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VASOMEDICAL INC
Form 10-Q
April 13, 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 February 28, 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

Number of Shares Outstanding of Common Stock,
\$.001 Par Value, at April 13, 2006 65,089,897

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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CONSOLIDATED CONDENSED BALANCE SHEETS

| | February 28, 2006 |
|--|-------------------------------|
| ASSETS | ----- (unaudited) |
| CURRENT ASSETS | |
| Cash and cash equivalents | \$733,423 |
| Certificates of deposit | 998,287 |
| Accounts receivable, net of an allowance for doubtful accounts of \$477,623 at February 28, 2006, and \$394,692 at May 31, 2005 | 2,571,241 |
| Inventories, net | 2,851,402 |
| Other current assets | 281,982 |
| Total current assets | ----- 7,436,335 |
| PROPERTY AND EQUIPMENT, net of accumulated depreciation of \$2,549,006 at February 28, 2006, and \$2,626,983 at May 31, 2005 | 1,664,538 |
| DEFERRED INCOME TAXES | -- |
| OTHER ASSETS | 308,191 |
| | ----- \$9,409,064 ===== |

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LIABILITIES AND STOCKHOLDERS' EQUITY

| | | |
|--|--------------|--|
| CURRENT LIABILITIES | | |
| Accounts payable and accrued expenses | \$1,281,668 | |
| Current maturities of long-term debt and notes payable | 150,658 | |
| Sales tax payable | 225,637 | |
| Deferred revenue | 1,629,143 | |
| Accrued warranty and customer support expenses | 42,750 | |
| Accrued professional fees | 497,661 | |
| Accrued commissions | 257,255 | |
| Total current liabilities | 4,084,772 | |
| LONG-TERM DEBT | 868,204 | |
| ACCRUED WARRANTY COSTS | 2,250 | |
| DEFERRED REVENUE | 816,741 | |
| OTHER LIABILITIES | -- | |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY | | |
| Preferred stock, \$.01 par value; 1,000,000 shares authorized; none issued and outstanding at February 28, 2006 and May 31, 2005 | -- | |
| Common stock, \$.001 par value; 110,000,000 shares authorized; 65,089,897 and 58,552,688 shares at February 28, 2006, and May 31, 2005, respectively, issued and outstanding | 65,089 | |
| Additional paid-in capital | 46,115,346 | |
| Accumulated deficit | (42,543,338) | |
| Total stockholders' equity | 3,637,097 | |
| | \$9,409,064 | |

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)

| | Nine Months Ended February 28, | | Th |
|--|-----------------------------------|-------------|----------|
| | 2006 | 2005 | 2006 |
| Revenues | | | |
| Equipment sales | \$5,998,943 | \$8,629,026 | \$1,807, |
| Equipment rentals and services | 3,059,433 | 2,618,393 | 1,034, |
| Total revenues | 9,058,376 | 11,247,419 | 2,841, |
| Cost of Sales and Services | | | |
| Cost of sales, equipment | 2,755,419 | 3,034,836 | 898, |
| Cost of equipment rentals and services | 993,613 | 965,413 | 330, |
| Total cost of sales and services | 3,749,032 | 4,000,249 | 1,228, |

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| | | | |
|--|-----------------|----------------|----------|
| Gross Profit | 5,309,344 | 7,247,170 | 1,613, |
| Operating Expenses | | | |
| Selling, general and administrative | 6,769,946 | 9,088,858 | 1,852, |
| Research and development | 1,528,699 | 2,521,321 | 412, |
| Provision for doubtful accounts | 89,559 | 135,156 | 18, |
| Total operating expenses | 8,388,204 | 11,745,335 | 2,284, |
| LOSS FROM OPERATIONS | (3,078,860) | (4,498,165) | (670, |
| Other Income (Expense) | | | |
| Interest and financing costs | (64,299) | (84,971) | (19, |
| Interest and other income, net | 59,041 | 51,795 | 18, |
| Total other income (expense) | (5,258) | (33,176) | (1, |
| LOSS BEFORE INCOME TAXES | (3,084,118) | (4,531,341) | (671, |
| Income tax expense, net | (7,112,826) | (29,661) | |
| NET LOSS | (10,196,944) | (4,561,002) | (671, |
| Preferred Stock Dividend | (877,870) | -- | (23, |
| NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS | \$ (11,074,814) | \$ (4,561,002) | \$ (694, |
| Net loss per common share | | | |
| - basic | \$ (0.18) | \$ (0.08) | \$ (0 |
| - diluted | \$ (0.18) | \$ (0.08) | \$ (0 |
| Weighted average common shares outstanding | | | |
| - basic | 60,063,566 | 58,545,850 | 62,162, |
| - diluted | 60,063,566 | 58,545,850 | 62,162, |

