

Edgar Filing: VASOMEDICAL INC - Form 10-Q

VASOMEDICAL INC  
Form 10-Q  
January 17, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended November 30, 2005

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: 0-18105

VASOMEDICAL, INC.

-----  
(Exact name of registrant as specified in its charter)

Delaware

11-2871434

-----  
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification Number)

180 Linden Ave., Westbury, New York 11590

-----  
(Address of principal executive offices)

Registrant's Telephone Number (516) 997-4600

Number of Shares Outstanding of Common Stock,  
\$.001 Par Value, at January 13, 2006 62,464,897

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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Vasomedical, Inc. and Subsidiaries

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CONSOLIDATED CONDENSED BALANCE SHEETS

	November 30, 2005
	-----
ASSETS	(unaudited)
CURRENT ASSETS	
Cash and cash equivalents	\$2,655,400
Certificates of deposit	293,686
Accounts receivable, net of an allowance for doubtful accounts of \$458,639 at November 30, 2005, and \$394,692 at May 31, 2005	2,068,038
Inventories, net	2,949,298
Other current assets	370,680
	-----
Total current assets	8,337,102
PROPERTY AND EQUIPMENT, net of accumulated depreciation of \$2,548,367 at November 30, 2005, and \$2,626,983 at May 31, 2005	1,892,501
DEFERRED INCOME TAXES	--
OTHER ASSETS	316,094
	-----
	\$10,545,697
	=====

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LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES	
Accounts payable and accrued expenses	\$1,702,527
Current maturities of long-term debt and notes payable	258,477
Sales tax payable	218,206
Deferred revenue	1,718,581
Accrued warranty and customer support expenses	62,000
Accrued professional fees	330,207
Accrued commissions	189,567
	-----
Total current liabilities	4,479,565
LONG-TERM DEBT	888,805
ACCRUED WARRANTY COSTS	3,000
DEFERRED REVENUE	842,449
OTHER LIABILITIES	--
COMMITMENTS AND CONTINGENCIES	
STOCKHOLDERS' EQUITY	
Preferred stock, \$.01 par value; 1,000,000 shares authorized; 20,500 and 0 at November 30, 2005, and May 31, 2005, respectively, issued and outstanding; aggregate liquidation preference of \$2,067,083 and \$0 at November 30, 2005 and May 31, 2005, respectively	205
Common stock, \$.001 par value; 110,000,000 shares authorized; 59,964,897 and 58,552,688 shares at November 30, 2005, and May 31, 2005, respectively, issued and outstanding	59,964
Additional paid-in capital	46,143,600
Accumulated deficit	(41,871,891)
	-----
Total stockholders' equity	4,331,878
	-----
	\$10,545,697
	=====

The accompanying notes are an integral part of these condensed financial statements.

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Vasomedical, Inc. and Subsidiaries

CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS  
(unaudited)

	Six Months Ended		Thru
	November 30,		
	2005	2004	2005
	-----	-----	-----
Revenues			
Equipment sales	\$4,191,318	\$6,497,459	\$1,734,
Equipment rentals and services	2,025,237	1,785,632	945,
	-----	-----	-----
Total revenues	6,216,555	8,283,091	2,680,

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Cost of Sales and Services			
Cost of sales, equipment	1,857,405	2,202,664	825,
Cost of equipment rentals and services	663,608	633,003	272,
	-----	-----	-----
Total cost of sales and services	2,521,013	2,835,667	1,097,
	-----	-----	-----
Gross Profit	3,695,542	5,447,424	1,582,
Operating Expenses			
Selling, general and administrative	4,917,773	6,140,879	2,508,
Research and development	1,115,702	1,657,846	603,
Provision for doubtful accounts	70,575	132,956	
	-----	-----	-----
Total operating expenses	6,104,050	7,931,681	3,112,
	-----	-----	-----
LOSS FROM OPERATIONS	(2,408,508)	(2,484,257)	(1,529,
Other Income (Expense)			
Interest and financing costs	(44,953)	(59,040)	(21,
Interest and other income, net	40,790	30,827	21,
	-----	-----	-----
Total other income (expense)	(4,163)	(28,213)	
	-----	-----	-----
LOSS BEFORE INCOME TAXES	(2,412,671)	(2,512,470)	(1,529,
Income tax expense, net	(7,112,826)	(21,683)	(7,103,
	-----	-----	-----
NET LOSS	(9,525,497)	(2,534,153)	(8,632,
Preferred Stock Dividend	(854,536)	--	(48,
	-----	-----	-----
NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	\$ (10,380,033)	\$ (2,534,153)	\$ (8,681,
	=====	=====	=====
Net loss per common share			
- basic	\$ (0.18)	\$ (0.04)	\$ (0
	=====	=====	=====
- diluted	\$ (0.18)	\$ (0.04)	\$ (0
	=====	=====	=====
Weighted average common shares outstanding			
- basic	59,031,491	58,542,488	59,421,
	=====	=====	=====
- diluted	59,031,491	58,542,488	59,421,
	=====	=====	=====

The accompanying notes are an integral part of these condensed financial statements.

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	Preferred Stock		Common Stock		Additional	Accumulated
	Shares	Amount	Shares	Amount	Paid-in Capital	Deficit
	-----	-----	-----	-----	-----	-----
Balance at June 1, 2005	--	--	58,552,688	\$58,552	\$51,450,639	\$(32,346,39
Issuance of Series D convertible preferred stock, net of costs	25,000	\$250			1,613,209	
Warrants issued in connection with the issuance of Series D convertible preferred stock					411,158	
Beneficial conversion feature embedded in Series D convertible preferred stock issued					786,247	
Dividends on Series D convertible preferred stock					(854,536)	
Issuance of common stock in connection with the issuance of Series D convertible preferred stock			200,000	200	125,800	
Issuance of common stock in connection with the conversion of Series D convertible preferred stock	(4,500)	(45)	987,209	987	(942)	
Issuance of common stock in payment of outside director fees			225,000	225	101,025	
Reserve for tax benefit of stock options and warrants exercised in prior years					(7,489,000)	
Net loss						(9,525,49
Balance at November 30, 2005	20,500	\$205	59,964,897	\$59,964	\$46,143,600	\$(41,871,89

The accompanying notes are an integral part of this condensed financial statement.

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Vasomedical, Inc. and Subsidiaries

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS  
(unaudited)

Six  
N

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2005

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Cash flows from operating activities	
Net loss	\$ (9,525,49)
Adjustments to reconcile net loss to net cash used in operating activities	
Depreciation and amortization	307,37
Provision for doubtful accounts	70,57
Reserve for excess and obsolete inventory	(82,76)
Deferred income taxes	7,093,00
Common stock issued for services	101,25
Changes in operating assets and liabilities	
Accounts receivable	(246,61)
Inventories	549,67
Other current assets	155,27
Other assets	(16,58)
Accounts payable, accrued expenses and other current liabilities	25,84
Other liabilities	(114,25)
	7,842,78
Net cash used in operating activities	(1,682,71)
Cash flows provided by (used in) investing activities	
Purchase of property and equipment	-
Purchase of certificates of deposit and treasury bills	-
Redemptions of certificates of deposit	1,464,75
Net cash provided by (used in) investing activities	1,464,75
Cash flows provided by financing activities	
Payments on long term debt and notes payable	(250,57)
Payments of preferred stock dividends	(51,20)
Payments of preferred stock issue costs	(314,38)
Proceeds from exercise of options and warrants	-
Proceeds from sale of convertible preferred stock	2,500,00
Net cash provided by financing activities	1,883,83
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,665,87
Cash and cash equivalents - beginning of period	989,52
Cash and cash equivalents - end of period	\$2,655,40
=====	
Non-cash investing and financing activities were as follows:	
Inventories transferred to (from) property and equipment, attributable to operating leases, net	\$ (55,93)
Issue of note for purchase of insurance policy	\$302,05
Preferred stock dividends	\$803,33
Preferred stock issue costs	\$227,08
Supplemental Disclosures	
Interest Paid	\$44,95
Income taxes paid	\$22,08

The accompanying notes are an integral part of these condensed financial statements.

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Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
November 30, 2005

## NOTE A - BASIS OF PRESENTATION

The consolidated condensed balance sheet as of November 30, 2005, and the related consolidated condensed statements of operations for the six and three-month periods ended November 30, 2005 and 2004, changes in stockholders' equity for the six-month period ended November 30, 2005, and cash flows for the six-month periods ended November 30, 2005 and 2004, have been prepared by Vasomedical, Inc. and Subsidiaries (the "Company") without audit. In the opinion of management, all adjustments (which include normal, recurring accrual adjustments) necessary to present fairly the financial position and results of operations as of November 30, 2005, and for all periods presented have been made.

Certain information and footnote disclosures, normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Annual Report on Form 10-K for the year ended May 31, 2005. Results of operations for the periods ended November 30, 2005 and 2004 are not necessarily indicative of the operating results expected or reported for the full year.

