Vascular subsidiary and Endologix entered into an Assets Sale and Purchase Agreement. Pursuant to this agreement, the Company acquired for cash the assets of Endologix's vascular access business in exchange for cash and also agreed to pay royalties to Endologix based on future sales of the vascular access business for a period of five years following the closing of the sale, with a guaranteed minimum royalty of \$300,000 per year. On February 1, 2001, the parties amended the agreement to eliminate any future royalty payments to Endologix. Pursuant to the amendment, the

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Company paid \$17,558 in cash to Endologix, delivered a short-term note in the amount of \$64,884 that was satisfied in January 2002, a note in the amount of \$717,558, payable in 11 quarterly installments that commenced on April 15, 2002 and the Company issued 50,000 shares of its common stock to Endologix.

As of June 30, 2004, the amount outstanding under the Endologix term loan was \$130,461 and the interest rate applicable to the loan was 5.00%. On September 30, 2004, the Company paid off the balance of the term debt.

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

| TWELVE MONTHS ENDING JUNE 30, | TEXAS MEZZANINE | SYMBIOTICS | TOTAL |
|-------------------------------------|--------------------------------------|------------|-----------|
| ----- | ----- | ----- | ----- |
| 2007 | \$132,841 | \$ 99,996 | 232,837 |
| 2008 | 145,876 | 16,675 | 162,551 |
| | ----- | ----- | ----- |
| TOTAL | \$278,717 | \$116,671 | 395,388 |
| | ===== | ===== | |
| | Current portion of long-term debt | | 232,837 |
| | | | ----- |
| | Long-term portion | | \$162,551 |
| | | | ===== |

7. CAPITAL STOCK TRANSACTIONS

STOCK OPTION PLANS

As of June 30, 2006, Escalon had in effect seven employee stock option plans which provide for incentive and non-qualified stock options. After accounting for shares issued upon exercise of options, a total of 1,281,352 shares of the Company's common stock remain available for issuance as of June 30, 2006. Under the terms of the plans, options may not be granted for less than the fair market value of the Common Stock at the date of grant. Vesting generally occurs ratably over five years and the option is exercisable over a period no longer than 10 years after the grant date. As of June 30, 2006, options to purchase 920,685 shares of the Company's common stock were outstanding and exercisable, and 360,667 shares were reserved for future grants.

On June 30, 2006, the Compensation Committee of the Company approved the acceleration of vesting of all of the outstanding stock options to purchase shares of the Company's common stock. The acceleration applies to all stock options outstanding as of June 30, 2006 under the Company's 1991 Stock Option Plan, 1992 Stock Option Plan, 1993 Stock Option Plan, 1999 Stock Option Plan and 2004 Equity Incentive Plan.

The Company is taking this action in order to reduce the future compensation expense associated with unvested stock options following the adoption of Statement of Financial Accounting Standards No. 123, Share Based Payment (revised 2004) ("SFAS 123R"). The Company will be required to apply the expense recognition provisions of SFAS 123R beginning in the first quarter of

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fiscal 2007. The Company currently estimates it will incur \$154,000 in stock-based compensation expense associated with the acceleration of the vesting of all of the outstanding options to purchase shares of the Company's common stock for the fiscal year ended 2006. As a result of the acceleration, the Company expects to reduce the stock option expense it otherwise would be required to record in connection with the accelerated options by approximately \$1.18 million over the original option vesting periods.

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The Company's Board of Directors took this action with the belief that it is in the best interest of our shareholders, as it will reduce the Company's reported compensation expense in future periods. In addition, because some of these options have exercise prices in excess of the current market value, the Board also believed that these options might not have been fully achieving the Company's original objective of employee retention and incentive compensation. The senior officers of the Company who are subject to reporting under Section 16(a) of the Securities Exchange Act of 1934 will be subject to the following restriction with respect to the sale of shares purchased upon exercise of a stock option whose vesting has been accelerated: Such sale shall be prohibited until the earlier of: (i) the date on which the option would otherwise have vested; (ii) twelve months from June 30, 2006; or (iii) termination of employment.