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

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Vasomedical, Inc. and Subsidiaries

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

| | Preferred Stock Shares | Amount | Common Stock Shares | Amount | Additional Paid-in Capital |
|-------------------------|---------------------------|--------|------------------------|----------|----------------------------------|
| Balance at June 1, 2005 | -- | -- | 58,552,688 | \$58,552 | \$51,450,639 |
| Issuance of Series | | | | | |

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| | | | | | |
|--|----------|-------|------------|----------|--------------|
| 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 | | | | | (877,870) |
| 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 | (25,000) | (250) | 6,112,209 | 6,112 | (5,862) |
| 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 | | | | | |
| Balance at February 28, 2006 | -- | \$-- | 65,089,897 | \$65,089 | \$46,115,346 |

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)

| | En |
|--------------------------------------|------------------------|
| | ----- 2006 ----- |
| Cash flows from operating activities | |
| Net loss | \$(10,196,9 |

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| | |
|---|----------|
| Adjustments to reconcile net loss to net cash used in operating activities | |
| Depreciation and amortization | 413,0 |
| Provision for doubtful accounts | 89,5 |
| Reserve for excess and obsolete inventory | (11,5 |
| Deferred income taxes | 7,093,0 |
| Common stock issued for services | 101,2 |
| Changes in operating assets and liabilities | |
| Accounts receivable | (768,7 |
| Inventories | 709,7 |
| Other current assets | 243,9 |
| Other assets | (19,8 |
| Accounts payable, accrued expenses and other current liabilities | (244,0 |
| Other liabilities | (140,7 |
| | 7,465,6 |
| Net cash used in operating activities | (2,731,2 |
| | |
| 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 | 760,1 |
| Net cash provided by (used in) investing activities | 760,1 |
| | |
| Cash flows provided by financing activities | |
| Payments on long term debt and notes payable | (378,9 |
| Payments of preferred stock dividends | (91,6 |
| Payments of preferred stock issue costs | (314,3 |
| Proceeds from exercise of options and warrants | |
| Proceeds from sale of convertible preferred stock | 2,500,0 |
| Net cash provided by financing activities | 1,714,9 |
| | |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (256,1 |
| Cash and cash equivalents - beginning of period | 989,5 |
| Cash and cash equivalents - end of period | \$733,4 |
| Non-cash investing and financing activities were as follows: | |
| Inventories transferred to (from) property and equipment, attributable to operating leases, net | \$(189,3 |
| Issue of note for purchase of insurance policy | \$302,0 |
| Preferred stock dividends | \$786,2 |
| Preferred stock issue costs | \$227,0 |
| Supplemental Disclosures | |
| Interest paid | \$64,2 |
| Income taxes paid | \$22,9 |

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

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February 28, 2006

NOTE A - BASIS OF PRESENTATION

The consolidated condensed balance sheet as of February 28, 2006, and the related consolidated condensed statements of operations for the nine and three-month periods ended February 28, 2006 and 2005, changes in stockholders' equity for the nine-month period ended February 28, 2006, and cash flows for the nine-month periods ended February 28, 2006 and 2005, 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 February 28, 2006, 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 February 28, 2006 and 2005, 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 as a going concern is dependent upon achieving profitability in the refractory angina market or through additional debt or equity financing. Achieving profitability is largely dependent on our ability to reduce operating costs sufficiently as well as halting the current trend of declining revenue. Our ability to maintain our current base of revenue is largely dependent upon restructuring our sales and marketing efforts in the angina market and operating in a more efficient manner. If we are not able to maintain our existing base of revenue and sufficiently reduce operating costs to generate an adequate cash flow, or raise additional capital, we will not be able to continue as a going concern.