We have incurred declines in revenue and significant operating losses during the last three fiscal years and our ability to continue operating is dependent upon achieving profitability in the refractory angina market or through additional debt or equity financing. Profitability is largely dependent on reducing operating costs as well as halting the declining revenue trend and maintaining our current base of revenue in the refractory angina market. Our ability to maintain our current base of revenue is largely dependent upon refocusing our sales and marketing efforts in the refractory angina market and operating in a more efficient manner. If we are not able to maintain our existing base of revenue and reduce operating costs as described below or raise additional capital we will not be able to continue as a going concern.

In order to bring the Company's cost structure more into alignment with its current revenue base in the refractory angina market, we have planned a company restructuring to be initiated in January 2006. The restructure will reduce manufacturing and operating costs by approximately \$3 million per year compared to current levels, help us to conserve cash and provide additional time necessary to complete the application process for expanded reimbursement coverage with The Centers for Medicare and Medicaid Services (CMS) and an opportunity to rebuild sales to a profitable level.

We believe that our cash flow from operations following the restructuring initiated in January 2006, together with our current cash reserves and the cash received from the sale of convertible preferred stock and warrants on July 19, 2005, will be sufficient to fund our minimum projected capital requirements through at least May 31, 2006, however it is not possible to predict the impact of the Proposed Decision Memorandum issued December 20, 2005, on current operations.

In the event that additional capital is required, we may seek to raise such capital through public or private equity or debt financings or other means. We may not be able to obtain additional financing on favorable terms or at all. If

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we are unable to raise additional funds when we need them, we may be required to further scale back our operations, research, marketing or sales efforts or obtain funds through arrangements with collaborative partners or others that may require us to license or relinquish rights to technologies or products. Future capital funding, if available, may result in dilution to current shareholders, and new investors could have rights superior to existing stockholders.

The accompanying financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

### Reclassifications

Certain reclassifications have been made to the prior year's amounts to conform with the current year's presentation.

### NOTE B - IMPACT OF NEW ACCOUNTING PRONOUNCEMENTS

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154 ("SFAS No. 154"), "Accounting Changes and Error Corrections." SFAS No. 154 replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting

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### Vasomedical, Inc. and Subsidiaries

#### NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited) November 30, 2005

principle. The Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 153 ("SFAS No. 153"), "Exchanges of Non-monetary Assets - an amendment of APB Opinion No. 29". SFAS No. 153 amends Opinion 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for fiscal periods after June 15, 2005. The Company adopted SFAS No. 153 effective for fiscal periods beginning September 1, 2005. The adoption of SFAS No. 153 did not have a material impact on the Company's consolidated financial statements.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123(R) ("SFAS No. 123(R)"), "Accounting for Stock-Based Compensation". SFAS No. 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires that the fair value of such equity instruments be recognized as expense in the historical financial statements as services are performed. Prior to SFAS No. 123(R), only certain pro-forma disclosures of fair value were required. SFAS No. 123(R) shall be effective for the Company as of



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the beginning of the next fiscal year that begins after June 15, 2005. The adoption of this new accounting pronouncement is expected to have a material impact on the financial statements of the Company commencing with the quarter ending August 31, 2006.

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151 ("SFAS No. 151"), Inventory Costs, an amendment of ARB No. 43, Chapter 4. The amendments made by SFAS No. 151 will improve financial reporting by clarifying that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 24, 2004. The Company adopted SFAS No. 151 effective for fiscal periods beginning June 1, 2005. We determined that our production facilities are currently operating below normal capacity and as a result we applied production overhead rates based on normal production capacity which resulted in a reduction of the amount of overhead allocated to inventory for the six month and three month periods ended November 30, 2005 of \$141,000 and \$68,000, respectively. Had the Company adopted the provisions of SFAS No. 151 beginning in fiscal 2005, there would have been no change in overhead allocation as the Company was operating within its normal production capacity at that time.

### NOTE C - STOCK-BASED COMPENSATION

The Company has five stock-based employee and director compensation plans. The Company accounts for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations ("APB No. 25") and has adopted the disclosure provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123." Under APB No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Accordingly, no compensation expense has been recognized in the consolidated financial statements in connection with employee stock option grants.

During the six-month period ended November 30, 2005, the Board of Directors granted non-qualified stock options under the 2004 Stock Option/Stock Issuance Plan to three officers, and 49 employees to purchase an aggregate of 1,218,045 shares of common stock, at an exercise price of \$0.45 to \$0.58 per share, which represented the fair market value of the underlying common stock at the time of the respective grants. These options vest over one to three year periods, and expire ten years from the date of grant.

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Vasomedical, Inc. and Subsidiaries

### NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited) November 30, 2005

During the six-month period ended November 30, 2005, options to purchase 391,410 shares of common stock at an exercise price of \$0.57 - \$5.15 were cancelled.

The following table illustrates the effect on net loss and loss per share had the Company applied the fair value recognition provisions of Statement of

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Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation.

	Six Months Ended November 30,		Three Nove
	2005	2004	2005
Net loss attributable to common stockholders, as reported	\$(10,380,033)	\$(2,534,153)	\$(8,681,548)
Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards	(433,742)	(653,526)	(221,448)
Pro forma net loss	\$(10,813,775)	\$(3,187,679)	\$(8,902,996)
Loss per share:			
Basic and diluted - as reported	\$(0.18)	\$(0.04)	\$(0.15)
Basic and diluted - pro forma	\$(0.18)	\$(0.05)	\$(0.15)

For purposes of estimating the fair value of each option on the date of grant, the Company utilized the Black-Scholes option-pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Equity instruments issued to non-employees in exchange for goods, fees and services are accounted for under the fair value-based method of SFAS No. 123.

The fair value of the Company's stock-based awards was estimated assuming no expected dividends and the following weighted-average assumptions for the six months ended November 30, 2005:

Expected life (years)	5
Expected volatility	70%
Risk-free interest rate	4.13%
Expected dividend yield	0.0%

### NOTE D - LOSS PER COMMON SHARE

Basic loss per share is based on the weighted average number of common shares outstanding without consideration of potential common shares. Diluted loss per share is based on the weighted average number of common and potential common shares outstanding. The calculation takes into account the shares that may be issued upon the exercise of stock options and warrants, reduced by the shares that may be repurchased with the funds received from the exercise, based on the average price during the period, plus conversion of convertible preferred

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stock into common shares based upon the most advantageous conversion rate during the period, unless the effect on results of operations is antidilutive.

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Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
November 30, 2005

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

	Six Months Ended November 30,		Three M N
	2005	2004	2005
<b>Numerator:</b>			
Net loss	\$ (9,525,497)	\$ (2,534,153)	\$ (8,632,)
Deemed dividend related to beneficial conversion feature on Series D preferred stock	(786,247)	--	(48,
Series D preferred stock dividends	(68,289)	--	(48,
Net loss attributable to common stockholders - basic and diluted	\$ (10,380,033)	\$ (2,534,153)	\$ (8,681,
<b>Denominator:</b>			
Basic - weighted average common shares	59,031,491	58,542,488	59,421,
Stock options	--	--	
Warrants	--	--	
Convertible preferred stock	--	--	
Diluted - weighted average common shares	59,031,491	58,542,488	59,421,
Basic and diluted loss per common share	\$ (0.18)	\$ (0.04)	\$ (0

Options, warrants, and convertible preferred stock to purchase common stock, in accordance with the following table, were excluded from the computation of diluted loss per share because the effect of their inclusion would be antidilutive.

	Six months and three m ended November 30,	
	2005	
Options to purchase common stock	7,372,179	6,8
Warrants to purchase common stock	2,454,538	2
Convertible preferred stock	5,125,000	

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14,951,717 7,0  
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NOTE E - INVENTORIES, NET

Inventories, net consist of the following:

	November 30, 2005	Ma 2
Raw materials	\$857,239	\$
Work in process	1,053,185	1,
Finished goods	1,038,874	1,
	-----	-----
	\$2,949,298	\$3,
	=====	=====

At November 30, 2005 and May 31, 2005, the Company has recorded reserves for excess and obsolete inventory of \$483,384 and \$566,149, respectively.

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Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
November 30, 2005

NOTE F - PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows:

	November 30, 2005	May 3 2005
Land	\$ 200,000	\$ 200,
Building and improvements	1,383,976	1,383,
Office, laboratory and other equipment	1,444,850	1,445,
EECP systems under operating leases or under loan for clinical trials or evaluations	1,132,171	1,552,
Furniture and fixtures	162,068	162,
Leasehold improvements	117,803	117,
	-----	-----
	4,440,868	4,861,
	-----	-----
Less: accumulated depreciation and amortization	(2,548,367)	(2,626,
	-----	-----
	\$1,892,501	\$2,234,
	=====	=====

NOTE G - NOTES PAYABLE

The Company financed the purchase of Director's and Officer's Liability Insurance through the issuance of a note with a principal value of \$302,052. The note, which bears interest at 5.85%, is payable in ten monthly installments consisting of principal and interest, and expires in March 2006. The balance outstanding at November 30, 2005, of \$122,586 is presented on the consolidated

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condensed balance sheet in current maturities of long-term debt and notes payable.

