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VASOMEDICAL INC  
Form 10QSB  
October 15, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-QSB

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the quarterly period ended August 31, 2007

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 small business issuer 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)

Issuer's Telephone Number (516) 997-4600

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

Number of Shares Outstanding of Common Stock, \$.001 Par Value,  
at October 12, 2007 93,618,004

Vasomedical, Inc. and Subsidiaries

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INDEX

PART I - FINANCIAL INFORMATION

Item 1 - Financial Statements (unaudited)

Consolidated Condensed Balance Sheets as of  
August 31, 2007 and May 31, 2007

Consolidated Condensed Statements of Operations for the  
Three Months Ended August 31, 2007 and 2006

Consolidated Condensed Statement of Changes in Stockholders'  
Equity for the Period from June 1, 2007 to August 31, 2007

Consolidated Condensed Statements of Cash Flows for the  
Three Months Ended August 31, 2007 and 2006

Notes to Consolidated Condensed Financial Statements

Item 2 - Management's Discussion and Analysis or Plan of Operation

Item 3 - Controls and Procedures

PART II - OTHER INFORMATION

Item 1 - Legal Proceedings

Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

Item 3 - Defaults upon Senior Securities

Item 4 - Submission of Matters to a Vote of Security Holders

Item 5 - Other Information

Item 6 - Exhibits

Page 2

ITEM 1. FINANCIAL STATEMENTS

Vasomedical, Inc. and Subsidiaries  
CONSOLIDATED CONDENSED BALANCE SHEETS

August 31,  
2007

-----  
(Unaudited)

CURRENT ASSETS

ASSETS

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Cash	\$2,791,016
Accounts receivable, net of an allowance for doubtful accounts of \$333,448 at August 31, 2007 and \$364,809 at May 31, 2007	442,877
Inventories, net	1,939,230
Other current assets	237,310
	-----
Total current assets	5,410,433
PROPERTY AND EQUIPMENT, net of accumulated depreciation of \$2,136,295 at August 31, 2007 and \$2,836,938 at May 31, 2007	145,386
DEFERRED DISTRIBUTOR COSTS, net of accumulated amortization of \$25,444 at August 31, 2007	483,432
OTHER ASSETS	248,514
	-----
	\$6,287,765
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES	
Accounts payable and accrued expenses	\$529,359
Current maturities of long-term debt and notes payable	--
Sales tax payable	140,254
Deferred revenue	1,244,920
Deferred gain on sale of building	53,245
Accrued director fees	23,000
Accrued warranty and customer support expenses	15,250
Accrued professional fees	109,374
Accrued commissions	89,236
	-----
Total current liabilities	2,204,638
LONG-TERM DEBT	--
DEFERRED REVENUE	374,711
DEFERRED GAIN ON SALE OF BUILDING	208,545
COMMITMENTS AND CONTINGENCIES	
STOCKHOLDERS' EQUITY	
Preferred stock, \$.01 par value; 1,000,000 shares authorized; none issued and outstanding	--
Common stock, \$.001 par value; 110,000,000 shares authorized; 93,618,004 shares issued and outstanding at August 31, 2007 and 65,198,592 at May 31, 2007	93,618
Additional paid-in capital	48,043,640
Accumulated deficit	(44,637,387)
	-----
Total stockholders' equity	3,499,871
	-----
	\$6,287,765
	=====

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

Page 3

Vasomedical, Inc. and Subsidiaries

CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS  
(Unaudited)

Three mon

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	August
	----- 2007 -----
Revenues	
Equipment sales	\$493,268
Equipment rentals and services	846,808
	-----
Total revenues	1,340,076
Cost of Sales and Services	
Cost of sales, equipment	340,638
Cost of equipment rentals and services	314,699
	-----
Total cost of sales and services	655,337
	-----
Gross profit	684,739
Operating Expenses	
Selling, general and administrative	583,612
Research and development	139,175
Provision for doubtful accounts	(25,456)
	-----
Total operating expenses	697,331
	-----
LOSS FROM OPERATIONS	(12,592)
Other Income (Expense)	
Interest and financing costs	(16,666)
Interest and other income, net	12,331
Gain on Sale of Fixed Assets	4,437
	-----
Total other income (expense)	102
NET LOSS BEFORE INCOME TAXES	(12,490)
Income tax expense, net	6,296
	-----
NET LOSS AFTER TAXES ATTRIBUTABLE TO COMMON STOCKHOLDERS	\$ (18,786)
	=====
Net loss per common share	
- basic	\$0.00
	=====
- diluted	\$0.00
	=====
Weighted average common shares outstanding	87,748,778
	=====
- diluted	87,748,778
	=====