In order to reduce the Company's cash burn and bring its cost structure more into alignment with current revenue, we initiated a company restructuring in January 2006, to reduce personnel and spending on marketing and development projects. We anticipate that the restructuring will reduce manufacturing and operating cost by approximately \$3 million per year compared to prior levels. In addition, in April 2006, certain senior executives elected to defer approximately \$0.4 million in annual salary compensation. We believe that these steps to conserve cash will provide the Company with the opportunity to rebuild sales to a profitable level and/or explore strategic opportunities.

Based on the continuation of current revenue levels and the implementation of our restructuring plan initiated in January 2006, we believe that we will be able to fund our minimum projected capital requirements through at least the end of the calendar year.

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.

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

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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 principle. The Statement applies to all voluntary changes in accounting

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Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited) February 28, 2006

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 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

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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 nine-month and three-month periods ended February 28, 2006 of \$290,000 and \$149,000, 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 nine-month period ended February 28, 2006, the Board of Directors granted non-qualified stock options under the 1999 Stock Option Plan to eight employees to purchase 560,000 shares of common stock, at an exercise price of \$0.20 per share, and granted non-qualified stock options under the 2004 Stock Option/Stock Issuance Plan to three officers, and 49 employees to purchase an aggregate of 1,418,045 shares of common stock, at an exercise price of \$0.20 to \$0.58 per share, which represented the fair market value of the underlying

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)
February 28, 2006

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.

During the nine-month period ended February 28, 2006, options to purchase 895,611 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 Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation.

| Nine Months Ended February 28, | | Three M Febr |
|-----------------------------------|------|-----------------|
| ----- 2006 | 2005 | ----- 2006 |

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| | | | |
|---|-----------------|----------------|--------------|
| Net loss attributable to common stockholders, as reported | \$ (11,074,814) | \$ (4,561,002) | \$ (694,781) |
| Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards | (618,715) | (888,075) | (184,973) |
| Pro forma net loss | \$ (11,693,529) | \$ (5,449,077) | \$ (879,754) |
| Loss per share: | | | |
| Basic and diluted - as reported | \$ (0.18) | \$ (0.08) | \$ (0.01) |
| Basic and diluted - pro forma | \$ (0.19) | \$ (0.08) | \$ (0.01) |

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 nine months ended February 28, 2006:

| | |
|-------------------------|-------|
| Expected life (years) | 5 |
| Expected volatility | 74% |
| Risk-free interest rate | 4.21% |
| 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 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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The following table sets forth the computation of basic and diluted earnings (loss) per common share:

| | Nine Months Ended February 28, | | Thre |
|--|-----------------------------------|----------------|----------|
| | 2006 | 2005 | 200 |
| Numerator: | | | |
| Net loss | \$ (10,196,944) | \$ (4,561,002) | \$ (671, |
| Deemed dividend related to beneficial conversion feature on Series D preferred stock | (786,247) | -- | |
| Series D preferred stock dividends | (91,623) | -- | (23, |
| Net loss attributable to common stockholders - basic and diluted | \$ (11,074,814) | \$ (4,561,002) | \$ (694, |
| Denominator: | | | |
| Basic - weighted average common shares | 60,063,566 | 58,545,850 | 62,162, |
| Stock options | -- | -- | |
| Warrants | -- | -- | |
| Diluted - weighted average common shares | 60,063,566 | 58,545,850 | 62,162, |
| Basic and diluted loss per common share | \$ (0.18) | \$ (0.08) | \$ (0 |

Options and warrants 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.

| | Nine Months and Three Months Ended February 28, | |
|-----------------------------------|--|-----------|
| | 2006 | 2005 |
| Options to purchase common stock | 7,627,978 | 6,632,253 |
| Warrants to purchase common stock | 2,454,538 | 200,000 |
| | 10,082,516 | 6,832,253 |

NOTE E - INVENTORIES, NET

Inventories, net consist of the following:

| | February 28, 2006 | May 31, 2005 |
|-----------------|----------------------|-----------------|
| Raw materials | \$890,661 | \$960,101 |
| Work in process | 1,355,442 | 1,194,688 |
| Finished goods | 605,299 | 1,205,483 |

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\$2,851,402
=====

\$3,360,272
=====

At February 28, 2006 and May 31, 2005, the Company has recorded reserves for excess and obsolete inventory of \$554,640 and \$566,149, respectively.