The following is a summary of Escalon's stock option activity and related information for the fiscal years ended June 30, 2006 and 2005:

| | 2006 | | 2005 | |
|---|----------------------------|---------------------------------------|----------------------------|---------------------------------------|
| | COMMON STOCK OPTIONS | WEIGHTED AVERAGE EXERCISE PRICE | COMMON STOCK OPTIONS | WEIGHTED AVERAGE EXERCISE PRICE |
| Outstanding at the beginning of the year | 847,210 | \$4.195 | 618,706 | \$3.395 |
| Granted | 318,400 | \$6.632 | 242,004 | \$6.131 |
| Exercised | (121,183) | \$2.216 | (13,500) | \$2.244 |
| Forfeited | (123,742) | \$1.000 | 0 | \$0.000 |
| | ----- | ----- | ----- | ----- |
| Outstanding at the end of the year | 920,685 | \$5.310 | 847,210 | \$4.195 |
| | ===== | | ===== | |
| Exercisable at the end of the year | 684,264 | | 581,556 | |
| | ===== | | ===== | |
| Weighted average fair value of options granted during year | | \$6.632 | | \$6.131 |
| | | ----- | | ----- |

The following table summarizes information about stock options outstanding as of June 30, 2006:

| RANGE OF EXERCISE | NUMBER OUTSTANDING AT JUNE 30, | WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE | WEIGHTED AVERAGE EXERCISE | NUMBER EXERCISABLE AT JUNE 30, | WEIGHTED AVERAGE EXERCISE |
|----------------------|--------------------------------------|---|---------------------------------|--------------------------------------|---------------------------------|
|----------------------|--------------------------------------|---|---------------------------------|--------------------------------------|---------------------------------|

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| PRICES ----- | 2006 ----- | (YEARS) ----- | PRICE ----- | 2006 ----- | PRICE ----- |
|-----------------|---------------|------------------|----------------|---------------|----------------|
| 1.45 to 2.12 | 141,981 | 4.33 | \$1.82 | 141,981 | \$1.86 |
| 2.25 to 4.31 | 188,675 | 4.76 | \$2.83 | 188,675 | \$2.83 |
| 4.90 to 5.71 | 134,400 | 9.27 | \$5.17 | 134,400 | \$5.03 |
| 6.19 to 6.19 | 189,250 | 8.13 | \$6.19 | 189,250 | \$6.19 |
| 6.94 to 8.06 | 266,379 | 8.20 | \$7.48 | 266,379 | \$7.41 |

SALE OF COMMON STOCK AND WARRANTS

On March 17, 2004, the Company completed a \$10,400,000 private placement of common stock and common stock purchase warrants to accredited and institutional investors. The Company sold 800,000 shares of its common stock at \$13.00 per share. The investors also received warrants to purchase an additional 120,000 shares of common stock at an exercise price of \$15.60 per share. If not exercised, the warrants expire on September 13, 2009. The securities were sold pursuant to the exemptions from registration of Rule 506 of Regulation D and Section 4(2) under the Securities Act of 1933. The Company

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has subsequently filed a registration statement with the Securities and Exchange Commission, declared effective on April 20, 2004, to register for resale by the holders all of the common stock issued in conjunction with this private placement and common stock purchasable upon exercise of the warrants.

The net proceeds to the Company from the offering, after costs associated with the offering, of \$9,787,918, have been allocated among common stock and warrants based on their relative fair values. The Company used the Black-Sholes pricing model to determine the fair value of the warrants to be \$1,601,346.

EXERCISE OF WARRANTS TO PURCHASE COMMON STOCK

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

EXCHANGE OFFER FOR DREW SCIENTIFIC GROUP, PLC

On July 23, 2004, Escalon 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 issuances of shares of Escalon common stock in the exchange offer for the acquisition of Drew were made in accordance with Rule 802 under the Securities Act of 1933, as an exchange offer for a class of securities of a foreign private issuer in which the conditions regarding the limitation on United States ownership of Drew, the equal treatment of and United States holders and Form CB filings were satisfied.

The Company did not effect any repurchases of its common stock during the fiscal years ended June 30, 2006 and 2005.

8. INCOME TAXES

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The provision for income taxes for the years ended June 30, 2006, 2005 and 2004 consists of the following:

| | 2006 | 2005 | |
|-------------------------------|-------------|-------------|--|
| | ----- | ----- | |
| Current income tax provision | | | |
| Federal | \$ -- | \$ 100,000 | |
| State | 31,309 | 131,664 | |
| | ----- | ----- | |
| | 31,309 | 231,664 | |
| | ----- | ----- | |
| Deferred income tax provision | | | |
| Federal | (1,962,685) | 1,572,610 | |
| State | (460,383) | 370,026 | |
| Change in valuation allowance | (2,423,068) | (1,942,636) | |
| | ----- | ----- | |
| | -- | -- | |
| | ----- | ----- | |
| Income tax expense | \$ 31,309 | \$ 231,664 | |
| | ===== | ===== | |