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

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(Unaudited)

	Common Stock		Additional
	Shares	Amount	Paid-in Capital
	-----	-----	-----
Balance at June 1, 2007	65,198,592	\$65,198	\$46,165,998
Common stock and warrant issued to Kerns Manufacturing Corp. for Securities Purchase Agreement	21,428,572	21,429	1,354,461
Common stock issued to Living Data Technology Corporation for distribution and supplier agreement	6,990,840	6,991	461,395
Stock based compensation	--	--	61,786
Net loss	--	--	--
	-----	-----	-----
Balance at August 31, 2007	93,618,004	\$93,618	\$48,043,640
	=====	=====	=====

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

Page 5

Vasomedical, Inc. and Subsidiaries

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Three Au
	-----
	2007
	-----
Cash flows from operating activities	
Net loss	\$ (18,786)
	-----
Adjustments to reconcile net loss to net cash provided by (used in) operating activities	
Depreciation and amortization	70,060
Amortization of deferred gain on sale of building	(4,437)
Provision for doubtful accounts	(25,456)
Amortization of deferred distributor costs	25,444
Expenses paid for distributor agreement	(40,490)
Stock based compensation	61,786
Changes in operating assets and liabilities:	
Accounts receivable	316,234
Inventories	216,928
Other current assets	(202,549)
Other assets	--
Accounts payable, accrued expenses and other current liabilities	(198,823)
Other liabilities	(94,915)
	-----

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	123,782
	-----
Net cash provided by (used in) operating activities	104,996
Cash flows provided by investing activities	
Proceeds from the building sale	1,400,000
Expenses paid for sale of building	(89,143)
	-----
Net cash provided by investing activities	1,310,857
Cash flows provided by (used in) financing activities	
Payments on long term debt and notes payable	(851,015)
Proceeds from Securities Purchase agreement	1,500,000
Expenses paid in relation to Securities Purchase Agreement	(124,110)
	-----
Net cash provided by (used in) financing activities	524,875
	-----
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,940,728
Cash and cash equivalents - beginning of period	850,288
	-----
Cash and cash equivalents - end of period	\$2,791,01
	=====
Non-cash investing and financing activities were as follows:	
Inventories transferred to (from) property and equipment, attributable to operating leases, net	\$(38,531)
Issue of note for purchase of insurance policy	\$--
Common stock issued for distributor agreement	\$468,386
Supplemental Disclosures	
Interest paid	\$16,666
Income taxes paid	\$2,983

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

Page 6

Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
August 31, 2007

NOTE A - ORGANIZATION AND PLAN OF OPERATIONS

Vasomedical, Inc. was incorporated in Delaware in July 1987. Unless the context requires otherwise, all references to "we", "our", "us", "Company", "registrant", "Vasomedical" or "management" refer to Vasomedical Inc. and its subsidiaries. Since 1995, we have been primarily engaged in designing, manufacturing, marketing and supporting EEC(R) enhanced external counterpulsation systems based on our unique proprietary technology currently indicated for use in cases of stable or unstable angina (i.e., chest pain), congestive heart failure (CHF), acute myocardial infarction (i.e., heart attack, (MI)) and cardiogenic shock. The EEC(R) therapy system 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 helps to restore systemic vascular function. The therapy also increases blood flow and oxygen supply to the heart muscle and other organs and decreases the heart's workload and need for oxygen, while also

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improving function of the endothelium, the lining of blood vessels throughout the body, lessening resistance to blood flow. We provide hospitals, clinics and physician private practices with EECP(R) equipment, treatment guidance, and a staff training and equipment maintenance program designed to provide optimal patient outcomes. EECP(R) is a registered trademark for Vasomedical's enhanced external counterpulsation systems. For more information visit [www.vasomedical.com](http://www.vasomedical.com).

We have Food and Drug Administration (FDA) clearance to market our EECP(R) therapy for use in the treatment of stable and unstable angina, congestive heart failure, acute myocardial infarction, and cardiogenic shock, however, our current marketing efforts are limited to the treatment of chronic stable angina and congestive heart failure. Medicare and other third-party payers currently reimburse for the treatment of angina symptoms in patients with moderate to severe symptoms who are refractory to medication and not candidates for invasive procedures. Patients with primary diagnoses of heart failure, diabetes, peripheral vascular disease, etc. are also reimbursed under the same criteria, provided the primary indication for treatment with EECP(R) therapy is angina symptoms.