### NOTE H - LONG-TERM DEBT

The following table sets forth the computation of long-term debt:

	November 30, 2005	May 2004
	-----	-----
Facility loans (a)	\$942,183	\$96,000
Term loans (b)	82,513	12,000
	-----	-----
	1,024,696	1,092,000
Less: current portion	(135,891)	(14,000)
	-----	-----
	\$888,805	\$948,000
	=====	=====

(a) The Company purchased its headquarters and warehouse facility and secured notes of \$641,667 and \$500,000, respectively, under two programs sponsored by New York State. These notes, which bear interest at 7.8% and 6%, respectively, are payable in monthly installments consisting of principal and interest payments over fifteen-year terms, expiring in September 2016 and January 2017, respectively, and are secured by the building.

(b) In fiscal years 2003 and 2004, the Company financed the cost and implementation of a management information system and secured several notes, aggregating approximately \$305,219. The notes, which bear interest at rates ranging from 7.5% through 12.5%, are payable in monthly installments consisting of principal and interest payments over four-year terms, expiring at various times between August and October 2006.

### NOTE I - DEFERRED REVENUES

The Company records revenue on extended service contracts ratably over the term of the related warranty contracts. Effective September 1, 2003, the Company prospectively adopted the provisions of EITF 00-21. Upon adoption of the provisions of EITF 00-21, the Company began to defer revenue related to domestic

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Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
November 30, 2005

EECP system sales for the fair value of in-service and training to the period when the services are rendered and for service arrangements ratably over the service period, which is generally one year:

The changes in the Company's deferred revenues are as follows:

	Six Months Ended November 30,	
	-----	-----
	2005	2004
		2005

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Deferred Revenue at the beginning of the period	\$2,551,532	\$2,846,451	\$2,476,000
ADDITIONS			
Deferred extended service contracts	1,177,310	1,044,364	666,000
Deferred in-service and training	85,000	117,500	37,000
Deferred service arrangements	265,000	497,500	112,000
RECOGNIZED AS REVENUE			
Deferred extended service contracts	(1,143,855)	(883,446)	(563,000)
Deferred in-service and training	(85,000)	(170,000)	(35,000)
Deferred service arrangements	(288,957)	(678,751)	(133,000)
Deferred revenue at end of period	2,561,030	2,773,618	2,561,000
Less: current portion	(1,718,581)	(1,959,910)	(1,718,000)
Long-term deferred revenue at end of period	\$842,449	\$813,708	\$842,000

NOTE J - WARRANTY COSTS

Equipment sold is generally covered by a warranty period of one year. Effective September 1, 2003, we adopted the provisions of EITF 00-21 on a prospective basis for our shipments to customers in the United States. Under EITF 00-21, for certain arrangements, a portion of the overall system price attributable to the first year service arrangement is deferred and recognized as revenue over the service period. As such, we no longer accrue warranty costs upon delivery for these customers but rather recognize warranty and related service costs as incurred. Prior to September 1, 2003, we accrued a warranty reserve for estimated costs to provide warranty services when the equipment sale was recognized.

Equipment sold to international customers through our distributor network is generally covered by a one-year warranty period. We do not offer a service arrangement to international customers; consequently, for these customers we accrue a warranty reserve for estimated costs to provide warranty services when the equipment sale is recognized.

The factors affecting our warranty liability included the number of units sold and historical and anticipated rates of claims and costs per claim. The warranty provision resulting from transactions prior to September 1, 2003, will be reduced in future periods for material and labor costs incurred as related product is returned during the warranty period or when the warranty period elapses.

The changes in the Company's product warranty liability are as follows:

	Six Months Ended November 30,		Three
	2005	2004	2005
Warranty liability at the beginning of the period	\$118,333	\$244,917	\$95,000
Expense for new warranties issued	15,000	--	3,000
Warranty amortization	(68,333)	(90,334)	(33,000)
Warranty liability at end of period	65,000	154,583	65,000
Less: current portion	(62,000)	(120,083)	(62,000)

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Long-term warranty liability at end of period	\$3,000	\$34,500	\$3,
	=====	=====	=====

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NOTE K - INCOME TAXES

As of August 31, 2005, we had recorded deferred tax assets of \$14,582,000 net of a \$4,674,000 valuation allowance related to the anticipated recovery of tax loss carryforwards.

As discussed in Note N, on December 20, 2005, Centers for Medicare and Medicaid Services (CMS) issued a Proposed Decision Memorandum (PDM) for External Counterpulsation in response to Vasomedical's application to expand reimbursement coverage to include Canadian Cardiovascular Society (CCSC) Class II angina and New York Heart Association (NYHA) Class II/III congestive heart failure (CHF). The PDM stated that the evidence was not adequate to conclude that external counterpulsation therapy is reasonable and necessary to expand reimbursement coverage to CCSC Class II angina and NYHA Class II/III CHF. Current coverage for CCSC class III/IV refractory angina will remain in effect.

Consequently, we could no longer conclude that, based upon the weight of available evidence, it was "more likely than not" that the net deferred tax asset of \$14,582,000 would be realized, and added \$14,582,000 to the valuation allowance to bring the net deferred tax asset carrying value to zero. During the six-months ended November 30, 2005 and 2004, we thus recorded a provision for income taxes of \$7,112,826 and \$21,683, respectively. The provision for income taxes for the second quarter of fiscal 2006 consisted mainly of a \$7,093,000 increase in the valuation allowance, but does not include an additional \$7,489,000 added to the deferred tax valuation allowance for tax benefits associated with prior years' exercises of stock options and warrants, which was charged directly to additional paid-in capital.

Prior to December 20, 2005, we believed that the Company was positioned for long-term growth despite the declines in revenue and significant operating losses during the last three fiscal years, and that based upon the weight of available evidence, that it was "more likely than not" that net deferred tax assets would be realized. The "more likely than not" standard is subjective, and was based upon management's estimate of a greater than 50% probability that its long range business plan could be realized. Our estimates were largely dependent upon achieving considerable growth in revenue and profits resulting from the successful commercialization of EECF therapy into the congestive heart failure indication, which we believed would have enabled us to reverse the current trend of increasing losses and generate pre-tax income in excess of \$39 million over the next seven years in order to fully utilize all of the deferred tax assets.

Ultimate realization of the deferred tax assets is dependent upon our generating sufficient taxable income prior to the expiration of the tax loss carryforwards.

NOTE L - SERIES D CONVERTIBLE PREFERRED STOCK AND WARRANTS

On July 19, 2005, we entered into a Securities Purchase Agreement that provided us with gross proceeds of \$2.5 million through a private placement of preferred stock with M.A.G. Capital, LLC through its designated funds, Monarch Pointe Fund Ltd., Mercator Momentum Fund III, LP, and Mercator Momentum Fund, LP

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(the "Investors"). The agreement provided for a private placement of 25,000 shares of Vasomedical's Series D Preferred Stock at \$100 per share. The preferred stock is convertible into shares of Vasomedical's common stock at 85 percent of the volume weighted average price per share for the five trading days preceding any conversion, but not at more than \$0.6606 or less than \$0.40 per share. Vasomedical may, at its option, require the holders to convert all their preferred stock into common shares if the closing price for the common stock for the preceding 20 trading days has been greater than \$1.30 per share. The Investors also acquired warrants for the purchase of 1,892,219 shares of common stock. The warrants may be exercised at a price of \$0.69 per share for a term of five years, ending July 19, 2010. Conversion of the preferred stock and exercise of the warrants are subject to limitation such that the beneficial ownership of the Investors and their affiliates shall not exceed 9.99% of the common stock outstanding.

An event of default occurs if we fail to timely pay the dividend or commence a voluntary case or proceeding under the bankruptcy laws, among other specified occurrences. Upon an event of default, the price at which the preferred stock may be converted into common stock is reduced from 85 percent to 75 percent of the then current volume weighted average market price per share, but not more than \$0.6606 or less than \$0.40 per share (the "Floor Price"). In the event that our quarterly gross revenues are less than \$2,500,000, then the Floor Price shall automatically reduce to \$0.30. In addition, the holders of the preferred stock have the right to be paid first from the assets of Vasomedical upon any dissolution or liquidation of the Company in an amount equal to \$100 per share plus any declared but unpaid dividends.

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Under the terms of a Registration Rights Agreement with the Investors, Vasomedical filed a Form S-3 registration statement with the Securities and Exchange Commission (SEC) on August 22, 2005, for 10,787,871 shares of common stock representing up to 8,533,333 shares issuable in connection with conversion of our Series D Convertible Preferred Stock and up to 2,254,538 shares issuable upon the exercise of our common stock purchase warrants. The registration statement was declared effective by the SEC on September 1, 2005. The total number of shares registered is based on a conversion price of \$0.30 per share, which would only have affect in the event of default by Vasomedical of its obligation to holders of the Series D Convertible Preferred Stock.

These securities were offered and sold to the Investors in a private placement transaction made in reliance upon exemptions from registration pursuant to Section 4(2) of the Securities Act of 1933. The Investors are accredited investors as defined in Rule 501 of Regulation D promulgated under the Securities Act of 1933. Vasomedical intends to apply the funds for working capital.