NOTE F - PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows:

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)
February 28, 2006

| | February 28, 2006 | May 31, 2005 |
|---|----------------------|-----------------|
| | ----- | ----- |
| Land | \$ 200,000 | \$ 200,000 |
| Building and improvements | 1,383,976 | 1,383,976 |
| Office, laboratory and other equipment | 1,444,850 | 1,445,000 |
| EECP systems under operating leases or under loan for clinical trials or evaluations | 904,847 | 1,552,000 |
| Furniture and fixtures | 162,068 | 162,068 |
| Leasehold improvements | 117,803 | 117,803 |
| | ----- | ----- |
| | 4,213,544 | 4,861,847 |
| | ----- | ----- |
| Less: accumulated depreciation and amortization | (2,549,006) | (2,626,000) |
| | ----- | ----- |
| | \$1,664,538 | \$2,234,847 |
| | ===== | ===== |

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 February 28, 2006, of \$30,871 is presented on the consolidated 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:

| | February 28, 2006 | May 31, 2005 |
|--------------------|----------------------|-----------------|
| | ----- | ----- |
| Facility loans (a) | \$927,033 | \$969,566 |
| Term loans (b) | 60,958 | 126,243 |
| | ----- | ----- |
| | 987,991 | 1,095,809 |

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| | | |
|-----------------------|-----------|-----------|
| Less: current portion | (119,787) | (148,212) |
| | ----- | ----- |
| | \$868,204 | \$947,597 |
| | ===== | ===== |

(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. In addition, the Company defers revenue related to domestic 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.

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Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)
February 28, 2006

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

| | Nine Months Ended February 28, | | Th |
|---|-----------------------------------|-------------|---------|
| | 2006 | 2005 | 200 |
| | ----- | ----- | ----- |
| Deferred Revenue at the beginning of the period | \$2,551,532 | \$2,846,451 | \$2,561 |
| ADDITIONS | | | |
| Deferred extended service contracts | 1,713,937 | 1,473,022 | 536 |
| Deferred in-service and training | 115,000 | 147,500 | 30 |
| Deferred service arrangements | 355,000 | 630,000 | 90 |
| RECOGNIZED AS REVENUE | | | |
| Deferred extended service contracts | (1,770,002) | (1,395,461) | (626 |
| Deferred in-service and training | (107,500) | (230,000) | (22 |
| Deferred service arrangements | (412,083) | (947,917) | (123 |
| | ----- | ----- | ----- |
| Deferred revenue at end of period | 2,445,884 | 2,523,595 | 2,445 |
| Less: current portion | (1,629,143) | (1,646,918) | (1,629 |
| | ----- | ----- | ----- |
| Long-term deferred revenue at end of period | \$816,741 | \$876,677 | \$816 |
| | ===== | ===== | ===== |

NOTE J - WARRANTY COSTS

Equipment sold is generally covered by a warranty and service arrangement

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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:

| | Nine Months Ended February 28, | | Thru |
|---|-----------------------------------|-----------|-------|
| | 2006 | 2005 | 2006 |
| Warranty liability at the beginning of the period | \$118,333 | \$244,917 | \$65, |
| Expense for new warranties issued | 24,000 | -- | 9, |
| Warranty amortization | (97,333) | (122,084) | (29, |
| Warranty liability at end of period | 45,000 | 122,833 | 45, |
| Less: current portion | (42,750) | (105,583) | (42, |
| Long-term warranty liability at end of period | \$2,250 | \$17,250 | \$2, |