During the last two fiscal years ended May 31, 2007 and 2006 we incurred large operating losses. The Company has attempted to achieve profitability by reducing operating costs and halting the trend of declining revenue, to reduce cash usage through bringing its cost structure more into alignment with current revenues by engaging in restructurings during January 2006, March 2007 and April 2007 to substantially reduce personnel and spending on sales, marketing and development projects. In addition, the Company was seeking to obtain a strategic alliance within the sales and marketing areas and/or to raise additional capital through public or private equity or debt financings.

During the first quarter of fiscal 2008 the following events took place which allowed us to raise additional capital through a private equity financing and by the sale of our facility under a leaseback agreement.

- o On June 21, 2007 we entered into a Securities Purchase Agreement with Kerns Manufacturing Corp. ("Kerns"). Concurrently with our entry into the Securities Purchase Agreement, we also entered into a Distribution Agreement and a Supplier Agreement with Living Data Technology Corporation ("Living Data"), an affiliate of Kerns.
- o We sold to Kerns, pursuant to the Securities Purchase Agreement, 21,428,572 shares of our common stock at \$.07 per share for an aggregate of \$1,500,000 as well a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of \$.08 per share (the "Warrant"). We also have an option to sell an additional \$1 million of our common stock to Kerns. The agreement further provided for the appointment to our Board of Directors of two representatives of Kerns. In furtherance thereof, Mr. Jun Ma and Mr. Simon Srybnik, Chairman of both Kerns and Living Data, have been appointed members of our Board of Directors. On July 10, 2007, Mr.

Page 7

Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
August 31, 2007

Benham Movaseghi, Treasurer of Kerns, was also appointed to our Board of Directors. Pursuant to the Distribution Agreement, we have become the exclusive distributor in the United States of the AngioNew ECP

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systems manufactured by Living Data. As additional consideration for such agreement, we agreed to issue an additional 6,990,840 shares of our common stock to Living Data. Pursuant to the Supplier Agreement, Living Data now will be the exclusive supplier to us of the ECP therapy systems that we market under the registered trademark EECF(R). The Distribution Agreement and the Supplier Agreement each have an initial term extending through May 31, 2012.

- o Pursuant to a Registration Rights Agreement, we granted to Kerns and Living Data, subject to certain restrictions, "piggyback registration rights" covering the shares sold to Kerns as well as the shares issuable upon exercise of the Warrant and the shares issued to Living Data.
- o On August 15, 2007 we sold our facility under a five-year leaseback agreement for \$1.4 million. The net proceeds from the sale was approximately \$425,000 after payment in full of the two secured notes on our facility, brokers fees, closing costs, and the opening of a certificate of deposit in accordance with the provisions of the new lease.

### NOTE B - STOCK-BASED COMPENSATION

As of June 1, 2006 the Company has adopted Statement of Financial Standards No. 123 (revised 2004), Share-Based Payment ("SFAS No. 123 (R)"), which is a revision of SFAS No. 123. SFAS No. 123 (R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally, the approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure of the fair value of share-based payments is no longer an alternative to financial statement recognition.

Prior to first quarter of fiscal 2007 the Company accounted for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations ("APB No. 25") and adopted the disclosure provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123." Under APB No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Accordingly, no compensation expense has been recognized in the consolidated financial statements in connection with employee stock option grants prior to fiscal 2007.

During the three-month period ended August 31, 2007, the Board of Directors granted non-qualified stock options under the 2004 Stock Option/Stock Issuance Plan to four directors to purchase an aggregate of 600,000 shares of common stock, at an exercise price of \$0.12 per share, which represented the fair market value of the underlying common stock at the time of the respective grants. These options vest immediately, and expire ten years from the date of grant.

Stock-based compensation expense recognized under SFAS 123(R) for the quarter ended August 31, 2007 was \$61,786. 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



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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.

Page 8

Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
August 31, 2007

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

The fair value of the Company's stock-based awards was estimated assuming the following weighted-average assumptions for the three months ended August 31, 2007:

Expected life (years)	5
Expected volatility	108.9%
Risk-free interest rate	4.95%
Expected dividend yield	0.0%

During the three-month period ended August 31, 2007, options to purchase 1,195,625 shares of common stock at an exercise price of \$0.20 - \$3.96 were cancelled.