Income taxes as a percentage of income for the years ended June 30, 2006 and 2005 differ from statutory federal income tax rate due to the following:

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| | 2006 | 2005 | |
|--|--------|--------|--|
| | ----- | ----- | |
| Statutory federal income tax rate | -34.0% | 34.0% | |
| State income taxes, net of federal income tax impact | -- | 4.9% | |
| Change in valuation allowance | 34.0% | -34.0% | |
| Other | -- | 3.7% | |
| | ----- | ----- | |
| Effective income tax rate | -- | 8.6% | |
| | ===== | ===== | |

As of June 30, 2006, the Company had deferred income tax assets of \$14,267,101. The deferred income tax assets have been reduced by a \$14,930,826 valuation allowance. The valuation allowance is based on uncertainty with respect to the ultimate realization of net operating loss carryforwards.

The components of the net deferred tax income tax assets and liabilities as of June 30, 2006 and 2005 are as follows:

| | 2006 | 2005 | |
|---------------------------------|---------------|---------------|--|
| | ----- | ----- | |
| Deferred income tax assets: | | | |
| Net operating loss carryforward | \$ 12,837,989 | \$ 15,468,279 | |

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| | | |
|---------------------------------------|--------------|--------------|
| Accrued bonus | 273,966 | -- |
| Executive post retirement costs | 456,540 | 456,540 |
| General business credit | 450,199 | 450,199 |
| Allowance for doubtful accounts | 146,876 | 76,256 |
| Accrued vacation | 202,722 | 156,040 |
| Inventory reserve | 84,601 | 51,654 |
| Accelerated depreciation | 382,450 | 46,354 |
| Warranty reserve | 95,574 | 84,805 |
| | ----- | ----- |
| Total deferred income tax assets | 14,930,826 | 16,790,127 |
| Valuation allowance | (12,711,806) | (15,139,874) |
| | ----- | ----- |
| | 2,214,020 | 1,650,253 |
| | ----- | ----- |
| Deferred income tax liabilities: | | |
| Accelerated amortization | (2,214,020) | (1,650,253) |
| | ----- | ----- |
| Total deferred income tax liabilities | (2,214,020) | (1,650,253) |
| | ----- | ----- |
| | \$ -- | \$ -- |
| | ===== | ===== |

As of June 30, 2006, the Company has a valuation allowance of \$12,711,806, which primarily relates to the federal net operating loss carryforwards. The valuation allowance is a result of management evaluating its estimates of the net operating losses available to the Company as they relate to the results of operations of acquired businesses subsequent to their being acquired by the Company. The Company evaluates a variety of factors in determining the amount of the valuation allowance, including the Company's earnings history, the number of years the Company's operating loss and tax credits can be carried forward, the existence of taxable temporary differences, and near term earnings expectations. Future reversal of the valuation allowance will be recognized either when the benefit is realized or when it has been determined that it is more likely than not that the benefit will be realized through future earnings. Any tax benefits related to stock options that may be recognized in the future through reduction of the associated valuation allowance will be recorded as additional paid-in capital. The Company has available federal and state net operating loss carryforwards of approximately \$37,349,000 and \$1,521,000, respectively, of which \$30,298,000 and \$1,456,000, respectively, will expire over the next ten years, and \$7,051,000 and \$65,000, respectively, will expire in years eleven through twenty. Not included in the \$37,349,000 federal net operating loss is approximately \$8.2 million federal NOL carryforward at June 30, 2006 which represents amounts that were transferred to the Company as a result of the acquisition of Drew. Use of this transferred NOL could be limited under Section 382 and can only be used against future Drew taxable income. Any tax benefit realized from such use would first reduce acquired goodwill.

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The Company continues to monitor the realization of its deferred tax assets based on changes in circumstances, for example, recurring periods of income for tax purposes following historical periods of cumulative losses or changes in tax laws or regulations. The Company's income tax provision and management's assessment of the realizability of the Company's deferred tax assets involve significant judgments and estimates. If taxable income expectations change, in the near term the Company may be required to reduce the valuation allowance which would result in a material benefit to the Company's results of operations in the period in which the benefit is determined by the Company.