### Warrants and Beneficial Conversion Feature

The Company applied Emerging Issues Task Force Issue No. 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" (EITF No. 98-5) and Emerging Issues Task Force (EITF 00-27) Application of Issue No. 98-5 to Certain Convertible Instruments in accounting for the preferred stock issuance. EITF No. 98-5 provides that detachable warrants issued with convertible securities are valued separately, and that the beneficial conversion feature of the convertible security be measured and recognized over the minimum period over which the shareholders can



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realize the return.

The Task Force reached a consensus that convertible preferred securities with a non-detachable conversion feature that is in-the-money at the commitment date represents an embedded beneficial conversion feature that should be recognized as a dividend and recorded to additional paid-in capital. That amount should be calculated at the commitment date as the difference between the allocated portion of the gross proceeds to the convertible preferred stock and the fair value of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible (intrinsic value method).

The beneficial conversion feature is treated analogous to a dividend and is recognizable immediately over the minimum period during which the preferred shareholders can realize that return. The imputed dividend will increase the Company's loss for the purpose of computing the loss-per-share. The beneficial conversion feature is calculated at its intrinsic value at the commitment date (that is, the difference between the total gross proceeds allocated to the preferred stock as compared to the total market value of the common stock into which the Preferred Stock is convertible on the commitment date. The computed value of the beneficial conversion feature is treated as a deemed dividend immediately with a corresponding increase to paid-in capital. No additional amount will be recognized at the conversion date in recognition of an increase in the fair value of the stock conversion.

In circumstances in which convertible securities are issued with detachable warrants, the Task Force noted that in order to determine the amount to be allocated to the beneficial conversion feature, the issuer must first allocate the proceeds between the convertible instrument and the detachable warrants using the relative fair value method of APB Opinion Number 14.

The investors and consultants acquired detachable warrants for the purchase of 1,892,219 and 362,319 shares of common stock, respectively, which were valued at \$345,071 and \$66,087, respectively. The warrants may be exercised at a price of \$0.69 per share for a term of five years, ending July 18, 2010. For purposes of estimating the intrinsic fair value of each warrant as of July 19, 2005, we utilized the Black-Scholes option-pricing model. We estimated the fair value of the warrants assuming no expected dividends and the following weighted-average assumptions:

Expected life (years)	2.5
Expected volatility	66%
Risk-free interest rate	4.16%
Expected dividend yield	0.0%

We next determined the intrinsic fair value of the convertible preferred stock as of July 19, 2005, to be \$2,941,176 based on the number of common shares that could be acquired as of the date of closing times \$0.63, the closing price of the common stock on the date preceding the close of the transaction. In

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applying EITF No. 98-5, we then allocated the gross proceeds of \$2,500,000 between the warrants and preferred stock based on intrinsic value of each

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instrument. As a result, we allocated \$2,154,929 of gross proceeds to the convertible preferred stock and \$345,071 to the detachable warrants. The beneficial conversion feature of \$786,247 was then determined by subtracting the allocated proceeds of convertible preferred stock from the intrinsic fair value of convertible preferred stock. The beneficial conversion feature was immediately recognized as a preferred stock dividend, as the preferred stock can be converted immediately.

### Dividends

By the placement of the convertible preferred stock described above, we became obligated to pay a cash dividend monthly on the outstanding shares of convertible preferred stock. The dividend rate is the higher of (i) the prime rate as reported by the Wall Street Journal on the first day of the month, plus three percent or, (ii) 8.5% times \$100 per share, but in no event greater than 10% annually. For the six-month period ended November 30, 2005, cash dividends of \$68,289 were recorded, of which \$17,083 were unpaid. Preferred stock dividends for the six months ended November 30, 2005, are summarized as follows:

	Amount
	-----
Cash dividends paid	\$51,206
Cash dividends accrued	17,083
Beneficial conversion feature	786,247
	-----
	\$854,536
	=====

### Common stock

The Company issued 200,000 shares of common stock in lieu of cash for \$126,000 in consultant services associated with the issuance of the Series D Convertible Preferred Stock. These issue costs were treated as a reduction in the paid-in capital associated with the preferred stock issuance.

### Conversion of preferred stock to common stock

During the three months ended November 30, 2005, 4,500 shares of Series D Convertible Preferred Stock were converted into 987,209 shares of common stock.

### NOTE M - COMMITMENTS AND CONTINGENCIES

#### Litigation

The Company is currently, and has in the past been, a party to various routine legal proceedings incident to the ordinary course of business. The Company believes that the outcome of all such pending legal proceedings in the aggregate is unlikely to have a material adverse effect on the business or consolidated financial condition of the Company.

### NOTE N - SUBSEQUENT EVENT

We sponsored a pivotal study to demonstrate the efficacy of EECP therapy in the most prevalent types of heart failure patients. This study, known as PEECH (Prospective Evaluation of EECP in Congestive Heart Failure), was intended to provide additional clinical data in order to support our application for expanded Medicare national coverage policy for the use of EECP therapy in the

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treatment of CHF. The preliminary results of the trial were presented at the American College of Cardiology scientific sessions in March 2005, and we expect the results of the PEECH clinical trial to be published in a peer-reviewed journal within the next few months. On June 20, 2005, the Centers for Medicare and Medicaid Services (CMS) accepted our application for expanded coverage of EECF therapy to include CHF as a primary indication, as well as additional patients with angina.

However, on December 20, 2005, CMS issued a Proposed Decision Memorandum (PDM) to keep the existing coverage with no changes for expansion of External Counterpulsation therapy. In its announcement, CMS states, "CMS is seeking public comment on the proposed determination that the evidence is not adequate

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to conclude that external counterpulsation therapy is reasonable and necessary for Canadian Cardiovascular Society classification (CCSC) II Angina and NYHA Class II/III stable heart failure with ejection fraction <35%." Current coverage for CCSC class III/IV refractory angina will remain in effect. A final decision is anticipated by March 20, 2006. It is not possible to predict the impact of the Centers for Medicare and Medicaid Services (CMS) Proposed Decision Memorandum (PDM) issued December 20, 2005, on current operations.

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Except for historical information contained in this report, the matters discussed are forward-looking statements that involve risks and uncertainties. When used in this report, words such as "anticipated", "believes", "could", "estimates", "expects", "may", "plans", "potential" and "intends" and similar expressions, as they relate to the Company or its management, identify forward-looking statements. Such forward-looking statements are based on the beliefs of the Company's management, as well as assumptions made by and information currently available to the Company's management. Among the factors that could cause actual results to differ materially are the following: the effect of business and economic conditions; the effect of the dramatic changes taking place in the healthcare environment; the impact of competitive procedures and products and their pricing; medical insurance reimbursement policies, including the continued inability to obtain Medicare reimbursement for congestive heart failure patents; unexpected manufacturing or supplier problems; the ability to attract and retain qualified executives and employees; unforeseen difficulties and delays in the conduct of clinical trials and other product development programs; the actions of regulatory authorities and third-party payers in the United States and overseas; uncertainties about the acceptance of a novel therapeutic modality by the medical community; and the risk factors reported from time to time in the Company's SEC reports. The Company undertakes no obligation to update forward-looking statements as a result of future events

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or developments.

### General Overview

Vasomedical, Inc. incorporated in Delaware in July 1987 is primarily engaged in designing, manufacturing, marketing and supporting EECP(R) external counterpulsation systems based on our proprietary technology. EECP therapy is a non-invasive, outpatient therapy for the treatment of diseases of the cardiovascular system. The therapy serves to increase circulation in areas of the heart with less than adequate blood supply and has been shown to improve systemic vascular function. We provide hospitals and physician private practices with EECP equipment, treatment guidance, and a staff training and equipment maintenance program designed to provide optimal patient outcomes. EECP is a registered trademark for Vasomedical's enhanced external counterpulsation systems.

We have Food and Drug Administration (FDA) clearance to market our EECP therapy for use in the treatment of stable and unstable angina, congestive heart failure, acute myocardial infarction, and cardiogenic shock, however our current marketing efforts are limited to the treatment of stable angina and congestive heart failure indications. Within the stable angina and CHF indications, Medicare and other third-party payers currently reimburse for stable angina patients with moderate to severe symptoms who are refractory to medications and not candidates for invasive procedures. CHF patients are also reimbursed under the same criteria, provided their primary symptoms are angina.

We sponsored a pivotal study to demonstrate the efficacy of EECP therapy in the most prevalent types of heart failure patients. This study, known as PEECH (Prospective Evaluation of EECP in Congestive Heart Failure), was intended to provide additional clinical data in order to support our application for expanded Medicare national coverage policy for the use of EECP therapy in the treatment of CHF. The preliminary results of the trial were presented at the American College of Cardiology scientific sessions in March 2005, and we expect the results of the PEECH clinical trial to be published in a peer-reviewed journal within the next few months. On June 20, 2005, the Centers for Medicare and Medicaid Services (CMS) accepted our application for expanded coverage of EECP therapy to include CHF as a primary indication, as well as additional patients with angina.