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NOTE K - INCOME TAXES

During the nine months ended February 28, 2006 and 2005, we recorded income tax expense of \$7,112,826 and \$29,661, respectively. The fiscal 2006 tax expense consists mainly of \$7,093,000 in additional valuation allowance provided for the deferred tax asset in the second fiscal quarter. The income tax expense for the first nine months 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

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net of a \$4,674,000 valuation allowance related to the anticipated recovery of tax loss carryforwards. 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 and that current coverage for CCSC class III/IV refractory angina would remain in effect. Consequently, at the end of the second fiscal quarter, we concluded that, based upon the weight of available evidence, it was no longer "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. On March 20, 2006, CMS issued its final decision, which upheld the PDM.

As of February 28, 2006, the recorded deferred tax asset remained at zero, consisting of a gross tax asset and offsetting valuation allowance of \$19,394,000, reflecting an increase of \$1,038,000 during the first nine months of fiscal 2006.

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 (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 was 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. 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. As of February 28, 2006, all of the Series D Preferred Stock had been converted into 6,112,209 shares of common stock.

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 was 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 applied the funds to 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

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accounting for the preferred stock issuance. EITF No. 98-5 provides that detachable warrants issued with convertible securities are valued separately,

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and that the beneficial conversion feature of the convertible security be measured and recognized over the minimum period over which the shareholders can 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

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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 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 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.

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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 nine-month period ended February 28, 2006, cash dividends of \$91,623 were paid. Preferred stock dividends for the nine months ended February 28, 2006, are summarized as follows:

| | Amount |
|-------------------------------|-----------|
| | ----- |
| Cash dividends paid | \$91,623 |
| Beneficial conversion feature | 786,247 |
| | ----- |
| | \$877,870 |
| | ===== |

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.

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

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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. However, on March 20, 2006, CMS issued a final decision to keep the existing coverage with no changes for expansion of External Counterpulsation therapy. It is not possible to predict the impact of the CMS' final decision 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", "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 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.

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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 (CHF), 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 indication, Medicare and other third-party payers currently reimburse for stable angina patients with moderate to severe symptoms who remain symptomatic on medications and are not candidates for invasive procedures. Some 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. However, on March 20, 2006, CMS issued a final decision to maintain the existing coverage with no changes for expansion of external counterpulsation therapy. The fact that the results of the PEECH trial have not been published to date factored into CMS' decision. However, it is not clear whether CMS will decide otherwise once the results are published.

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

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In order to reduce the Company's cash burn and bring its cost structure more into alignment with current revenue, we initiated a company restructuring in January 2006, to reduce personnel and spending on marketing and development projects. We anticipate that the restructuring will reduce manufacturing and operating cost by approximately \$3 million per year compared to prior levels. In addition, in April 2006, certain senior executives elected to defer approximately \$0.4 million in annual salary compensation. We believe that these steps to conserve cash will provide the Company with the opportunity to rebuild sales to a profitable level and/or explore strategic opportunities.

Based on the continuation of current revenue levels and the implementation of our restructuring plan initiated in January 2006, we believe that we will be able to fund our minimum projected capital requirements through at least the end of the calendar year.

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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 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,
- ii. provision of in-service and training support consisting of equipment set-up and training provided at the customer's facilities, and

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- 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 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 in cost of equipment 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.

Revenues from the sale of EECP 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.

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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 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 February 28, 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

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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 \$290,000 less in fixed production overheads into inventory.

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Deferred Revenues

We record revenue on extended service contracts ratably over the term of the related contracts. In addition, we 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 in domestic markets is generally covered by a warranty and service arrangement period of one year. 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 don't accrue warranty costs upon delivery but rather recognize warranty and related service costs as incurred.

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 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

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the realization of the deferred tax assets changes, 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

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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 on 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 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

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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.