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9. 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 June 30, 2006 are as follows:

| TWELVE MONTHS ENDING | LEASE OBLIGATIONS |
|----------------------|----------------------|
| ----- | ----- |
| 2007 | \$ 731,368 |
| 2008 | 411,137 |
| 2009 | 284,615 |
| 2010 | 292,710 |
| 2011 | 308,770 |
| Thereafter | 116,354 |
| | ----- |
| TOTAL | \$2,144,954 |
| | ===== |

Rent expense charged to operations during the years ended June 30, 2006, 2005 and 2004 was approximately \$890,000, \$772,000, and \$386,000, respectively.

CONTINGENCIES

ROYALTY AGREEMENT: CLINICAL DIAGNOSTICS SOLUTIONS

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

INTRALASE CORP. ("INTRALASE") LEGAL PROCEEDINGS

In October 1997, the Company and IntraLase entered into a License Agreement wherein the Company granted IntraLase the exclusive right to use the Company'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 the Company 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, the Company gave IntraLase notice of its intention to terminate the License Agreement due to IntraLase's failure to pay certain royalties that the Company 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 the Company 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 the Company ("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 the Company 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 the Company 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 the Company. 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 the Company royalties on IntraLase's accounts receivable. The court also held that IntraLase must give the Company 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 the Company 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. The Company 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 the Company 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 the Company and a declaration concerning the Company's audit rights under the License Agreement. On June 3, 2005, after having been served with the Company's Complaint filed in the Delaware Court of Chancery ("Delaware Action," described below), IntraLase filed an Amended Complaint in the Second Action. The Company, 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, the Company 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 the Company in the Company's Delaware Action. Accepting the Company's arguments for dismissal, the California Court held that

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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, the Company, 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, the Company 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 the Company.

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On February 21, 2006, the Company again gave IntraLase notice of its intention to terminate the License Agreement due to IntraLase's failure to pay certain royalties that the Company believed were due under the License Agreement as well as IntraLase's refusal to permit the Company 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 the Company to audit IntraLase's records and books of account and, instead, conditioned any inspection by the Company'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 the Company. On the same day, the Company filed its First Amended Complaint in the Delaware Action adding to its pending claims a claim for declaratory relief wherein the Company seeks a judgment declaring that the License Agreement terminated fifteen days after IntraLase received the Company's notice of defaults and intent to terminate and failed to cure said defaults.

On February 28, 2006, the Company agreed to suspend the cure periods applicable to the alleged breaches set out in its February 21, 2006 letter while the Company 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 did send its independent auditor to IntraLase's headquarters in early September, 2006 to commence the audit review, which is continuing. The Company is desirous of concluding this audit in October, 2006.

Separately, on April 22, 2005, the Company, 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, the Company 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 November 8, 2006.

The Company is cognizant of the legal expenses and costs associated with the IntraLase matter. The Company, however, is taking all necessary and appropriate actions to protect its rights and interests under the License Agreement. The Company expects expenses associated with this litigation to

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adversely impact earnings in the near term. The Company believes that IntraLase has sufficient funds to support such payments based on its filings with the SEC and filings in connection with the First Action.

DREW LEGAL PROCEEDINGS

CARVER LITIGATION-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,

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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

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legal counsel and disputes the allegations for 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.

10. RETIREMENT AND POST-RETIREMENT PLANS

The Company adopted a 401(k) retirement plan effective January 1, 1994. Escalon employees become eligible for the plan commencing on the date of employment. Company contributions are discretionary, and no Company contributions have been made since the plan's inception.

On January 14, 2000, Escalon acquired Sonomed. Sonomed adopted a 401(k) retirement plan effective on January 1, 1993. This plan has continued subsequent to the acquisition and is available only to Sonomed employees. The Company's contribution for the fiscal years ended June 30, 2006 and 2005 was \$35,034 and \$24,928, respectively.

On July 23, 2004, the Company acquired Drew. Drew adopted a 401(k) retirement plan effective on July 1, 1995. This plan has continued subsequent to the acquisition and is available only to Drew's United States employees. Company contributions are discretionary, and no contributions have been made since Drew was acquired by the Company. Drew also has two defined contribution retirement plans which were effective November 24, 2002 and February 1, 1992. These plans have continued subsequent to the acquisition and are available only to Drew's United Kingdom Employees. Drew contributions for the fiscal years ended June 30, 2006 and 2005 was \$10,000 and \$30,817, respectively.

On June 23, 2005, the Company entered into a Supplemental Executive Retirement Benefit Agreement with its Chairman and Chief Executive Officer. The agreement provides for the payment of

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supplemental retirement benefits to the covered executive in the event of his termination of services with the Company under the following circumstances.