On December 20, 2005, CMS issued a Proposed Decision Memorandum to maintain the existing coverage with no changes for expansion of external counterpulsation therapy. In its announcement, CMS states, "CMS is seeking public comment on the proposed determination that the evidence is not adequate to conclude that external counterpulsation therapy is reasonable and necessary for Canadian Cardiovascular Society classification (CCSC) II Angina and NYHA Class II/III stable heart failure with ejection fraction <35%."

We have incurred declines in revenue and significant operating losses during the last three fiscal years and our ability to continue operating is dependent upon achieving profitability in the refractory angina market or through additional debt or equity financing. Profitability is largely dependent on reducing operating costs as well as halting the declining revenue trend and maintaining our current base of revenue in the refractory angina market. Our ability to maintain our current base of revenue is largely dependent upon refocusing our sales and marketing efforts in the refractory angina market and operating in a more efficient manner. If we are not able to maintain our existing base of revenue and reduce operating costs as described below or raise additional capital we will not be able to continue as a going concern.

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In order to bring the Company's cost structure more into alignment with its current revenue base in the refractory angina market, we have planned a company restructuring to be initiated in January 2006. The restructure will reduce manufacturing and operating costs by approximately \$3 million per year compared to current levels, help us to conserve cash and provide additional time necessary to complete the application process for expanded reimbursement coverage with The Centers for Medicare and Medicaid Services (CMS) and an opportunity to rebuild sales to a profitable level.

We believe that our cash flow from operations following the restructuring initiated in January 2006, together with our current cash reserves and the cash received from the sale of convertible preferred stock and warrants on July 19, 2005, will be sufficient to fund our minimum projected capital requirements through at least May 31, 2006, however it is not possible to predict the impact of the Proposed Decision Memorandum issued December 20, 2005, on current operations.

In the event that additional capital is required, we may seek to raise such capital through public or private equity or debt financings or other means. We may not be able to obtain additional financing on favorable terms or at all. If we are unable to raise additional funds when we need them, we may be required to further scale back our operations, research, marketing or sales efforts or obtain funds through arrangements with collaborative partners or others that may require us to license or relinquish rights to technologies or products. Future capital funding, if available, may result in dilution to current shareholders, and new investors could have rights superior to existing stockholders.

### Critical Accounting Policies

Financial Reporting Release No. 60, which was released by the Securities and Exchange Commission, or SEC, in December 2001, requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. Note A of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended May 31, 2005, includes a summary of our significant accounting policies and methods used in the preparation of our financial statements. In preparing these financial statements, we have made our best estimates and judgments of certain amounts included in the financial statements, giving due consideration to materiality. The application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. Our critical accounting policies are as follows:

### Revenue Recognition

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or service has been rendered, the price is fixed or determinable and collectibility is reasonably assured. In the United States, we recognize revenue from the sale of our EECF systems in the period in which we deliver the system to the customer. Revenue from the sale of our EECF systems to international markets is recognized upon shipment, during the period in which we deliver the product to a common carrier, as are supplies, accessories and spare parts delivered to both domestic and international customers. Returns are accepted prior to the in-service and training subject to a 10% restocking charge or for normal warranty matters, and we are not obligated for post-sale upgrades to these systems. In addition, we use the installment method to record revenue based on cash receipts in situations where the account receivable is collected

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over an extended period of time and in our judgment the degree of collectibility is uncertain.

In most cases, revenue from domestic EECF system sales is generated from multiple-element arrangements that require judgment in the areas of customer acceptance, collectibility, the separability of units of accounting, and the fair value of individual elements. Effective September 1, 2003, we adopted the provisions of Emerging Issues Task Force, or EITF, Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables", ("EITF 00-21"), on a prospective basis. The principles and guidance outlined in EITF 00-21 provide a framework to determine (a) how the arrangement consideration should be measured (b) whether the arrangement should be divided into separate units of accounting, and (c) how the arrangement consideration should be allocated among the separate units of accounting. We determined that the domestic sale of our EECF systems includes a combination of three elements that qualify as separate units of accounting:

- i. EECF equipment sale,

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- ii. provision of in-service and training support consisting of equipment set-up and training provided at the customer's facilities, and
- iii. a service arrangement (usually one year), consisting of: service by factory-trained service representatives, material and labor costs, emergency and remedial service visits, preventative maintenance, software upgrades, technical phone support and preferred response times.

Each of these elements represent individual units of accounting as the delivered item has value to a customer on a stand-alone basis, objective and reliable evidence of fair value exists for undelivered items, and arrangements normally do not contain a general right of return relative to the delivered item. We determine fair value based on the price of the deliverable when it is sold separately or based on third-party evidence. In accordance with the guidance in EITF 00-21, we use the residual method to allocate the arrangement consideration when it does not have fair value of the EECF system sale. Under the residual method, the amount of consideration allocated to the delivered item equals the total arrangement consideration less the aggregate fair value of the undelivered items. Assuming all other criteria for revenue recognition have been met, we recognize revenue for:

- i. EECF equipment sales, when delivery and acceptance occurs based on delivery and acceptance documentation received from independent shipping companies or customers,
- ii. in-service and training, following documented completion of the training, and
- iii. the service arrangement, ratably over the service period, which is generally one year.

In-service and training generally occurs within three weeks of shipment and our return policy states that no returns will be accepted after in-service and training has been completed. The amount related to in-service and training is recognized as equipment revenue at the time the in-service and training is completed and the amount related to service arrangements is recognized ratably over the related service period, which is generally one year. Costs associated with the provision of in-service and training and the service arrangement, including salaries, benefits, travel, spare parts and equipment, are recognized

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in cost of equipment sales as incurred.

We also recognize revenue generated from servicing EECF systems that are no longer covered by the service arrangement, or by providing sites with additional training, in the period that these services are provided. Revenue related to future commitments under separately priced extended service agreements on our EECF system are deferred and recognized ratably over the service period, generally ranging from one year to four years. Costs associated with the provision of service and maintenance, including salaries, benefits, travel, spare parts and equipment, are recognized in cost of sales as incurred. Amounts billed in excess of revenue recognized are included as deferred revenue in the consolidated balance sheets.

Revenues from the sale of EECF systems through our international distributor network are generally covered by a one-year warranty period. We do not offer a service arrangement to international customers; consequently, for these customers we accrue a warranty reserve for estimated costs to provide warranty services when the equipment sale is recognized.

We have also entered into lease agreements for our EECF systems, generally for terms of one year or less, that are classified as operating leases. Revenues from operating leases are generally recognized, in accordance with the terms of the lease agreements, on a straight-line basis over the life of the respective leases. For certain operating leases in which payment terms are determined on a "fee-per-use" basis, revenues are recognized as incurred (i.e., as actual usage occurs). The cost of the EECF system utilized under operating leases is recorded as a component of property and equipment and is amortized to cost of equipment rentals and services over the estimated useful life of the equipment, not to exceed five years. There were no significant minimum rental commitments on these operating leases at November 30, 2005.

Accounts Receivable, net

The Company's accounts receivable - trade are due from customers engaged in the provision of medical services. Credit is extended based on evaluation of a customer's financial condition and, generally, collateral is not required. Accounts receivable are generally due 30 to 90 days from shipment and are stated at amounts due from customers net of allowances for doubtful accounts, returns, term discounts and other allowances. Accounts outstanding longer than the contractual payment terms are considered past due. Estimates are used in determining the allowance for doubtful accounts based on the Company's historical collections experience, current trends, credit policy and a percentage of our accounts receivable by aging category. In determining these percentages, we look at historical write-offs of our receivables. The Company

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also looks at the credit quality of its customer base as well as changes in its credit policies. The Company continuously monitors collections and payments from its customers. While credit losses have historically been within expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past.

Inventories, net

The Company values inventory at the lower of cost or estimated market, cost being determined on a first-in, first-out basis. The Company often places EECF

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systems at various field locations for demonstration, training, evaluation, and other similar purposes at no charge. The cost of these EECF systems is transferred to property and equipment and is amortized over the next two to five years. The Company records the cost of refurbished components of EECF systems and critical components at cost plus the cost of refurbishment. The Company regularly reviews inventory quantities on hand, particularly raw materials and components, and records a provision for excess and obsolete inventory based primarily on existing and anticipated design and engineering changes to our products as well as forecasts of future product demand.

Effective June 1, 2005, we adopted the provisions of Statement of Financial Accounting Standards No. 151, "Inventory Costs", on a prospective basis. The statement clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. As a result of adopting SFAS No. 151, we absorbed approximately \$141,000 less in fixed production overheads into inventory.

### Deferred Revenues

We record revenue on extended service contracts ratably over the term of the related contracts. Effective September 1, 2003, we prospectively adopted the provisions of EITF 00-21. Upon adoption of the provisions of EITF 00-21 we began to defer revenue related to EECF system sales for the fair value of installation and in-service training to the period when the services are rendered and for service arrangements ratably over the service period, which is generally one year.

