VASOMEDICAL INC
Form 10-Q
October 16, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended August 31, 2006

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _______________ to ______________

Commission File Number: 0-18105

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large Accelerated Filer [ ] Accelerated Filer [ ] Non-Accelerated Filer [X]

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

Number of Shares Outstanding of Common Stock, $.001 Par Value, at October 16, 2006 - 65,198,592

Vasomedical, Inc. and Subsidiaries

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ITEM 1. FINANCIAL STATEMENTS

Vasomedical, Inc. and Subsidiaries
CONSOLIDATED CONDENSED BALANCE SHEETS

ASSETS	August 31, 2006 (Unaudited)
CURRENT ASSETS	
Cash and cash equivalents	$1,790,851
Accounts receivable, net of an allowance for doubtful accounts of $373,071 at August 31, 2006, and $410,691 at May 31, 2006	1,000,870
Inventories, net	2,394,623
Other current assets	276,683

Total current assets	5,463,027
PROPERTY AND EQUIPMENT, net of accumulated depreciation of $2,683,979 at August 31, 2006, and $2,613,180 at May 31, 2006	1,483,752
OTHER ASSETS	297,440
	$7,244,219
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES	
Accounts payable and accrued expenses	$846,822
Current maturities of long-term debt and notes payable	223,170
Sales tax payable	137,651
Deferred revenue	1,492,179
Accrued director and executive compensation	321,500
Accrued warranty and customer support expenses	29,250
Accrued professional fees	42,439
Accrued commissions	114,907
Total current liabilities	3,207,918
LONG-TERM DEBT	835,000
ACCRUED WARRANTY COSTS	750
DEFERRED REVENUE	573,852
COMMITMENTS AND CONTINGENCIES	
STOCKHOLDERS' EQUITY	
Common stock, $.001 par value; 110,000,000 shares authorized; 65,198,592 shares at August 31, 2006, and May 31, 2006, issued and outstanding	65,198
Additional paid-in capital	46,148,493
Accumulated deficit	(43,586,992)
Total stockholders' equity	2,626,699
	$7,244,219

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

Vasomedical, Inc. and Subsidiaries

CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
(Unaudited)

	Three mon Augus
	2006

Revenues	
Equipment sales	$1,073,216
Equipment rentals and services	1,008,640
Total revenues	2,081,856
Cost of Sales and Services	
Cost of sales, equipment	609,342
Cost of equipment rentals and services	355,268
Total cost of sales and services	964,610
Gross profit	1,117,246
Operating Expenses	
Selling, general and administrative	1,323,826
Research and development	328,495
Provision for doubtful accounts	1,681
Total operating expenses	1,654,002
LOSS FROM OPERATIONS	(536,756)
Other Income (Expense)	
Interest and financing costs	(18,889)
Interest and other income, net	20,738
Total other income (expense)	1,849
LOSS BEFORE INCOME TAXES	(534,907)
Income tax expense, net	(4,550)
NET LOSS	(539,457)
Preferred stock dividend	--
NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	$(539,457)
Net loss per common share	
- basic	$(.01)
- diluted	$(.01)
Weighted average common shares outstanding	
- basic	65,198,592
- diluted	65,198,592

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

Vasomedical, Inc. and Subsidiaries

CONSOLIDATED CONDENSED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited)

	Common Stock Shares	Amount	Additional Paid-in Capital	Acc D
Balance at June 1, 2006	65,198,592	$65,198	$46,148,493	$(43
Net loss				
Balance at August 31, 2006	65,198,592	$65,198	$46,148,493	$(43

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

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Vasomedical, Inc. and Subsidiaries

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	Th ende 2006
Cash flows from operating activities	
Net loss	$(539,457
Adjustments to reconcile net loss to net cash used in operating activities	
Depreciation and amortization	94,313
Provision for doubtful accounts	1,681
Reserve for excess and obsolete inventory	--
Changes in operating assets and liabilities	
Accounts receivable	(159,269
Inventories	308,059
Other current assets	23,486
Other assets	(3,256
Accounts payable, accrued expenses and other current liabilities	
Other liabilities	(148,599
	28,978
Net cash used in operating activities	(510,479
Cash flows provided by investing activities	
Redemptions of certificates of deposit	--
Net cash provided by investing activities	--

Cash flows provided by (used in) financing activities	
Payments on long term debt and notes payable	(84,448
Payments of preferred stock dividends	--
Payments of preferred stock issue costs	--
Proceeds from sale of convertible preferred stock	--
Net cash provided by (used in) financing activities	(84,448
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(594,927
Cash and cash equivalents - beginning of period	2,385,778
Cash and cash equivalents - end of period	$1,790,851
Non-cash investing and financing activities were as follows:	
Inventories transferred to (from) property and equipment, attributable to operating leases, net	$(3,009
Issue of note for purchase of insurance policy	$192,120
Preferred stock dividends	$--
Preferred stock issue costs	$--
Supplemental Disclosures	
Interest paid	$18,889
Income taxes paid	$2,825