- If the covered executive retires at age 65 or older, the Company would be obligated to pay the executive \$8,000 per month for life, with payments commencing the month after retirement. If the covered executive were to die within a period of three years after such retirement, the Company would be obligated to continue making such payments until a minimum of 36 monthly payments have been made to the covered executive and his beneficiaries in the aggregate.
- If the covered executive dies before his retirement while employed by the Company, the Company would be obligated to make 36 monthly payments to his beneficiaries of \$8,000 per month commencing in the month after his death.
- If the covered executive were to become disabled while employed by the Company, the Company would be obligated to pay the executive \$8,000 per month for life, with payments commencing the month after he

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suffers such disability. If the covered executive were to die within three years after suffering such disability, the Company would be obligated to continue making such payments until a minimum of 36 monthly payments have been made to the covered executive and his beneficiaries in the aggregate.

- If the covered executive's employment with the Company is terminated by the Company, or if the executive terminates his employment with the Company for good reason, as defined in the agreement, the Company would be obligated to pay the executive \$8,000 per month for life. If the covered executive were to die within a period of three years after such termination, the Company would be obligated to continue making such payments until a minimum of 36 monthly payments have been made to the covered executive and his beneficiaries in the aggregate.

In fiscal 2005 the Company accrued \$1,087,000, which represents the present value of the supplemental retirement benefits awarded. This amount is accrued at June 30, 2006 and 2005.

11. SALE OF SILICONE OIL PRODUCT LINE, LICENSING OF LASER TECHNOLOGY AND OTHER REVENUE

SALE OF SILICONE OIL PRODUCT LINE

In the first quarter of fiscal 2000, Escalon received \$2,117,000 from the sale to Bausch & Lomb of its license and distribution rights for the Silicone Oil product line. This sale resulted in a \$1,864,000 gain after writing off the remaining net book value of license and distribution rights associated with that product line. The Company's contract to receive additional consideration based on sales of Silicone Oil by Bausch & Lomb expired on August 12, 2005.

The 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 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% |

Royalties received from Silicone Oil during 2006 and 2005 were \$203,000 and \$1,486,000, respectively.

INTRALASE: LICENSING OF LASER TECHNOLOGY

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The material terms of the license of the Company's laser patents to IntraLase, 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 to the Company, 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

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year during the remaining term of the license. The minimum annual license fee is offset against the royalty payments.

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

1. Termination by the Company if IntraLase defaults in the payment of any royalty to the Company;
2. Termination by the Company if IntraLase makes any false report to the Company;
3. Termination by the Company in IntraLase defaults in the making of any required report to the Company;
4. Termination by either party due to the commission of any material breach of any covenant or promise by the other party under the license agreement; or
5. Termination of the license by IntraLase after 90 days notice (if IntraLase were to terminate the license, it would not be permitted to utilize the licensed technology necessary to manufacture its current products).

Also contributed to the venture were the Company's laser inventory, equipment and related furniture having a net book value of \$-0-. In December 1999, IntraLase received its first 510(K) approval from the FDA. IntraLase began selling its products in calendar 2002 (see note 9 for a description of the Company's legal proceedings with IntraLase).

BIO-RAD LABORATORIES, INC. ROYALTY

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

The material terms of the OEM Agreement, provided:

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

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

OTHER REVENUE

Other revenue includes quarterly payments received from:

- (1) Bausch & Lomb in connection with the sale of the Silicone Oil product line. This agreement expired August 12, 2005;

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- (2) Royalty payments received from IntraLase relating to the licensing of the Company's intellectual laser technology; and
- (3) Royalty payments received from Bio-Rad.

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The following table presents other revenue received by the Company for the years ended June 30, 2006 and 2005:

| | 2006 | 2005 |
|-------------------|-------------|-------------|
| | ----- | ----- |
| ROYALTY INCOME: | | |
| Bio-Rad royalty | \$ 283,000 | \$ 240,000 |
| Baush and Lomb | 203,000 | 1,486,000 |
| IntraLase royalty | 1,761,000 | 1,334,000 |
| | ----- | ----- |
| TOTAL | \$2,247,000 | \$3,060,000 |
| | ===== | ===== |

12. ACQUISITION OF DREW AND MRP, AND PRO FORMA RESULTS OF OPERATIONS

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 acquired all of the remaining Drew shares during fiscal year ended June 30, 2005. The results of Drew's operations have been included in the consolidated financial statements, and the Company has been operating Drew as an additional 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.