### Warranty Costs

Equipment sold is generally covered by a warranty period of one year. Effective September 1, 2003, we adopted the provisions of EITF 00-21 on a prospective basis. Under EITF 00-21, for certain arrangements, a portion of the overall system price attributable to the first year service arrangement is deferred and recognized as revenue over the service period. As such, we no longer accrue warranty costs upon delivery but rather recognize warranty and related service costs as incurred. Prior to September 1, 2003, we accrued a warranty reserve for estimated costs to provide warranty services when the equipment sale was recognized.

Equipment sold to international customers through our distributor network is generally covered by a one year warranty period. We do not offer a service arrangement to international customers; consequently, for these customers we accrue a warranty reserve for estimated costs to provide warranty services when the equipment sale is recognized.

The factors affecting our warranty liability included the number of units sold and historical and anticipated rates of claims and costs per claim. The warranty provision resulting from transactions prior to September 1, 2003, will be reduced in future periods for material and labor costs incurred as related product is returned during the warranty period or when the warranty period elapses.

### Net Loss per Common Share

Basic loss per share is based on the weighted average number of common shares outstanding without consideration of potential common stock. Diluted loss per share is based on the weighted number of common and potential dilutive common shares outstanding. The calculation takes into account the shares that may be issued upon the exercise of stock options and warrants, reduced by the shares that may be repurchased with the funds received from the exercise, based



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on the average price during the period.

### Income Taxes

Deferred income taxes are recognized for temporary differences between financial statement and income tax bases of assets and liabilities and loss carryforwards for which income tax benefits are expected to be realized in future years. A valuation allowance is established, when necessary, to reduce

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deferred tax assets to the amount expected to be realized. In estimating future tax consequences, we generally consider all expected future events other than an enactment of changes in the tax laws or rates. The deferred tax asset is continually evaluated for realizability. To the extent our judgment regarding the realization of the deferred tax assets change, an adjustment to the allowance is recorded, with an offsetting increase or decrease, as appropriate, in income tax expense. Such adjustments are recorded in the period in which our estimate as to the realizability of the asset changed that it is "more likely than not" that all of the deferred tax assets will be realized. The "more likely than not" standard is subjective, and is based upon our estimate of a greater than 50% probability that our long range business plan can be realized.

Deferred tax liabilities and assets are classified as current or non-current based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting, including deferred tax assets related to carryforwards, are classified according to the expected reversal date of the temporary difference. The deferred tax asset we previously recorded relates primarily to the realization of net operating loss carryforwards, of which the allocation of the current portion, if any, reflected the expected utilization of such net operating losses in the following twelve months. Such allocation was based our internal financial forecast and may be subject to revision based upon actual results.

### Stock-based Employee Compensation

We have five stock-based employee and director compensation plans. We account for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations ("APB No. 25") and have adopted the disclosure provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123." Under APB No. 25, when the exercise price of our employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Accordingly, no compensation expense has been recognized in the consolidated financial statements in connection with employee stock option grants.

For purposes of estimating the fair value of each option on the date of grant, the Company utilized the Black-Scholes option-pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly

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different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Equity instruments issued to non-employees in exchange for goods, fees and services are accounted for under the fair value-based method of SFAS No. 123.

### Recently Issued Accounting Standards

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154 ("SFAS No. 154"), "Accounting Changes and Error Corrections." SFAS No. 154 replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. The Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 153 ("SFAS No. 153"), "Exchanges of Non-monetary Assets an amendment of APB Opinion No. 29". SFAS No. 153 amends Opinion 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change

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Vsomedical, Inc. and Subsidiaries

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

significantly as a result of the exchange. SFAS No. 153 is effective for fiscal periods after June 15, 2005. The Company adopted SFAS No. 153 effective for fiscal periods beginning September 1, 2005. The adoption of SFAS No. 153 did not have a material impact on the Company's consolidated financial statements.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123(R) ("SFAS No. 123(R)"), "Accounting for Stock-Based Compensation". SFAS No. 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires that the fair value of such equity instruments be recognized as expense in the historical financial statements as services are performed. Prior to SFAS No. 123(R), only certain pro-forma disclosures of fair value were required. SFAS No. 123(R) shall be effective for the Company as of the beginning of the first interim reporting period that begins after June 15, 2005. The adoption of this new accounting pronouncement is expected to have a material impact on the financial statements of the Company commencing with the quarter ending August 31, 2006.

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151 ("SFAS No. 151"), Inventory Costs, an amendment of ARB No. 43, Chapter 4. The amendments made by SFAS No. 151 will improve financial reporting by clarifying that abnormal amounts of idle facility expense, freight, handling

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costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 24, 2004. The Company has adopted SFAS No. 151 effective June 1, 2005.

### Results of Operations

#### Three Months Ended November 30, 2005 and 2004

Net revenue from sales, leases and service of our EECF systems for the three-month periods ended November 30, 2005 and 2004, was \$2,680,184 and \$3,461,675, respectively, which represented a decline of \$781,491 or 23%. We reported a net loss of \$8,632,635 compared to \$1,609,823 for the three-month periods ended November 30, 2005 and 2004, respectively. Our net loss per common share was \$0.15 for the three-month period ended November 30, 2005 compared to a net loss of \$0.03 per share for the three-month period ended November 30, 2004. The increase in net loss is primarily due to the establishment of a valuation reserve for the remaining carrying value of the deferred tax asset.

### Revenues

Revenue from equipment sales declined approximately 31% to \$1,734,409 for the three-month period ended November 30, 2005 as compared to \$2,522,562 for the same period for the prior year. The decline in equipment sales is due primarily to a 35% decline in the number of equipment shipments, partially offset by a 10% improvement in average sales prices. A higher mix of both newer model equipment and new equipment versus used equipment was the primary cause of the increase in average sales prices.

We believe the decline in domestic units shipped reflects weakened demand in the refractory angina market as existing capacity is more fully utilized, coupled with increased competition from surgical procedures, mainly the use of drug-eluting stents. Although average domestic selling prices improved compared to the second quarter of fiscal 2005, we anticipate that a prevailing trend of declining prices will continue in the immediate future as our competition attempts to capture greater market share through pricing discounts. We sold an unusually high percentage of used equipment in the second quarter of fiscal 2005, which reduced the average selling price in that period. The average price of new systems sales declined approximately 5% in the second quarter of fiscal 2006 compared to the same period in the prior year. Our revenue from the sale of EECF systems to international distributors in the second quarter of fiscal 2006 decreased approximately 35% to \$90,000 compared to \$137,995 in the same period of the prior year as a result of decreased sales volume.

The above decline in revenue from equipment sales was partially offset by a 1% increase in revenue from equipment rental and services for the three month period ended November 30, 2005, from the same three-month period in the prior year. Revenue from equipment rental and services represented 35% of total

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Vasomedical, Inc. and Subsidiaries

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

revenue in the second quarter of fiscal 2006 compared to 27% in the second quarter of fiscal 2005. The increase in both absolute amounts and percentage of

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total revenue resulted primarily from an increase of approximately 19% in service related revenue. The higher service revenue reflects an increase in service and spare parts, plus greater marketing focus on the sale of extended service contracts. Rental revenue declined approximately 75%, largely offsetting the above. The decline was primarily due to a multi-system customer defaulting on its rental payments; consequently, we shifted to a cash basis for revenue recognition for this customer and have secured the return of our equipment.

### Gross Profit

The gross profit declined to \$1,582,355 or 59% of revenues for the three-month period ended November 30, 2005, compared to \$2,287,801 or 66% of revenues for the three-month period ended November 30, 2004. Gross profit margin as a percentage of revenue for the three-month period ended November 30, 2005, decreased compared to the same year of the prior fiscal year despite the improvement in average selling prices, mainly due to an unfavorable sales mix of lower cost used equipment, and the higher production units costs associated with reduced production volumes in the last three fiscal quarters. In addition, adoption of SFAS No. 151 lowered the amount of fixed overhead costs absorbed into inventory in the second quarter of fiscal 2006. Partially offsetting the decline was an improvement in the gross profit margins associated with accessory revenues, reflecting higher average selling prices. The decline in gross profit when compared to the prior year in absolute dollars is a direct result of the lower sales volume.

Gross profits are dependent on a number of factors, particularly the mix of EECF models sold and their respective average selling prices, the mix of EECF units sold, rented or placed during the period, the ongoing costs of servicing such units, and certain fixed period costs, including facilities, payroll and insurance. Gross profit margins are generally less on non-domestic business due to the use of distributors resulting in lower selling prices. Consequently, the gross profit realized during the current period may not be indicative of future margins.

### Selling, General and Administrative

Selling, general and administrative ("SG&A") expenses for the three-months ended November 30, 2005 and 2004, were \$2,508,624 or 94% of revenues and \$3,088,398 or 89% of revenues, respectively reflecting an decrease of \$579,774 or approximately 19%. The decrease in SG&A expenditures in the second quarter of fiscal 2006 compared to fiscal 2005 resulted primarily from decreased sales and marketing expenditures reflecting fewer sales and marketing personnel and reduced travel, plus lower market research, trade show, and accounting costs.