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

Vasomedical Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Unaudited)
August 31, 2006

NOTE A - ORGANIZATION AND PLAN OF OPERATIONS

The Company was incorporated in Delaware in July 1987. During fiscal 1996, the Company commenced the commercialization of its EECP external counterpulsation system ("EECP"), a microprocessor-based medical device for the noninvasive, outpatient treatment of patients with cardiovascular disease. EECP is marketed worldwide to hospitals and physician private practices. To date, the Company's revenues have been generated primarily from customers in the United States.

The Company has incurred large declines in revenue and significant operating losses during the last four fiscal years and its ability to continue operating as a going concern is dependent upon achieving profitability or through additional debt or equity financing. Achieving profitability is largely dependent on sufficiently reducing operating costs and halting the current trend of declining revenue. The Company's ability to halt the declines in revenue and restore its revenue base is largely dependent upon increasing the demand in the refractory angina market and operating in a more efficient manner. If the Company is not able to restore its revenue base and sufficiently reduce operating costs to generate an adequate cash inflow, or raise additional capital, it will not be able to continue as a going concern.

In order to reduce the Company's cash usage and bring its cost structure more into alignment with current revenue, the Company initiated a restructuring in January 2006, to reduce personnel and spending on marketing and development projects. Additional cost reductions are continuing. In addition, in April 2006,

the outside directors of the Company elected to defer payment of board of director meeting fees and senior officers elected to defer approximately $0.4 million in annual salary compensation. However, revenue has continued to decline and the Company has not achieved its goal of profitability.

Management believes that cash flow from operations together with current cash reserves will be sufficient to fund minimum projected capital requirements through at least May 2007, assuming the current revenue rate.

In the event that additional capital is required, the Company may seek to raise such capital through public or private equity or debt financings or by other means. The Company may not be able to obtain additional financing on favorable terms or at all. If the Company is unable to raise additional funds when needed, it may need to further scale back operations, research, marketing or sales efforts or obtain funds through arrangements with collaborative partners or others that may require the Company 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 years' amounts to conform with the current year's presentation.

NOTE B - STOCK-BASED COMPENSATION

In December 2004, the FASB issued Statement of Financial Standards No. 123 (revised 2004), Share-Based Payment ("SFAS No. 123 (R)"), which is a revision of SFAS No. 123. SFAS No. 123 (R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally, the approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values.

Pro forma disclosure of the fair value of share-based payments is no longer an alternative to financial statement recognition.

Prior to first quarter of fiscal 2007 the Company accounted 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 prior to fiscal 2007.

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

	Three months ended August 31,	
	2006	
Net loss attributable to common stockholders, as reported	$(539,457)	$(1,69
Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards	--	(21
Pro forma net loss	$(539,457)	$(1,91
Loss per share:		
Basic and diluted - as reported	$(.01)	$(
Basic and diluted - pro forma	$(.01)	$(

The pro forma impact of options on the net income for the three months ended August 31, 2006 is not representative of the effects on net income for future periods, as future periods will include the effects of additional stock option grants which will be immediately expensed.

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(R).

The fair value of the Company's stock-based awards was estimated assuming no expected dividends and the following weighted-average assumptions for the three months ended August 31, 2005:

Expected life (years)	5
Expected volatility	73%
Risk-free interest rate	4.18%
Expected dividend yield	0.0%

In May 2006, the compensation committee of the board of directors accelerated the vesting provision of all outstanding stock options and warrants so that they were fully vested at May 31, 2006, and as a result the Company expects that the adoption of SFAS No. 123(R) will not have an immediate material effect on its financial statements. However as new stock options are issued and with the adoption by the Company of SFAS No 123(R) the Company expects that this will have a material effect on its quarterly and annual financial statements, in the form of additional compensation expense. It is not possible to precisely determine the expense impact of adoption since a portion of the ultimate expense that is recorded will likely relate to awards that have not yet been granted. The expense associated with these future awards can only be determined based on factors such as the price for the Company's common stock, volatility of the Company's stock price and risk free interest rates as measured at the grant date. However, the pro forma disclosures related to SFAS No. 123 included in the Company's historic financial statements are relevant data points for gauging the potential level of expense that might be recorded in future periods.

During the three-month period ended August 31, 2006, the Company did not issue any share based compensation.

During the three-month period ended August 31, 2006, options to purchase 133,567 shares of common stock at an exercise price of $0.88 - $3.88 were cancelled.