NOTE C -LOSS PER COMMON SHARE

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

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

	Three months ended August 31,	
	2007	2006
Numerator:		
Net income/(loss)	\$ (18,876)	\$ (539,457)
Denominator:		
Basic - weighted average common shares	87,748,778	65,198,592
Stock options	--	--
Warrants	--	--

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Diluted - weighted average common shares	87,748,778	65,198,592
	=====	=====
Basic and diluted loss per common share	\$0.00	\$(0.01)

Options, warrants, and convertible preferred stock, in accordance with the following table, were excluded from the computation of diluted loss per share for the three months ended August 31, 2007 and 2006, respectively, because the effect of their inclusion would be antidilutive.

Page 9

Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
August 31, 2007

	Three months ended August 31,	
	2007	2006
	-----	-----
Options to purchase common stock	5,996,710	7,800,000
Warrants to purchase common stock	6,540,252	2,400,000
	-----	-----
	12,536,962	10,300,000
	=====	=====

NOTE D - INVENTORIES, NET

Inventories, net consist of the following:

	August 31, 2007	August 31, 2006
	-----	-----
Raw materials	\$745,236	\$745,236
Work in process	932,109	932,109
Finished goods	261,885	261,885
	-----	-----
	\$1,939,230	\$1,939,230
	=====	=====

At August 31, 2007 and May 31, 2007, the Company has recorded reserves for excess and obsolete inventory of \$677,166.

NOTE E - PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows:

	August 31, 2007	August 31, 2006
	-----	-----
Land	\$--	\$--
Building and improvements	--	1,372,248
Office, laboratory and other equipment	1,372,248	1,372,248

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EECP systems under operating leases or under loan for clinical trials	747,367	
Furniture and fixtures	162,066	
Leasehold improvements	--	
	-----	-----
	2,281,681	4
Less: accumulated depreciation and amortization	(2,136,295)	(2
	-----	-----
	\$145,386	\$1
	=====	=====

NOTE F - LONG-TERM DEBT

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

	August 31, 2007	
	-----	-----
Facility loans (a)	\$--	
Less: current portion	--	
	-----	-----
	\$--	
	=====	=====

- (a) The Company purchased its headquarters and warehouse facility with secured notes of \$641,667 and \$500,000, respectively, under two programs sponsored by New York State. These notes, which bore interest at 7.8% and 6%, respectively, were payable in monthly installments

Page 10

Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
August 31, 2007

consisting of principal and interest payments over fifteen-year terms, expiring in September 2016 and January 2017, respectively, and were secured by the building.

On August 15, 2007 we sold our facility for \$1.4 million under a sale with a five-year leaseback agreement. The net proceeds from the sale was approximately \$425,000 after payment in full of the two secured notes above, brokers fees, closing costs, and the opening of a certificate of deposit in accordance with the provisions of the new lease.

NOTE G - DEFERRED REVENUES

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

	Three months e August 31	
	-----	-----
	2007	
	-----	-----
Deferred revenue at the beginning of the period	\$1,756,352	
ADDITIONS		
Deferred extended service contracts	411,900	

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Deferred in-service training	10,000
Deferred warranty obligations	50,000
Deferred service contract promotion	4,500
RECOGNIZED AS REVENUE	
Deferred extended service contracts	(566,004)
Deferred in-service training	(7,500)
Deferred warranty obligations	(36,167)
Deferred service contract promotion	(3,450)
Deferred revenue at end of period	1,619,631
Less: current portion	(1,244,920)
Long-term deferred revenue at end of period	\$374,711

NOTE H - SALE-LEASEBACK

In August 2007, the Company sold its warehouse and corporate facility for \$1,400,000. Under the agreement, the Company is leasing back the property from the purchaser over a period of five years. The Company is accounting for the leaseback as an operating lease. The gain of \$266,226 realized in this transaction has been deferred and is being amortized to income ratably over the term of the lease. At August 31, 2007, the unamortized deferred gain of \$261,790 is shown as "Deferred gain on sale of building" in the Company's consolidated condensed balance sheet.

NOTE I - WARRANTY COSTS

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

	Three months ended August 31,	
	2007	2006
Warranty liability at the beginning of the period	\$15,750	\$32,000
Expense for new warranties issued	9,000	21,000
Warranty amortization	(9,500)	(23,000)
Warranty liability at end of period	15,250	30,000
Less: current portion	15,250	29,250
Long-term warranty liability at end of period	\$--	\$750

Page 11

Vasomedical, Inc. and Subsidiaries

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)  
August 31, 2007

NOTE J - INCOME TAXES

During the three-months ended August 31, 2007 and 2006, state income taxes were \$6,296 and \$4,550, respectively.