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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 |

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| | |
|---------------------------|--------------|
| Current liabilities | 3,392,286 |
| Long-term debt | 1,072,457 |
| | ----- |
| Total liabilities assumed | \$ 6,081,951 |
| | ----- |
| Net assets acquired | \$ 8,525,966 |
| | ===== |

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

| | FISCAL YEAR ENDED | |
|-----------------------------------|-------------------|--------------|
| | 2006 | 2005 |
| | ----- | ----- |
| Revenues, net | \$29,790,698 | \$26,924,622 |
| Cost of goods sold | 16,003,904 | 13,158,061 |
| | ----- | ----- |
| GROSS PROFIT | 13,786,794 | 13,766,561 |
| | ----- | ----- |
| Operating expenses | 16,822,984 | 14,449,080 |
| Other income and (expense) | 1,081,559 | 3,362,294 |
| | ----- | ----- |
| NET (LOSS) INCOME BEFORE TAXES | (1,954,631) | 2,679,775 |
| | ----- | ----- |
| Provision for income taxes | 31,309 | 231,664 |
| | ----- | ----- |
| NET (LOSS) INCOME | \$ (1,985,940) | \$ 2,448,111 |
| | ===== | ===== |
| BASIC NET (LOSS) INCOME PER SHARE | \$ (0.323) | \$ 0.420 |

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| | | |
|-------------------------------------|------------|-----------|
| | ===== | ===== |
| DILUTED NET (LOSS) INCOME PER SHARE | \$ (0.323) | \$ 0.393 |
| | ===== | ===== |
| WEIGHTED AVERAGE SHARES - BASIC | 6,152,455 | 5,831,564 |
| | ===== | ===== |
| WEIGHTED AVERAGE SHARES - DILUTED | 6,152,455 | 6,231,024 |
| | ===== | ===== |

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 \$905,807. 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. 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.

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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 MRP of January 30, 2006.

| | | |
|-------------------------|----|-------------|
| Current assets | \$ | 143,569 |
| Furniture and equipment | | 50,000 |
| Patents and Trademarks | | 11,200 |
| Covenant not to compete | | 319,609 |
| Customer list | | 123,360 |
| | | ----- |
| Goodwill | | 905,807 |
| Total assets acquired | | \$1,553,545 |
| | | ----- |
| Current liabilities | | 78,984 |
| | | ----- |
| Net assets acquired | | \$1,474,561 |
| | | ===== |

13. SEGMENT REPORTING

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The Company's operations are classified into four principal reporting segments. Table amounts in thousands:

SEGMENT STATEMENTS OF OPERATIONS (IN THOUSANDS) - TWELVE MONTHS ENDED JUNE 30,

| | DREW | | SONOMED | | VASCULAR | |
|---|------------|------------|----------|----------|----------|---------|
| | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| REVENUES, NET: | | | | | | |
| Product revenue | \$14,253 | \$11,294 | \$ 7,737 | \$ 7,663 | \$3,640 | \$3,180 |
| Other revenue | 283 | 240 | 0 | 0 | 0 | 0 |
| TOTAL REVENUE, NET | 14,536 | 11,534 | 7,737 | 7,663 | 3,640 | 3,180 |
| COSTS AND EXPENSES: | | | | | | |
| Cost of goods sold | 9,225 | 7,554 | 3,962 | 3,115 | 1,535 | 1,432 |
| Operating expenses | 7,741 | 5,211 | 3,671 | 3,593 | 2,112 | 1,747 |
| TOTAL COSTS AND EXPENSES | 16,966 | 12,765 | 7,633 | 6,708 | 3,647 | 3,179 |
| (LOSS) INCOME FROM OPERATIONS | (2,430) | (1,231) | 104 | 955 | (7) | 1 |
| OTHER (EXPENSE) AND INCOME: | | | | | | |
| Gain on sale of available for sale securities | 0 | 0 | 0 | 0 | 0 | 0 |
| Equity in OTM | 0 | 0 | 0 | 0 | 0 | 0 |
| Interest income | 0 | 4 | 0 | 0 | 0 | 0 |
| Interest expense | (63) | (83) | 0 | 0 | 0 | (1) |
| TOTAL OTHER (EXPENSE) AND INCOME | (63) | (79) | 0 | 0 | 0 | (1) |
| (LOSS) AND INCOME BEFORE TAXES | (2,493) | (1,310) | 104 | 955 | (7) | 0 |
| Income taxes | 0 | 0 | 21 | 21 | 0 | 0 |
| NET (LOSS) INCOME | \$ (2,493) | \$ (1,310) | \$ 83 | \$ 934 | \$ (7) | \$ 0 |
| Depreciation and amortization | \$ 271 | \$ 213 | \$ 22 | \$ 24 | \$ 94 | \$ 45 |
| Assets | \$17,205 | \$ 7,977 | \$13,381 | \$13,472 | \$3,838 | \$2,174 |
| Expenditures for long-lived assets | \$ 167 | \$ 26 | \$ 15 | \$ 23 | \$ 14 | \$ 11 |