NOTE C - 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 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 stock into common shares based upon the most advantageous conversion rate during the period.

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

Three months

	ended August 31	
	2006	2
Numerator:		
Basic and diluted net loss	$(539,457)	$(89
Deemed dividend related to beneficial conversion feature on Series D preferred stock	--	(78
Series D preferred stock dividends	--	(1
Net loss attributable to common stockholders	$(539,457)	$(1,69
Denominator:		
Basic - weighted average common shares	65,198,592	58,64
Stock options	--	
Warrants	--	
Diluted - weighted average common shares	65,198,592	58,64
Basic and diluted loss per common share	$(.01)	$(

Options, warrants, and convertible preferred stock, in accordance with the following table, were excluded from the computation of diluted loss per share for the three months ended August 31, 2006 and 2005, respectively, because the effect of their inclusion would be antidilutive.

	Three months ended August 31,	
	2006	2
Options to purchase common stock	7,878,508	6,789
Warrants to purchase common stock	2,454,538	2,454
Convertible preferred stock	--	5,159
	10,333,046	14,403

NOTE D - INVENTORIES, NET

Inventories, net consist of the following:

	August 31, 2006	May 20
Raw materials	$904,613	$8
Work in process	1,014,906	1,2
Finished goods	475,104	5
	$2,394,623	$2,6

At August 31, 2006 and May 31, 2006, the Company has recorded reserves for excess and obsolete inventory of $677,166.

NOTE E - PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows:

	August 31, 2006	May 31,
Land	$ 200,000	$ 200,
Building and improvements	1,383,976	1,383,
Office, laboratory and other equipment	1,436,362	1,444,
EECP systems under operating leases or under loan for clinical trials	867,522	874,
Furniture and fixtures	162,068	162,
Leasehold improvements	117,803	117,
	4,167,731	4,182,
Less: accumulated depreciation and amortization	(2,683,979)	(2,613,
	$1,483,752	$1,569,

NOTE F - 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 $192,120. The note, which bears interest at 8.15%, is payable in ten monthly installments consisting of principal and interest, and expires in March 2007. The balance outstanding at August 31, 2006, of $154,729 is presented on the consolidated condensed balance sheet in current maturities of long-term debt and notes payable.

NOTE G - LONG-TERM DEBT

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

	August 31, 2006	May 31
Facility loans (a)	$897,417	$9
Term loans (b)	6,024	
	903,441	9
Less: current portion	(68,441)	(

	$835,000	$8

(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 H - DEFERRED REVENUES

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

	Three months ende August 31,	
	2006	2
Deferred Revenue at the beginning of the period	$2,322,588	$2,55
ADDITIONS		
Deferred extended service contracts	390,534	51
Deferred in-service training	17,500	4
Deferred warranty obligations	52,500	15
RECOGNIZED AS REVENUE		
Deferred extended service contracts	(606,049)	(58
Deferred in-service training	(20,000)	(5
Deferred warranty obligations	(91,042)	(15
Deferred revenue at end of period	2,066,031	2,47
Less: current portion	(1,492,179)	(1,51
Long-term deferred revenue at end of period	$573,852	$95

NOTE I - WARRANTY COSTS

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

	Three months ended August 31,	
	2006	2005
Warranty liability at the beginning of the period	$32,000	$118,333
Expense for new warranties issued	21,000	12,000
Warranty amortization	(23,000)	(35,333)
Warranty liability at end of period	30,000	95,000
Less: current portion	(29,250)	(90,750)
Long-term warranty liability at end of period	$750	$4,250

NOTE J - INCOME TAXES

During the three-months ended August 31, 2006 and 2005, we recorded a provision for state income taxes of $4,550 and $9,826, respectively.

As of August 31, 2006, the recorded deferred tax assets were $19,741,653, reflecting an increase of $182,195 during the first quarter of fiscal 2007, which was offset by the valuation allowance of the same amount.

Ultimate realization of any or all of the deferred tax assets is not assured, due to significant uncertainties and material assumptions associated with estimates of future taxable income during the carryforward period. In February 2006, we concluded that, based upon the weight of available evidence, it was "more likely than not" that the net deferred tax asset would not be realized and increased the valuation allowance to bring the net deferred tax asset carrying value to zero.

NOTE K - COMMITMENTS AND CONTINGENCIES

Employment Agreements

The approximate aggregate minimum compensation obligation under active employment agreements at August 31, 2006 is summarized as follows:

Twelve month period ended August 31,	Amount
2007	$260,000
2008	210,000
Total	$470,000

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 L - SUBSEQUENT EVENT

Change in Senior Management

On September 20, 2006 Thomas W. Fry resigned as Chief Financial Officer of the Company and his employment agreement was terminated. Mr. Fry continues to act as a consultant to the company. Tricia Efstathiou was appointed Chief Financial Officer of the Company on September 20, 2006. Prior thereto, Ms. Efstathiou served as Controller of the Company since June 2000.