As of August 31, 2007, the recorded deferred tax assets were \$19,589,352,

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reflecting no change during the first quarter of fiscal 2008. The deferred tax asset was offset by a valuation allowance of the same amount.

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

At May 31, 2007, the Company had net operating loss carryforwards for Federal and state income tax purposes of approximately \$53,290,050, expiring at various dates from 2008 through 2027.

### NOTE K - COMMITMENTS AND CONTINGENCIES

#### Leases

On August 15, 2007 we sold our facility under a five-year leaseback agreement. Future rental payments under the operating lease are as follows:

May 31, 2008	\$103,964
May 31, 2009	142,777
May 31, 2010	148,488
May 31, 2011	154,427
May 21, 2012	160,604
May 31, 2013	40,540
	-----
Total	\$750,800
	=====

#### 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.

Page 12

Vasomedical, Inc. and Subsidiaries

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

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 "anticipates", "believes", "could", "estimates", "expects", "may", "plans", "potential" and "intends" and similar expressions, as they relate to the Company or its management, identify forward-looking statements. Such forward-looking statements are based on the beliefs of the Company's management, as well as assumptions made by and information currently available to the Company's management. Among the factors that could cause actual results to differ materially are the following: the effect of business and economic conditions; the effect of the dramatic changes taking place in the healthcare environment; the impact of competitive procedures and products and their pricing; medical insurance reimbursement policies; unexpected manufacturing or supplier problems; unforeseen difficulties and delays in the conduct of clinical trials and other product development programs;

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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. was incorporated in Delaware in July 1987. Unless the context requires otherwise, all references to "we", "our", "us", "Company", "registrant", "Vasomedical" or "management" refer to Vasomedical Inc. and its subsidiaries. Since 1995, we have been primarily engaged in designing, manufacturing, marketing and supporting EECP(R) enhanced external counterpulsation systems based on our unique proprietary technology currently indicated for use in cases of stable or unstable angina (i.e., chest pain), congestive heart failure (CHF), acute myocardial infarction (i.e., heart attack, (MI)) and cardiogenic shock. The EECP(R) therapy system 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 helps to restore systemic vascular function. The therapy also increases blood flow and oxygen supply to the heart muscle and other organs and decreases the heart's workload and need for oxygen, while also improving function of the endothelium, the lining of blood vessels throughout the body, lessening resistance to blood flow. We provide hospitals, clinics and physician private practices with EECP(R) equipment, treatment guidance, and a staff training and equipment maintenance program designed to provide optimal patient outcomes. EECP(R) is a registered trademark for Vasomedical's enhanced external counterpulsation systems. For more information visit [www.vasomedical.com](http://www.vasomedical.com).

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

During the last two fiscal years ended May 31, 2007 and 2006 we incurred large operating losses. We attempted to achieve profitability by reducing operating costs and halting the trend of declining revenue, to reduce cash usage through bringing our cost structure more into alignment with current revenue by engaging in restructurings during January 2006, March 2007 and April 2007 to substantially reduce personnel and spending on sales, marketing and development projects. In addition, we sought to obtain a strategic alliance within the sales and marketing areas and/or to raise additional capital through public or private equity or debt financings.

During the first quarter of fiscal 2008 the following events took place, which allowed us to raise additional capital through a private equity financing and by the sale of our facility under a leaseback agreement.

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- o On June 21, 2007 we entered into a Securities Purchase Agreement with Kerns Manufacturing Corp. ("Kerns"). Concurrently with our entry into the Securities Purchase Agreement, we also entered into a Distribution Agreement and a Supplier Agreement with Living Data Technology Corporation, an affiliate of Kerns ("Living Data").