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SEGMENT STATEMENTS OF OPERATIONS (IN THOUSANDS) - TWELVE MONTHS ENDED JUNE 30,

| | MEDICAL/TREK/EMI | | TOTAL | |
|-----------------|------------------|----------|----------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| REVENUES, NET: | | | | |
| Product revenue | \$1,914 | \$ 1,727 | \$27,544 | \$23,864 |

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| | | | | |
|---|---------|----------|------------|----------|
| Other revenue | 1,964 | 2,820 | 2,247 | 3,060 |
| | ----- | ----- | ----- | ----- |
| TOTAL REVENUE, NET | 3,878 | 4,547 | 29,791 | 26,924 |
| | ----- | ----- | ----- | ----- |
| COSTS AND EXPENSES: | | | | |
| Cost of goods sold | 1,282 | 1,058 | 16,004 | 13,159 |
| Operating expenses | 3,301 | 3,897 | 16,825 | 14,448 |
| | ----- | ----- | ----- | ----- |
| TOTAL COSTS AND EXPENSES | 4,583 | 4,955 | 32,829 | 27,607 |
| | ----- | ----- | ----- | ----- |
| (LOSS) INCOME FROM OPERATIONS | (705) | (408) | (3,038) | (683) |
| | ----- | ----- | ----- | ----- |
| OTHER (EXPENSE) AND INCOME: | | | | |
| Gain on sale of available for sale securities | | | | |
| | 1,157 | 3,412 | 1,157 | 3,412 |
| Equity in OTM | (174) | (64) | (174) | (64) |
| Interest income | 162 | 66 | 162 | 70 |
| Interest expense | 0 | 29 | (63) | (55) |
| | ----- | ----- | ----- | ----- |
| TOTAL OTHER (EXPENSE) AND INCOME | 1,145 | 3,443 | 1,082 | 3,363 |
| | ----- | ----- | ----- | ----- |
| (LOSS) AND INCOME BEFORE TAXES | 440 | 3,035 | (1,956) | 2,680 |
| | ----- | ----- | ----- | ----- |
| Income taxes | 10 | 211 | 31 | 232 |
| | ----- | ----- | ----- | ----- |
| NET (LOSS) INCOME | \$ 430 | \$ 2,824 | \$ (1,986) | \$ 2,448 |
| | ===== | ===== | ===== | ===== |
| Depreciation and amortization | \$ 96 | \$ 106 | \$ 483 | \$ 388 |
| Assets | \$4,221 | \$16,426 | \$38,645 | \$40,049 |
| Expenditures for long-lived assets | \$ 138 | \$ 44 | \$ 334 | \$ 104 |

The Company operates in the healthcare market, specializing in the development manufacture and marketing of (1) ophthalmic medical devices and pharmaceuticals; (2) in-vitro diagnostic ("IVD") instrumentation and consumables for use in human and veterinary hematology; and (3) vascular access devices. The business segments reported above are the segments for which separate financial information is available and for which operating results are evaluated regularly by executive management in deciding how to allocate resources and assessing performance. The accounting policies of the business segments are the same as those described in the summary of significant accounting policies. For the purposes of this illustration, corporate expenses, which consist primarily of executive management and administrative support functions, are allocated across the business segments based upon a methodology that has been established by the Company, which includes a number of factors and estimates and that has been consistently applied across the business segments. These expenses are otherwise included in the Medical/Trek/EMI business unit.