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

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; unexpected manufacturing or supplier problems; 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 , including the ability of the Company to continue as a going concern. The Company undertakes no obligation to update forward-looking statements as a result of future events or developments.

General Overview

Vasomedical, Inc. incorporated in Delaware in July 1987, develops, manufactures and markets EECP(R) therapy systems to deliver its proprietary form of enhanced external counterpulsation therapy. EECP(R) therapy is a noninvasive, outpatient therapy used in the treatment of ischemic cardiovascular diseases, currently used to manage chronic stable angina and heart failure. The therapy increases blood flow and oxygen supply to the heart muscle and other organs and decreases the heart's workload and need for oxygen, while also improving function of the endothelium, the inner lining of blood vessels throughout the body, lessening resistance to blood flow. 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. For more information visit www.vasomedical.com.

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 chronic stable angina and congestive heart failure . Medicare and other third-party payers currently reimburse for the treatment of angina or angina equivalent symptoms in patients with moderate to severe symptoms who are refractory to medications and not candidates for invasive procedures, including patients with serious comorbidities, such as heart failure, diabetes and/or peripheral vascular disease, etc. Patients with primary diagnoses of heart failure, diabetes, peripheral vascular disease, etc. are also reimbursed under the same criteria, provided the primary indication for treatment with EECP therapy is angina or angina equivalent symptoms.

We recently sponsored a pivotal, randomized clinical trial to demonstrate the efficacy of EECP therapy in the most prevalent types of heart failure patients. This trial, known as PEECH (Prospective Evaluation of EECP in Congestive Heart Failure), was intended to provide additional evidence of the safety and efficacy of EECP therapy in the treatment of mild-to- moderate heart failure and to support our application for expansion of the Medicare national reimbursement coverage policy to include mild-to-moderate heart failure as a primary indication. The PEECH trial was a positive clinical trial, having met the statistical requirement of meeting at least one of its co-primary endpoints, a significant difference in the proportion of patients satisfying a prespecified threshold of improvement in exercise duration. The trial also demonstrated significant improvements in favor of EECP therapy on several important secondary endpoints, including exercise duration and improvement in symptom status and quality of life. Measures of change in peak oxygen consumption were not statistically significant in the overall study population, though a trend favoring EECP therapy was present in early follow-up. Patients in the trial who had an ischemic etiology, i.e. pre-existing coronary artery disease, demonstrated a greater response to EECP therapy than those who had an idiopathic (non-ischemic) etiology. Subsequent analyses of the subgroup of patients in the trial age 65 and over has been performed and a manuscript reporting those results has been accepted for publication.

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

The preliminary results of the PEECH trial were presented at the American College of Cardiology scientific sessions in March 2005, and the initial peer-reviewed report of the results of the trial were published in the Journal of the American College of Cardiology initially on-line on August 25, 2006 and subsequently in print on September 19, 2006. On June 20, 2005, the Centers for Medicare and Medicaid Services (CMS) accepted our application for expansion of reimbursement coverage of EECP therapy to include patients with New York Heart Association (NYHA) Class II/III stable heart failure symptoms with an ejection fraction of less than or equal to 35%, i.e. chronic, stable, mild-to-moderate systolic heart failure as a primary indication, as well as patients with Canadian Cardiovascular Society Classification (CCSC) II, i.e. chronic, stable mild angina.

On June 23, 2005, CMS also received a request from a competing manufacturer of external counterpulsation therapy equipment, to reconsider the reimbursement coverage policy. They requested expansion of coverage to include 1) treatment of congestive heart failure, to include NYHA Class II, III with a left ventricular ejection fraction (LVEF) less than or equal to 40%, and acute heart failure; 2) treatment of stable angina to include CCSC II angina; 3) treatment of acute myocardial infarction; 4) treatment of cardiogenic shock. On September 15, 2005, they amended their request to include NYHA Class IV heart failure.

On March 20, 2006, the Centers for Medicare and Medicaid Services (CMS) issued their Decision Memorandum regarding this reconsideration with the opinion "that the evidence is not adequate to conclude that external counterpulsation therapy is reasonable and necessary for the treatment of:

* Canadian Cardiovascular Society Classification (CCSC) II angina
* Heart Failure
    - New York Heart Association Class II/III stable heart failure symptoms with an ejection fraction of less than or equal to 35%
    - New York Heart Association Class II/III stable heart failure symptoms with an ejection fraction of less than or equal to 40%
    - New York Heart Association Class IV heart failure
    - Acute heart failure
* Cardiogenic shock
* Acute myocardial infarction."