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Vasomedical, Inc. and Subsidiaries

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

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 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 February 28, 2006 and 2005

Net revenue from sales, leases and service of our EECP systems for the three-month periods ended February 28, 2006 and 2005, was \$2,841,821 and \$2,964,328, respectively, which represented a decline of \$122,507 or 4%. We reported a net loss of \$671,447 compared to \$2,026,849 for the three-month periods ended February 28, 2006 and 2005, respectively. Our net loss per common share was \$0.01 for the three-month period ended February 28, 2006 compared to a net loss of \$0.03 per share for the three-month period ended February 28, 2005.

Revenues

Revenue from equipment sales declined approximately 15% to \$1,807,625 for the three-month period ended February 28, 2006 as compared to \$2,131,567 for the same period for the prior year. The decline in equipment sales is due primarily to a 10% decline in average sales prices. A higher mix of sales to international

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distributors was the primary cause of the decrease in average sales prices and increased international shipments offset the decline in domestic systems shipped.

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 were essentially flat compared to the third 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. Our revenue from the sale of EECF systems to international distributors in the third quarter of fiscal 2006 increased approximately 103% to \$295,000 compared to \$145,000 in the same period of the prior year as a result of increased sales volume.

The above decline in revenue from equipment sales was partially offset by a 24% increase in revenue from equipment rental and services for the three-month period ended February 28, 2006, from the same three-month period in the prior year. Revenue from equipment rental and services represented 36% of total revenue in the third quarter of fiscal 2006 compared to 28% in the third quarter of fiscal 2005. The increase in both absolute amounts and percentage of total revenue resulted primarily from an increase of approximately 27% 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 43% due to fewer rental units in service, partially offsetting the above.

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Vasomedical, Inc. and Subsidiaries

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

Gross Profit

The gross profit declined to \$1,613,802 or 57% of revenues for the three-month period ended February 28, 2006, compared to \$1,799,746 or 61% of revenues for the three-month period ended February 28, 2005. Gross profit margin as a percentage of revenue for the three-month period ended February 28, 2006, decreased compared to the same period of the prior fiscal year due to the decline in average selling prices and the adoption of SFAS No. 151, which lowered the amount of fixed overhead costs absorbed into inventory in the third quarter of fiscal 2006 by \$149,000. 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 margin percentage as volume was essentially flat.

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

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ended February 28, 2006 and 2005, were \$1,852,173 or 65% of revenues and \$2,947,978 or 99% of revenues, respectively reflecting a decrease of \$1,095,805 or approximately 37%. The decrease in SG&A expenditures in the third 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 consulting, trade show, and accounting costs.

Research and Development

Research and development ("R&D") expenses of \$412,997 or 14% of revenues for the three months ended February 28, 2006, decreased by \$450,479 or 52%, from the three months ended February 28 2005, of \$863,476 or 29% of revenues. The decrease is primarily attributable to fewer R&D personnel and lower new product development and clinical research spending.

Provision for Doubtful Accounts

During the three-month periods ended February 28, 2006 and 2005, we charged \$18,984 and \$2,200, respectively, to our provision for doubtful accounts. In the prior fiscal year period, we collected funds from previously reserved accounts, which largely offset new reserve requirements.

Interest Expense and Financing Costs

Interest expense and financing costs decreased to \$19,346 in the three-month period ended February 28, 2006, from \$25,931 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 third fiscal quarters of 2006 and 2005, was \$18,251 and \$20,968, respectively. The decrease in interest income from the prior period resulted from lower cash, cash equivalents, and certificates of deposit balances, partially offset by higher average interest rates on invested balances.

Income Tax Expense, Net

During the three months ended February 28, 2006 and 2005, we recorded income tax expense of \$0 and \$7,978, respectively. An increase of \$223,000 was made to the gross deferred tax asset and related valuation allowance during the third quarter of fiscal 2006.

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

Nine Months Ended February 28, 2006 and 2005

Net revenue from sales, leases and service of our EECF systems for the nine-month periods ended February 28, 2006 and 2005, was \$9,058,376 and \$11,247,419, respectively, which represented a decline of \$2,189,043 or 19%. We reported a net loss of \$10,196,944 compared to \$4,561,002 for the nine-month periods ended February 28, 2006 and 2005, respectively. Our net loss per common share was \$0.18 for the nine-month period ended February 28, 2006 compared to a

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net loss of \$0.08 per share for the nine-month period February 28, 2005. The increase in net loss is primarily due to the establishment of a \$7,093,000 valuation reserve in the fiscal 2006 second quarter for the then-remaining carrying value of the deferred tax asset.