During the fiscal year ended June 30, 2005, Drew derived its revenue from the sale of instrumentation and consumables for blood cell counting and blood analysis in the areas of diabetes, cardiovascular diseases and human and veterinary hematology. Sonomed derived its revenue from the sale of A-Scans, B-Scans and pachymeters. These products are used for diagnostic or biometric applications in ophthalmology. Vascular derived its revenue from the sale of PD Access(TM) and SmartNeedle(TM) monitors, needles and catheter products. These products are used by medical personnel to assist in gaining access to arteries and veins in difficult cases. Medical/Trek/EMI derived its revenue from the sale of ISPAN(TM) gas products, various disposable ophthalmic surgical products, CFA digital imaging systems and related products, revenue derived from Bausch & Lomb's sale of Silicone Oil (the contract for which expired on August 12, 2005) and from royalty revenue related to IntraLase's licensing of the Company's intellectual laser technology.

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During the fiscal year ended June 30, 2004, there was one entity, Bausch & Lomb, from whom Escalon derived greater than 10% of consolidated net revenue. Revenue from Bausch & Lomb was

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approximately \$2,622,000, or 17.8% of consolidated net revenue during the year ended June 30, 2004. This revenue is recorded in the Medical/Trek/EMI business unit. No customer represented more than 10% of consolidated revenue during the years ended June 30, 2006 and 2005. Of the external revenue reported above, the following amounts were derived internationally during the years ended June 30:

| | 2006 | 2005 |
|------------------|--------------|-------------|
| | ----- | ----- |
| Drew | \$ 8,471,608 | \$5,616,000 |
| Sonomed | 4,316,856 | 3,818,000 |
| Vascular | 226,665 | 323,000 |
| Medical/Trek/EMI | 29,671 | 48,000 |
| | ----- | ----- |
| | \$13,044,800 | \$9,805,000 |
| | ===== | ===== |

14. RELATED-PARTY TRANSACTIONS

Escalon and a member of the Company's Board of Directors are founding and equal members of Ocular Telehealth Management, LLC ("OTM"). OTM is a diagnostic telemedicine company providing remote examination, diagnosis and management of disorders affecting the human eye. OTM's initial solution focuses on the diagnosis of diabetic retinopathy by creating access and providing annual dilated retinal examinations for the diabetic population. OTM was founded to harness the latest advances in telecommunications, software and digital imaging in order to create greater access and a more successful disease management for populations that are susceptible to ocular disease. Through June 30, 2006, Escalon had invested \$256,000 in OTM and owned 45% of OTM. The members of OTM have agreed to review the operations of OTM after 24 months of operations which began in April 2004, at which time the members each have the right to sell their membership back to OTM at fair market value. Such sale would be subject to OTM's ability to buy back the membership. The members met in May 2006 and decided to continue the operations of OTM, emphasizing that all additional funding will be provided pro-rata consistent with membership percentage ownership. The Company will provide administrative support functions to OTM. For the years ended 2006 and 2005 the Company recorded losses of \$173,844 and \$63,613, respectively. 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 years 2006 and 2005 were \$180,000 and \$165,000, respectively and in 2005 20,000 options to purchase common stock of the Company at an exercise price of \$8.06 per share. Caryn Lindsey (former daughter-in-law of the CEO) acted as a consultant for the Company in 2005 and as a consultant and employee during 2006. Ms. Lindsey in 2006 and 2005 received consulting fees and salary of \$110,939 and \$118,000, respectively and in 2005

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3,000 options to purchase common stock of the Company at an exercise price of \$4.97 per share.

15. INTRALASE INITIAL PUBLIC OFFERING AND SALE OF INTRALASE COMMON STOCK

In October 1997, Escalon licensed its intellectual laser properties to IntraLase in exchange for an equity interest of 252,535 shares of Common Stock (as adjusted for splits), as well as royalties on future product sales. The Company has historically accounted for these shares a \$0 basis because a readily determinable market value was previously not available. On October 7, 2004, IntraLase announced the initial public offering of shares of its common stock at a price of \$13.00 per share. The shares of common stock were restricted for a period of less than one year and were permitted to be sold after April 6, 2005 pursuant to a certain Fourth Amended Registration Rights Agreement between the Company and IntraLase. The Company sold 58,355 shares of IntraLase common stock in July 2005 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 \$1,157,335. The Company sold 191,000 shares of IntraLase common stock in May 2005 at \$17.9134 per share resulting in gross proceeds of \$3,421,459. After paying broker commissions and other fees of \$9,698, the Company received net proceeds of \$3,411,761. The net

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proceeds from the sales were recorded in other income and expense. As of June 30, 2006 and 2005, the Company had 3000 and 61,535 shares, respectively of IntraLase that were classified as available-for-sale securities and had a market value of \$50,220 and \$1,207,317.

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 was 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.

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