They reiterated in the decision memorandum that "Current coverage as described in Section 20.20 of the Medicare National Coverage Determination (NCD) manual will remain in effect."

We will continue to educate the marketplace that patients with a primary diagnosis of heart failure, diabetes, peripheral vascular disease, etc. are also eligible for reimbursement under the current coverage policy, provided the primary indication for treatment with EECP therapy is angina or angina equivalent symptoms and the patient satisfies other listed criteria. Additionally, we will continue to pursue expansion of coverage for EECP therapy with Medicare and other third-party payers as evidence of its clinical utility develops.

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, 2006, 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

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

recognize revenue from the sale of our EECP systems in the period in which we deliver the system to the customer. Revenue from the sale of our EECP 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 over an extended period of time and in our judgment the degree of collectibility is uncertain.

In most cases, revenue from domestic EECP 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 EECP systems includes a combination of three elements that qualify as separate units of accounting:

i. EECP equipment sale,

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 EECP 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. EECP 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 revenue at the time the in-service and training is completed and the amount related to service arrangements is recognized as service revenue 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 in cost of sales as incurred .

We also recognize revenue generated from servicing EECP 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 EECP 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.

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

Revenues from the sale of EECP systems through our international distributor network are generally covered by a one-year warranty period. 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 EECP 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 EECP system utilized under operating leases is recorded as a component of property and equipment and is amortized to cost of sales 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 August 31, 2006.

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

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 EECP systems at various field locations for demonstration, training, evaluation, and other similar purposes at no charge. The cost of these EECP 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 EECP 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 $78,000 less in fixed production overhead into inventory.

Deferred Revenues

We record revenue on extended service contracts ratably over the term of the related warranty 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 EECP system sales for the fair value of installation and in-service training to the period when the services are rendered and for warranty obligations ratably over the service period, which is generally one year.

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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. For these customers we

accrue a warranty reserve for estimated costs of providing a parts only warranty 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.

Net Loss per Common Share

Basic loss per share are based on the weighted average number of common shares outstanding without consideration of potential common stock. Diluted loss per share are 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 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 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 recorded relates primarily to the realization of net operating loss carryforwards, of which the allocation of the current portion, if any, reflects the expected utilization of such net operating losses in next twelve months. Such allocation is based on our internal financial forecast and may be subject to revision based upon actual results.

Stock-based Employee Compensation

In December 2004, the FASB issued Statement of Financial Standards No. 123 (revised 2004), Share-Based Payment ("SFAS No. 123 (R)"), which is a revision of SFAS No. 123. SFAS No. 123 (R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally, the approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees including grants of employee stock options, to be recognized in the financial statements based on

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

their fair values. Pro forma disclosure of the fair value of share-based payments is no longer an alternative to financial statement recognition. The Company has five stock-based employee compensation plans.

Prior to first quarter of fiscal 2007 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 prior to fiscal 2007.

The Company has five stock-based employee compensation plans.

In May 2006, the compensation committee of the board of directors accelerated the vesting provision of all outstanding stock options and warrants so that they were fully vested at May 31, 2006, and as a result the Company expects that the adoption of SFAS No. 123(R) will not have an immediate material effect on its financial statements, however as new stock options are issued the Company has adopted SFAS No 123(R) and this will have a material effect on its quarterly and annual financial statements, in the form of additional compensation expense. It is not possible to precisely determine the expense impact of adoption since a portion of the ultimate expense that is recorded will likely relate to awards that have not yet been granted. The expense associated with these future awards can only be determined based on factors such as the price for the Company's common stock, volatility of the Company's stock price and risk free interest rates as measured at the grant date. However, the pro forma disclosures related to SFAS No. 123 included in the Company's historic financial statements are relevant data points for gauging the potential level of expense that might be recorded in future periods.

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 (R).

Recently Issued Accounting Standards

Statement of Financial Accounting Standards No. 152, "Accounting for Real Estate Time-Sharing Transactions", an amendment of FASB Statements No. 66 and 67 (SFAS 152) was issued in December 2004 and becomes effective for financial

statements for fiscal years beginning after June 15, 2005. The Company does not expect that SFAS 152 will have an effect on future financial statements.

In December 2004, the 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 does not expect the adoption of SFAS No. 153 to have a material impact on the Company's consolidated financial statements.

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.

Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140, was issued in February 2006 and is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Certain parts of this Statement may be applied prior to the adoption of this Statement. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period for that fiscal year. Provisions of this Statement may be applied to instruments that an entity holds at the date of adoption on an instrument-by-instrument basis. The Company does not expect that SFAS 155 will have any significant effect on future financial statements.

Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140, pertains to the servicing of financial assets and was issued in March 2006 and should be adopted as of the beginning of its first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year. The Company does not expect that SFAS 156 will have any significant effect on future financial statements.

In March 2005, FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations - an interpretation of FASB Statement No. 143 (FIN 47). FIN 47 is effective no later than the end of fiscal years ending after December

15, 2005 (December 31, 2005, for calendar-year enterprises). Retrospective application for interim financial information is permitted but is not required. Early adoption of this Interpretation is encouraged. The Company does not expect that FIN 47 will have any significant effect on future financial statements.

In December 2004, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AcSEC) issued Statement of Position 04-2, Accounting for Real Estate Time-Sharing Transactions (SOP 04-2). SOP 04-2 is effective for financial statements issued for fiscal years beginning after June 15, 2005, with earlier application encouraged. The Company does not expect that SOP 04-2 will have any effect on future financial statements.

In September 2005, AcSEC issued Statement of Position 05-1: Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts (SOP 05-1). SOP 05-1 is effective for fiscal years beginning after December 15, 2006, with earlier adoption encouraged. The Company does not expect that SOP 05-1 will have any effect on future financial statements.

FASB Staff Position (FSP) FAS 13-1 - Accounting for Rental Costs Incurred during a Construction Period, was issued on October 6, 2005, and becomes effective for the for new transactions or arrangements entered into after the beginning of the first fiscal quarter following the date that the final FSP is posted by the FASB. The Company does not expect that FSP 13-1 will have any significant effect on future financial statements.

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On June 29, 2005, the FASB ratified the consensus reached for Emerging Issues Task Force (EITF) Issue No. 05-5, Accounting for Early Retirement or Postemployment Programs with Specific Features (Such As Terms Specified in Altersteilzeit Early Retirement Arrangements). The consensus in this Issue should be applied to fiscal years beginning after December 15, 2005, and reported as a change in accounting estimate effected by a change in accounting principle as described in paragraph 19 of FASB Statement 154. The Company does not expect that EITF 05-5 will have any significant effect on future financial statements.

On September 28, 2005, the FASB ratified the consensus reached for EITF Issue No. 05-7, Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues. The provisions of this Issue should be applied to future modifications of debt instruments beginning in the first interim or annual reporting period beginning after December 15, 2005. The Company expects that the application of EITF 05-7 could have an effect on interest and debt valuations in future financial statements. It is not possible to determine the impact, if any, from the application since the Company does not presently have any convertible debt.

On July 13, 2006, the FASB issued Interpretation No. 48 for Uncertainty in Income Taxes and interpretation of FASB Statement 109. Interpretation 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with Statement No. 109 and prescribes a recognition threshold and measurement attribute for financial statements disclosure of tax position taken or expected to be taken on a tax return. Additionally, Interpretation No. 48 provides guidance on depreciation, classification, interest and penalties accounting in interim periods, disclosure

and transition. Interpretation No. 48 is effective for fiscal years beginning after December 15, 2006, with early adoption permitted. The Company is currently evaluating whether the adoption of Interpretation No. 48 will have a material effect on our consolidated financial position, results of operations and cash flows.

In July 2006, the FASB issued Staff Position ("FSB") on FAS 13, FSP FAS 13-2, Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease transaction. FSP FAS 13-2 addresses how a change or projected change in the timing of cash flows relating to income taxes generated by a leveraged lease transaction affects the accounting by a lessor for that lease and amends FAS 13 Accounting for Leases. FSP FAS 13-2 is effective for fiscal years beginning December 15, 2006, with earlier application permitted. The Company does not expect that FSP FAS 13-2 will have any significant effect on future financial statements.

Statement of Financial Accounting Standards No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. The Company does not expect that this pronouncement will have any significant effect on future financial statements.

FASB Staff Position (FSP) No. FIN 46(R)-6, Determining the Variability to Be Considered in Applying FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities. Posted on April 13, 2006. An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under Interpretation 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of Interpretation 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. Early application is permitted for periods for which financial statements have not yet been issued. Retrospective application to the date of the initial application of Interpretation 46(R) is permitted but not required. Retrospective application,

if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006. The Company does not expect that this pronouncement will have any significant effect on future financial statements.

FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations - an interpretation of FASB Statement No. 143 (FIN 47) was issued in March 2005. FIN 47 is effective no later than the end of fiscal years ending after December 15, 2005 (December 31, 2005, for calendar-year enterprises).