Revenues

Revenue from equipment sales declined approximately 30% to \$5,998,943 for the nine-month period ended February 28, 2006 as compared to \$8,629,026 for the same period for the prior year. The decline in equipment sales is due primarily to a 32% decline in the number of EECF system shipments, partially offset by a 5% 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 nine months 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 nine 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 nine 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 nine months of fiscal 2006 increased approximately 13% to \$690,000 compared to \$607,995 in the same period of the prior year, as a result of increased volume.

The above decline in revenue from equipment sales was partially offset by a 17% increase in revenue from equipment rental and services for the nine-month period ended February 28, 2006, from the same nine-month period in the prior year. Revenue from equipment rental and services represented 34% of total revenue in the first nine months of fiscal 2006 compared to 23% in the same period of fiscal 2005. The increase in both absolute amounts and percentage of 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 52%, partially offsetting the above. The decline was primarily due to a multi-system customer defaulting on its rental payments during fiscal 2005; consequently, we shifted to a cash basis for revenue recognition for this customer and our equipment was eventually returned.

Gross Profit

The gross profit declined to \$5,309,344 or 59% of revenues for the nine-month period ended February 28, 2006, compared to \$7,247,170 or 64% of revenues for the nine-month period ended February 28, 2005. Gross profit margin as a percentage of revenue for the nine-month period ended February 28, 2006, 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 four fiscal quarters. In addition, adoption of SFAS No. 151 lowered the amount of fixed overhead costs absorbed into inventory in the first nine months of fiscal 2006 by \$290,000. 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.

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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.

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Vasomedical, Inc. and Subsidiaries

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

Selling, General and Administrative

Selling, general and administrative ("SG&A") expenses for the nine-months ended February 28, 2006 and 2005, were \$6,769,946 or 75% of revenues and \$9,088,858 or 81% of revenues, respectively reflecting an decrease of \$2,318,912 or approximately 26%. The decrease in SG&A expenditures in the first nine months 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 \$1,528,699 or 17% of revenues for the nine months ended February 28, 2006, decreased by \$992,622 or 39%, from the nine months ended February 28, 2005, of \$2,521,321 or 22% of revenues. The decrease is primarily attributable to fewer R&D personnel and lower new product development and clinical research spending.

Provision for Doubtful Accounts

During the nine-month period ended February 28, 2006, we charged \$89,559 to our provision for doubtful accounts, as compared to \$135,156 during the nine-month period ended February 28, 2005. The decrease was mainly due to reduced sales.

Interest Expense and Financing Costs

Interest expense and financing costs decreased to \$64,299 in the nine-month period ended February 28, 2006, from \$84,971 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 nine months of fiscal 2006 and fiscal 2005, were \$59,041 and \$51,795, respectively. The increase in interest income from the prior period is the direct result of \$15,405 in increased unrealized gain on investments. Lower average cash, cash equivalents, and certificates of deposit balances invested during the first nine months of fiscal 2006 compared to the prior period partially offset the above.

Income Tax Expense, Net

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During the nine months ended February 28, 2006 and 2005, we recorded income tax expense of \$7,112,826 and \$29,661, respectively. The fiscal 2006 tax expense consists mainly of \$7,093,000 in additional valuation allowance provided for the deferred tax asset in the second fiscal quarter. The income tax expense for the first nine months 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. 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 and that current coverage for CCSC class III/IV refractory angina would remain in effect. Consequently, at the end of the second fiscal quarter, we concluded that, based upon the weight of available evidence, it was no longer "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. On March 20, 2006, CMS issued its final decision, which upheld the PDM.

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

An increase of \$1,038,000 was made to the gross deferred tax asset and related valuation allowance during the nine months ended February 28, 2006.