### Research and Development

Research and development ("R&D") expenses of \$603,696 or 23% of revenues for the three months ended November 30, 2005, decreased by \$182,252 or 23%, from the three months ended November 30 2004, of \$785,948 or 23% of revenues. The decrease is primarily attributable to lower new product development spending.

### Provision for Doubtful Accounts

During the three month periods ended November 30, 2005 and 2004, we collected funds from previously reserved accounts, which offset new reserve requirements. As a result, we did not incur a charge to our provision for doubtful accounts in either of these fiscal periods.

### Interest Expense and Financing Costs

Interest expense and financing costs decreased to \$21,444 in the three-month period ended November 30, 2005, from \$28,678 for the same period in

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the prior year. Interest expense primarily reflects interest on loans secured to refinance the November 2000 purchase of the Company's headquarters and warehouse facility, as well as on loans secured to finance the cost and implementation of a new management information system.

### Interest and Other Income, Net

Interest and other income for the second fiscal quarters of 2006 and 2005, was \$21,774 and \$17,083, respectively. The increase in interest income from the prior period is the direct result of \$7,243 in increased unrealized gain on investments. Lower average cash balances invested during the quarter compared to the prior period partially offset the above.

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### Vasomedical, Inc. and Subsidiaries

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Income Tax Expense, Net

During the three-months ended November 30, 2005 and 2004, we recorded a provision for income taxes of \$7,103,000 and \$11,683, respectively, of which \$7,093,000 was associated with an increase in the valuation allowance for the deferred tax asset in the three months ended November 30, 2005. The provision for income taxes for the second quarter of fiscal 2006 does not include \$7,489,000 added to the deferred tax valuation allowance for tax benefits associated with prior years' exercises of stock options and warrants, which was charged directly to additional paid-in capital.

As of August 31, 2005, we had recorded deferred tax assets of \$14,582,000 net of a \$4,674,000 valuation allowance related to the anticipated recovery of tax loss carryforwards. As discussed in Note N, on December 20, 2005, Centers for Medicare and Medicaid Services (CMS) issued a Proposed Decision Memorandum (PDM) for External Counterpulsation in response to Vasomedical's application to expand reimbursement coverage to include Canadian Cardiovascular Society (CCSC) Class II angina and New York Heart Association (NYHA) Class II/III congestive heart failure (CHF). The PDM stated that the evidence was not adequate to conclude that external counterpulsation therapy is reasonable and necessary to expand reimbursement coverage to CCSC Class II angina and NYHA Class II/III CHF. Current coverage for CCSC class III/IV refractory angina will remain in effect.

Consequently, we could no longer conclude that, based upon the weight of available evidence, it was "more likely than not" that the net deferred tax asset of \$14,582,000 would be realized, and added \$14,582,000 to the valuation allowance to bring the net deferred tax asset carrying value to zero.

### Six Months Ended November 30, 2005 and 2004

Net revenue from sales, leases and service of our EECP systems for the six-month periods ended November 30, 2005 and 2004, was \$6,216,555 and \$8,283,091, respectively, which represented a decline of \$2,066,536 or 25%. We reported a net loss of \$9,525,497 compared to \$2,534,153 for the six-month periods ended November 30, 2005 and 2004, respectively. Our net loss per common share was \$0.18 for the six-month period ended November 30, 2005 compared to a net loss of \$0.04 per share for the six-month period November 30, 2004. The increase in net loss is primarily due to the establishment of a \$7,093,000 valuation reserve in the second fiscal quarter for the remaining carrying value of the deferred tax asset.

### Revenues

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Revenue from equipment sales declined approximately 35% to \$4,191,318 for the six-month period ended November 30, 2005 as compared to \$6,497,459 for the same period for the prior year. The decline in equipment sales is due primarily to a 40% decline in the number of equipment shipments, partially offset by an 11% improvement in average sales prices. A higher mix of both newer model equipment and new equipment versus used equipment was the primary cause of the increase in average sales prices.

We believe the decline in domestic units shipped reflects weakened demand in the refractory angina market as existing capacity is more fully utilized, coupled with increased competition from surgical procedures, mainly the use of drug-eluting stents. Although average domestic selling prices improved compared to the first half of fiscal 2005, we anticipate that a prevailing trend of declining prices will continue in the immediate future as our competition attempts to capture greater market share through pricing discounts. We sold an unusually high percentage of used equipment in the first six months of fiscal 2005, which reduced the average selling price in that period. The average price of new systems sales declined approximately 2% in the first six months of fiscal 2006 compared to the same period in the prior year. Our revenue from the sale of EECF systems to international distributors in the first half of fiscal 2006 decreased approximately 15% to \$395,000 compared to \$462,995 in the same period of the prior year, as a result of decreased volume.

The above decline in revenue from equipment sales was partially offset by a 13% increase in revenue from equipment rental and services for the six month period ended November 30, 2005, from the same six-month period in the prior year. Revenue from equipment rental and services represented 33% of total revenue in the first six months of fiscal 2006 compared to 22% in the same period of fiscal 2005. The increase in both absolute amounts and percentage of

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### Vasomedical, Inc. and Subsidiaries

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

total revenue resulted primarily from an increase of approximately 28% in service related revenue. The higher service revenue reflects an increase in service, spare parts and accessories, plus greater marketing focus on the sale of extended service contracts. Rental revenue declined approximately 54%, partially offsetting the above. The decline was primarily due to a multi-system customer defaulting on its rental payments; consequently, we shifted to a cash basis for revenue recognition for this customer.

#### Gross Profit

The gross profit declined to \$3,695,542 or 59% of revenues for the six-month period ended November 30, 2005, compared to \$5,447,424 or 66% of revenues for the six-month period ended November 30, 2004. Gross profit margin as a percentage of revenue for the six-month period ended November 30, 2005, decreased compared to the same period of the prior fiscal year despite the improvement in average selling prices, mainly due to an unfavorable sales mix of lower cost used equipment, and the higher production units costs associated with reduced production volumes in the last three fiscal quarters. In addition, adoption of SFAS No. 151 lowered the amount of fixed overhead costs absorbed into inventory in the first six months of fiscal 2006. Partially offsetting the decline was an improvement in the gross profit margins associated with accessory revenues, reflecting higher average selling prices. The decline in gross profit

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when compared to the prior year in absolute dollars is a direct result of the lower sales volume.

Gross profits are dependent on a number of factors, particularly the mix of EECF models sold and their respective average selling prices, the mix of EECF units sold, rented or placed during the period, the ongoing costs of servicing such units, and certain fixed period costs, including facilities, payroll and insurance. Gross profit margins are generally less on non-domestic business due to the use of distributors resulting in lower selling prices. Consequently, the gross profit realized during the current period may not be indicative of future margins.

### Selling, General and Administrative

Selling, general and administrative ("SG&A") expenses for the six-months ended November 30, 2005 and 2004, were \$4,917,773 or 79% of revenues and \$6,140,879 or 74% of revenues, respectively reflecting an decrease of \$1,223,106 or approximately 20%. The decrease in SG&A expenditures in the second half of fiscal 2006 compared to fiscal 2005 resulted primarily from decreased sales and marketing expenditures reflecting fewer sales and marketing personnel and reduced travel, plus lower market research, advertising, trade show, and accounting costs.

### Research and Development

Research and development ("R&D") expenses of \$1,115,702 or 18% of revenues for the six months ended November 30, 2005, decreased by \$542,144 or 33%, from the six months ended November 30 2004, of \$1,657,846 or 20% of revenues. The decrease is primarily attributable to lower new product development spending.

### Provision for Doubtful Accounts

During the six month period ended November 30, 2005, we charged \$70,575 to our provision for doubtful accounts, as compared to \$132,956 during the six month period ended November 30, 2004. The decrease was mainly due to reduced sales.

### Interest Expense and Financing Costs

Interest expense and financing costs decreased to \$44,953 in the six-month period ended November 30, 2005, from \$59,040 for the same period in the prior year. Interest expense primarily reflects interest on loans secured to refinance the November 2000 purchase of the Company's headquarters and warehouse facility, as well as on loans secured to finance the cost and implementation of a new management information system.

### Interest and Other Income, Net

Interest and other income for the first half of fiscal 2006 and fiscal 2005, were \$40,790 and \$30,827, respectively. The increase in interest income from the prior period is the direct result of \$15,820 in increased unrealized gain on investments. Lower average cash balances invested during the first half of fiscal 2006 compared to the prior period partially offset the above.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS

Income Tax Expense, Net

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During the six-months ended November 30, 2005 and 2004, we recorded a provision for income taxes of \$7,112,826 and \$21,683, respectively. The fiscal 2006 provision consisted mainly of \$7,093,000 in additional valuation allowance provided for the deferred tax asset. The provision for income taxes for the second half of fiscal 2006 does not include \$7,489,000 added to the deferred tax valuation allowance for tax benefits associated with prior years' exercises of stock options and warrants, which was charged directly to additional paid-in capital.