Retrospective application for interim financial information is permitted but is not required. Early adoption of this Interpretation is encouraged. The Company does not expect that FIN 47 will have any significant effect on future financial statements. FASB Staff Position (FSP) No. FTB 85-4-1, Accounting for Life Settlement Contracts by Third-Party Investors, was posted in March 27, 2006 and is effective for fiscal years beginning after June 15, 2006. It provides initial and subsequent measurement guidance and financial statement presentation and disclosure guidance for investments by third-party investors in life settlement contracts. This FSP also amends certain provisions of FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance, and FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. The Company does not expect that (FSP) No. FTB 85-4-1 will have any effect on future financial statements.

Results of Operations

Three Months Ended August 31, 2006 and 2005

Net revenue from sales, leases and service of our EECP systems for the three-month periods ended August 31, 2006 and 2005, was $2,081,856 and $3,536,371, respectively, which represented a decline of $1,454,515 or 41%. We reported a net loss of $539,457 compared to $892,862 for the three-month periods ended August 31, 2006 and 2005, respectively. Our net loss per common share was $.01 for the three-month period ended August 31, 2006 compared to a net loss of $0.03 per share for the three-month period August 31, 2005.

Revenues

Revenue from equipment sales declined approximately 56% to $1,073,216 for the three-month period ended August 31, 2006 as compared to $2,456,909 for the same period for the prior year. The decline in equipment sales is due primarily to a 46% decline in the number of equipment shipments and a 16% decrease in average sales prices. A higher mix of used equipment verses both newer model equipment and new equipment was the primary cause of the decrease 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. We anticipate that demand for EECP systems will remain soft until there is greater clinical acceptance for the use of EECP therapy in treating patients with angina or angina equivalent symptoms who meet the current reimbursement guidelines or an expansion of the current CMS national reimbursement policy to include some or all Class II & III heart failure patients. Patients with angina or angina equivalent symptoms eligible for reimbursement under current policies include many with serious comorbidities, such as heart failure, diabetes, peripheral vascular disease and/or others. Despite this, many cardiology clinicians appear to be waiting for approval of reimbursement coverage for heart failure as a primary indication before they will move forward with the treatment of ischemic heart failure patients with angina equivalent symptoms. Reluctance to bill for ischemic heart failure patients under the current coverage guidelines, failure to get or maintain adequate reimbursement coverage for angina and heart failure would adversely affect our business prospects. 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 quarter of fiscal 2007 compared to the first quarter of fiscal 2006, which reduced the average selling price in that period. The average price of new systems sales declined approximately 3% in the first quarter of fiscal 2007 compared to the same period in the prior year. Lastly, we continue to reorganize certain territory responsibilities in our sales department due to vacant and/or unproductive

territories. Our revenue from the sale of EECP systems to international distributors in the first quarter of fiscal 2007 increased approximately 34% to $418,350 compared $313,334 in same period of the prior year reflecting increased volume.

The above decline in revenue was also partially due to a 7% decrease in revenue from equipment rental and services for the three-month period ended August 31, 2006, from the same three-month period in the prior year. Revenue from equipment rental and services represented 48 % of total revenue in the first quarter of fiscal 2007 compared to 31% in the first quarter of fiscal 2006. The decrease in the absolute amounts and the increase in the percentage of total revenue resulted primarily from a less than a 1% change in service related revenue, offset by a 71% decline in rental revenue. The decline was due to a decrease in the rental install base from the prior period ended August 31, 2005.

Gross Profit

The gross profit declined to $1,117,246 or 54% of revenues for the three-month period ended August 31, 2006, compared to $2,113,187 or 60% of revenues for the three-month period ended August 31, 2005. Gross profit margin as a percentage of revenue for the three-month period ended August 31, 2006, decreased compared to the same year of the prior fiscal mainly due to the higher production units costs associated with reduced production volumes in the last two fiscal quarters. In addition, adoption of SFAS No. 151 lowered the amount of fixed overhead costs absorbed into inventory in the first quarter of fiscal 2007. 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 EECP models sold and their respective average selling prices, the mix of EECP 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 August 31, 2006 and 2005, were $1,323,826 or 64% of revenues and $2,409,149 or 68% of revenues, respectively reflecting a decrease of $1,085,323 or approximately 45%. The decrease in SG&A expenditures in the first quarter of fiscal 2007 compared to fiscal 2006 resulted primarily from decreased sales and marketing expenditures reflecting lower sales and marketing personnel and travel, plus reduced market research and advertising costs.

Research and Development

Research and development ("R&D") expenses of $328,495 or 16% of revenues for the three months ended August 31, 2006, decreased by $183,511 or 36%, from the prior three months ended August 31 2005, of $512,006 or 14% of revenues. The decrease is primarily attributable to lower new product development spending and

reduced spending on clinical trials.