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 February 28, 2006, we had cash, cash equivalents, and certificates of deposit balances of \$1,731,710 and working capital of \$3,351,563 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 decreased \$1,016,257 for the first nine months of fiscal year 2006 primarily due to cash used in operating activities of \$2,731,252, and cash used in other financing activities of \$470,622, partially offset by \$2,185,617 in net proceeds from the issuance of preferred stock, which was subsequently converted to common stock.

The increase in cash used in our operating activities during the first nine months of fiscal year 2006 resulted primarily from the net loss of \$10,196,944 offset by adjustments to reconcile net loss to net cash used in operating activities of \$7,465,692. The adjustments to reconcile net loss to net cash used in operating activities consisted mainly of \$7,685,338 in non-cash adjustments, primarily \$7,093,000 for deferred income taxes, as well as an aggregate of \$592,338 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 used net cash of \$219,646. The changes

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in the asset components primarily reflect an increase in accounts receivable of \$768,798, offset by lower inventory of \$709,765. The changes in our operating liability components reflect a decrease in accounts payable and accrued liabilities of \$244,048 and a decrease in other liabilities of \$140,711. Net accounts receivable were 28% of revenues for the nine-month period ended February 28, 2006, compared to 14% at the end of the nine-month period ended February 28, 2005, and accounts receivable turnover increased to 6.2 times as of February 28, 2006, as compared to 5.4 times as of February 28, 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 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 three quarters 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 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 \$760,156 during the nine-month period ended February 28, 2006. 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 \$1,714,995 during the nine-month period ended February 28, 2006, reflecting \$2,185,617 in net proceeds received from the issuance of preferred stock, less payments on our outstanding notes and loans totaling \$378,999, and preferred stock dividend payments totaling \$91,623. 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.

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

Liquidity

We have incurred declines in revenue and significant operating losses during the last three fiscal years and our ability to continue operating as a going concern is dependent upon achieving profitability in the refractory angina

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market or through additional debt or equity financing. Achieving profitability is largely dependent on our ability to reduce operating costs sufficiently as well as halting the current trend of declining revenue. Our ability to maintain our current base of revenue is largely dependent upon restructuring our sales and marketing efforts in the angina market and operating in a more efficient manner. If we are not able to maintain our existing base of revenue and sufficiently reduce operating costs to generate an adequate cash flow, or raise additional capital, we will not be able to continue as a going concern.

In order to reduce the Company's cash burn and bring its cost structure more into alignment with current revenue, we initiated a company restructuring in January 2006, to reduce personnel and spending on marketing and development projects. We anticipate that the restructuring will reduce manufacturing and operating cost by approximately \$3 million per year compared to prior levels. In addition, in April 2006, certain senior executives elected to defer approximately \$0.4 million in annual salary compensation. We believe that these steps to conserve cash will provide the Company with the opportunity to rebuild sales to a profitable level and/or explore strategic opportunities.

Based on the continuation of current revenue levels and the implementation of our restructuring plan initiated in January 2006, we believe that we will be able to fund our minimum projected capital requirements through at least the end of the calendar year.

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.

Contractual Obligations

The following table presents the Company's expected cash requirements for contractual obligations outstanding as of February 28, 2006.

| | Total | Due as of 2/28/07 | Due as of 2/29/08 and 2/28/09 | Due as of 2/28/10 and 2/28/11 |
|---|--------------------|----------------------|-------------------------------------|-------------------------------------|
| Long-Term Debt | \$987,991 | \$119,787 | \$133,838 | \$154,022 |
| Notes Payable | 30,871 | 30,871 | -- | -- |
| Operating Leases | 24,917 | 24,917 | -- | -- |
| Litigation Settlement | 100,750 | 100,750 | -- | -- |
| Total Contractual Cash Obligations | \$1,144,529 | \$ 276,325 | \$133,838 | \$154,022 |

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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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 February 28, 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 February 28, 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.

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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:

None

ITEM 6 - EXHIBITS

Exhibits

31 Certifications pursuant to Rules 13a-14(a) as adopted pursuant to Section

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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.

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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

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

/s/ Thomas W. Fry

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

Date: April 13, 2006