As of August 31, 2005, we had recorded deferred tax assets of \$14,582,000 net of a \$4,674,000 valuation allowance related to the anticipated recovery of tax loss carryforwards. As discussed in Note N, on December 20, 2005, Centers for Medicare and Medicaid Services (CMS) issued a Proposed Decision Memorandum (PDM) for External Counterpulsation in response to Vasomedical's application to expand reimbursement coverage to include Canadian Cardiovascular Society (CCSC) Class II angina and New York Heart Association (NYHA) Class II/III congestive heart failure (CHF). The PDM stated that the evidence was not adequate to conclude that external counterpulsation therapy is reasonable and necessary to expand reimbursement coverage to CCSC Class II angina and NYHA Class II/III CHF. Current coverage for CCSC class III/IV refractory angina will remain in effect.

Consequently, we could no longer conclude that, based upon the weight of available evidence, it was "more likely than not" that the net deferred tax asset of \$14,582,000 would be realized, and added \$14,582,000 to the valuation allowance to bring the net deferred tax asset carrying value to zero.

### Liquidity and Capital Resources

#### Cash and cash flow

We have financed our operations in fiscal 2006 and fiscal 2005 from working capital and in fiscal 2006 from the issuance of preferred stock. At November 30, 2005, we had cash, cash equivalents, and certificates of deposit balances of \$2,949,086 and working capital of \$3,857,537 as compared to cash, cash equivalents, and certificates of deposit balances of \$2,747,967 and working capital of \$3,932,769 at May 31, 2005. Our cash, cash equivalents, and certificates of deposit balances increased \$201,119 for the first half of fiscal year 2006 primarily due to \$2,185,617 in net proceeds from the issuance of preferred stock, which offset cash used in operating activities of \$1,682,713 and other financing activities of \$301,785.

The increase in cash used in our operating activities during the first half of fiscal year 2006 resulted primarily from the net loss of \$9,525,497 offset by adjustments to reconcile net loss to net cash used in operating activities of \$7,842,784. The adjustments to reconcile net loss to net cash used in operating activities consisted mainly of \$7,489,439 in non-cash adjustments, primarily \$7,093,000 for deferred income taxes, as well as an aggregate of \$396,439 in depreciation and amortization, allowances for doubtful accounts and inventory write-offs, and common stock issued for services. In addition, changes in our operating assets and liabilities provided net cash of \$353,345. The changes in the asset components primarily reflect an increase in accounts receivable of \$246,611, offset by lower inventory of \$549,675. The changes in our operating liability components reflect an increase in accounts payable and accrued liabilities of \$25,843 and a decrease in other liabilities of \$114,253. Net accounts receivable were 33% of revenues for the six-month period ended November 30, 2005, compared to 30% at the end of the six-month period ended November 30, 2004, and accounts receivable turnover decreased to 5.7 times as of November 30, 2005, as compared to 5.8 times as of November 30, 2004.

Standard payment terms on our domestic equipment sales are generally net 30 to 90 days from shipment and do not contain "right of return" provisions. We



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have historically offered a variety of extended payment terms, including sales-type leases, in certain situations and to certain customers in order to expand the market for our EECF products in the US and internationally. Such extended payment terms were offered in lieu of price concessions, in competitive situations, when opening new markets or geographies and for repeat customers. Extended payment terms cover a variety of negotiated terms, including payment in full - net 120, net 180 days or some fixed or variable monthly payment amount for a six to twelve month period followed by a balloon payment, if applicable. During the first half of fiscal 2006 and 2005, approximately 0% and 2%, respectively, of revenues were generated from sales in which initial payment terms were greater than 90 days and we offered no sales-type leases during either period. In general, reserves are calculated on a formula basis considering factors such as the aging of the receivables, time past due, and the

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### Vasomedical, Inc. and Subsidiaries

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

customer's credit history and their current financial status. In most instances where reserves are required, or accounts are ultimately written-off, customers have been unable to successfully implement their EECF program. As we are creating a new market for the EECF therapy and recognizing the challenges that some customers may encounter, we have opted, at times, on a customer-by-customer basis, to recover our equipment instead of pursuing other legal remedies, which has resulted in our recording of a reserve or a write-off.

Investing activities provided net cash of \$1,464,757 during the six-month period ended November 30, 2005. Cash was provided by the sale of short-term certificates of deposit. All of our certificates of deposit have original maturities of greater than three months and mature in less than twelve months.

Our financing activities provided net cash of \$1,883,832 during the six-month period ended November 30, 2005, reflecting \$2,185,617 in net proceeds received from the issuance of preferred stock, less payments on our outstanding notes and loans totaling \$250,579, and preferred stock dividend payments totaling \$51,206. On July 19, 2005, we entered into a Securities Purchase Agreement that provided us with gross proceeds of \$2.5 million through a private placement of preferred stock with M.A.G. Capital, LLC through its designated funds, Monarch Pointe Fund Ltd., Mercator Momentum Fund III, LP, and Mercator Momentum Fund, LP. The agreement provided for a private placement of 25,000 shares of Vasomedical's Series D Preferred Stock at \$100 per share.

We do not have an available line of credit.

#### Liquidity

We have incurred declines in revenue and significant operating losses during the last three fiscal years and our ability to continue operating is dependent upon achieving profitability in the refractory angina market or through additional debt or equity financing. Profitability is largely dependent on reducing operating costs as well as halting the declining revenue trend and maintaining our current base of revenue in the refractory angina market. Our ability to maintain our current base of revenue is largely dependent upon refocusing our sales and marketing efforts in the refractory angina market and operating in a more efficient manner. If we are not able to maintain our existing base of revenue and reduce operating costs as described below or raise additional capital we will not be able to continue as a going concern.

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In order to bring the Company's cost structure more into alignment with its current revenue base in the refractory angina market, we have planned a company restructuring to be initiated in January 2006. The restructure will reduce manufacturing and operating costs by approximately \$3 million per year compared to current levels, help us to conserve cash and provide additional time necessary to complete the application process for expanded reimbursement coverage with The Centers for Medicare and Medicaid Services (CMS) and an opportunity to rebuild sales to a profitable level.

We believe that our cash flow from operations following the restructuring initiated in January 2006, together with our current cash reserves and the cash received from the sale of convertible preferred stock and warrants on July 19, 2005, will be sufficient to fund our minimum projected capital requirements through at least May 31, 2006, however it is not possible to predict the impact of the Proposed Decision Memorandum issued December 20, 2005, on current operations.

In the event that additional capital is required, we may seek to raise such capital through public or private equity or debt financings or other means. We may not be able to obtain additional financing on favorable terms or at all. If we are unable to raise additional funds when we need them, we may be required to further scale back our operations, research, marketing or sales efforts or obtain funds through arrangements with collaborative partners or others that may require us to license or relinquish rights to technologies or products. Future capital funding, if available, may result in dilution to current shareholders, and new investors could have rights superior to existing stockholders.

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### Vssomedical, Inc. and Subsidiaries

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

#### Contractual Obligations

The following table presents the Company's expected cash requirements for contractual obligations outstanding as of November 30, 2005.

	Total	Due as of 11/30/06	Due as of 11/30/07 and 11/30/08	Due as of 11/30/09 and 11/30/10
Long-Term Debt	\$1,024,696	\$135,891	\$137,382	\$151,107
Notes Payable	122,586	122,586	--	--
Operating Leases	35,596	35,596	--	--
Litigation Settlement	134,000	134,000	--	--
<b>Total Contractual Cash Obligations</b>	<b>\$1,316,878</b>	<b>\$ 428,073</b>	<b>\$137,382</b>	<b>\$151,107</b>

#### Effects of Inflation

We believe that inflation and changing prices over the past three years have not had a significant impact on our revenue or on our results of

operations.

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Vssomedical, Inc. and Subsidiaries

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to certain financial market risks, including changes in interest rates. All of our revenue, expenses and capital spending are transacted in US dollars. Our exposure to market risk for changes in interest rates relates primarily to our cash and cash equivalent balances. The majority of our investments are in short-term instruments and subject to fluctuations in US interest rates. Due to the nature of our short-term investments, we believe that there is no material risk exposure.

ITEM 4 - CONTROLS AND PROCEDURES

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of November 30, 2005, our disclosure controls and procedures are effective to provide reasonable assurances that such disclosure controls and procedures satisfy their objectives and that the information required to be disclosed by us in the reports we file under the Exchange Act is recorded, processed, summarized and reported within the required time periods. There were no changes during the fiscal quarter ended November 30, 2005 in our internal controls or in other factors that could have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS:

None.

ITEM 2 - CHANGES IN SECURITIES AND USE OF PROCEEDS:

None

ITEM 3 - DEFAULTS UPON SENIOR SECURITIES:

None

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

None

ITEM 5 - OTHER INFORMATION:

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None

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K:

Exhibits

- 31 Certifications pursuant to Rules 13a-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certifications pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Reports on Form 8-K

None

Vssomedical, Inc. and Subsidiaries

In accordance with to the requirements of the Exchange Act, the Registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

VASOMEDICAL, INC.

By: /s/ Thomas Glover

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Thomas Glover  
Chief Executive Officer and Director  
(Principal Executive Officer)

/s/ Thomas W. Fry

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Thomas W. Fry  
Chief Financial Officer  
(Principal Financial and Accounting  
Officer)

Date: January 17, 2006