Provision for Doubtful Accounts

During the three-month period ended August 31, 2006, the Company charged $1,681 to its provision for doubtful accounts as compared to $70,575 during the three-month period ended August 31, 2005. The decrease in the provision is a direct result of the first quarter of fiscal 2007 decrease in accounts receivable and sales from the corresponding quarter ended August 31, 2005.

Interest Expense and Financing Costs

Interest expense and financing costs decreased to $18,889 in the three-month period ended August 31, 2006, from $23,509 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.

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

Interest and Other Income, Net

Interest and other income for the first quarter of 2007 and 2006, were $20,738 and $19,016, respectively.

Income Tax Expense, Net

During the three-months ended August 31, 2006 and 2005, we recorded a provision for state income taxes of $4,550 and $9,826, respectively.

As of August 31, 2006, the recorded deferred tax assets were $19,741,653, reflecting an increase of $182,195 during fiscal 2007, which was offset by the valuation allowance of the same amount.

Ultimate realization of any or all of the deferred tax assets is not assured, due to significant uncertainties and material assumptions associated with estimates of future taxable income during the carryforward period. In February 2006, we concluded that, based upon the weight of available evidence, it was "more likely than not" that the net deferred tax asset would not be realized and increased the valuation allowance to bring the net deferred tax asset carrying value to zero.

Liquidity and Capital Resources

We have financed our operations in fiscal 2007 and fiscal 2006 from working capital and in fiscal 2006 from the issuance of preferred stock. At August 31, 2006, we had cash, cash equivalents, and certificates of deposit balance of $1,790,851 and working capital of $2,255,109 as compared to cash, cash equivalents, and certificates of deposit balance of $2,385,778 and working capital of $2,867,288 at May 31, 2006. Our cash, cash equivalents, and certificates of deposit balances decreased $594,927 in fiscal year 2007 primarily due to cash used in operating activities of $510,479 and $84,448 in cash used in financing activities.

The decrease in cash used in operating activities during the first quarter of fiscal year 2007 resulted primarily from the net loss of $539,457 plus adjustments to reconcile net loss to net cash provided by operating activities of $28,979. Changes in our operating assets and liabilities were $65,335. The changes in the asset components primarily reflect an increase in accounts receivable of $159,269 offset by lower inventory of $308,059 and other current assets of $23,486. The changes in our operating liability components reflect a decrease in accounts payable and accrued liabilities of $87,437 and a decrease in other liabilities of $148,599. Non-cash adjustments for depreciation, amortization, allowance for doubtful accounts and allowance for inventory write-offs of $95,994 partially offset the above. Net accounts receivable were 48% of quarterly revenues for the three-month period ended August 31, 2006, compared to 70% at the end of the three-month period ended August 31, 2005, and accounts receivable turnover increased to 7.0 times as of August 31, 2006, as compared to 4.0 times as of August 31, 2005.

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 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 EECP 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 quarter of fiscal 2007 and 2006, less than 1% 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 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 EECP program. As we are creating a new market for the EECP 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.

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Vasomedical, Inc. and Subsidiaries

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There were no investing activities during the three-month period ended August 31, 2006.

Our financing activities used cash of $84,448 during the three-month period ended August 31, 2006, reflecting payments on our outstanding notes and loans.

We believe that our projected cash flow from operations together with our current cash reserves and working capital will be sufficient to fund our business plan and projected capital requirements through at least May 2007, assuming current revenue rate, however, we have incurred significant losses during the last four fiscal years and our long-term ability to maintain current operations is dependent upon achieving profitable operations or through additional debt or equity financing. In the event that additional capital is required, we may seek to raise such capital through public or private equity or debt financings. Future capital funding, if available, may result in dilution to

current shareholders.

The following table presents the Company's expected cash requirements for contractual obligations outstanding as of August 31, 2006.

	Total	Due as of 8/31/07	Due as of 8/31/08 and 8/31/09	Due as of 8/31/10 an 8/31/11
Long-Term Debt	$903,441	$68,441	$138,595	$155,705
Notes Payable	154,729	154,729	--	--
Operating Leases	3,560	3,560	--	--
Employment Agreements	470,000	260,000	210,000	--
Total Contractual Cash Obligations	$1,531,730	$ 486,730	$348,595	$155,705

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.

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 August 31, 2006, 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 August 31, 2006 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.

Vasomedical, Inc.

PART II - OTHER INFORMATION

ITEM 1 -LEGAL PROCEEDINGS:

None

ITEM 2 UNREGISTERED SALES OF EQUITY 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:

None

ITEM 6 -EXHIBITS

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.

Vasomedical, Inc. and Subsidiaries

In accordance with 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

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

/s/ Tricia Efstathiou

Tricia Efstathiou
Chief Financial Officer (Principal

Financial and Accounting Officer)

Date: October 16, 2006