We sold to Kerns, pursuant to the Securities Purchase Agreement, 21,428,572 shares of our common stock at \$.07 per share for an aggregate of \$1,500,000 as well a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of \$.08 per share (the "Warrant"). We also have an option to sell an additional \$1 million of our common stock to Kerns. The agreement further provided for the appointment to our Board of Directors of two representatives of Kerns. In furtherance thereof, Mr. Jun Ma and Mr. Simon Srybnik, Chairman of both Kerns and Living Data, have been appointed members of our Board of Directors. On July 10, 2007, Mr. Benham Movaseghi, Treasurer of Kerns, was also appointed to our Board of Directors. Pursuant to the Distribution Agreement, we have become the exclusive distributor in the United States of the AngioNew ECP systems manufactured by Living Data. As additional consideration for such agreement, we agreed to issue an additional 6,990,840 shares of our common stock to Living Data. Pursuant to the Supplier Agreement, Living Data now will be the exclusive supplier to us of the ECP therapy systems that we market under the registered trademark EECP(R). The Distribution Agreement and the Supplier Agreement each have an initial term extending through May 31, 2012.

Pursuant to a Registration Rights Agreement, we granted to Kerns and Living Data, subject to certain restrictions, "piggyback registration rights" covering the shares sold to Kerns as well as the shares issuable upon exercise of the Warrant and the shares issued to Living Data.

- o On August 15, 2007 we sold our facility under a five-year leaseback agreement for \$1.4 million. The net proceeds from the sale was approximately \$425,000 after payment in full of the two secured notes on our facility, brokers fees, closing costs, and the opening of a certificate of deposit in accordance with the provisions of the new lease.

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

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

Page 14

Vasomedical, Inc. and Subsidiaries

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

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

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

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

They commented in their decision memorandum that they were not able to apply full weight to the evidence generated by the PEECH(TM) trial, as it had not yet been published in a peer-reviewed medical journal by the time they were required to issue a final decision on this application. Moreover, they did not opine on whether they would consider the results of the trial when published to be sufficient evidence to conclude that external counterpulsation therapy is reasonable and necessary for the treatment of New York Heart Association Class II/III stable heart failure symptoms with an ejection fraction of less than or equal to 35%. They did, however, reiterate in the decision memorandum that "Current coverage as described in Section 20.20 of the Medicare National Coverage Determination (NCD) manual will remain in effect.", for refractory angina patients.

On August 25, 2006 the results of the trial were initially published on line by the Journal of the American College of Cardiology (JACC), and in print in its September 19, 2006 issue. JACC is the official journal of the American College of Cardiology.

In the November-December issue of the journal Congestive Heart Failure, a second report of results from the PEECH(TM) trial was published, focusing on the



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results of a pre-specified subgroup analysis in trial patients age 65 and over. This analysis demonstrated a statistically positive response on both co-primary endpoints of the trial in patients receiving EECP(R) therapy versus those who did not, i.e. a significantly larger proportion of patients undergoing EECP(R) therapy met or exceeded pre-specified thresholds of improvement in exercise duration and peak oxygen consumption. Moreover, the patients age 65 and older who received EECP(R) therapy demonstrated the greatest differences in exercise duration, peak oxygen consumption and functional class (symptom status) compared with those who did not receive EECP(R) therapy.

The above 2 papers have been submitted to CMS for reconsideration of our application. We had met with representatives of CMS on February 28, 2007 and presented our case. CMS has requested more data from us. We will continue to gather the data and continue our dialogue with CMS to obtain coverage for heart failure patients. However, there is no assurance that the Company will have sufficient resources to gather the necessary data to be sufficient to support expansion of the Medicare national coverage policy for EECP(R) treatment for NYHA class II and III heart failure patients.

Page 15

Vasomedical, Inc. and Subsidiaries

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

We will continue to educate the marketplace that EECP(R) therapy is a therapy for ischemic cardiovascular disease and that patients with a primary diagnosis of heart failure, diabetes, peripheral vascular disease, etc. are also eligible for reimbursement under the current coverage policy, provided the primary indication for treatment with EECP(R) therapy is angina or angina equivalent symptoms and the patient satisfies other listed criteria.

#### 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 B of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-KSB for the year ended May 31, 2007, 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

The Company recognizes 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 EECP(R) systems in the period in which we deliver the system to the customer. Revenue from the sale of our EECP(R) systems to international markets is recognized upon shipment of 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

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cash receipts in situations where the account receivable is collected over an extended period of time and in our judgment the degree of collectibility is uncertain.

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

- i. EECP(R) equipment sale,
- ii. provision of in-service and training support consisting of equipment set-up and training provided at the customer's facilities, and
- iii. a service arrangement (usually one year), consisting of: service by factory-trained service representatives, material and labor costs, emergency and remedial service visits, 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

Page 16

Vasomedical, Inc. and Subsidiaries

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

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(R) 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(R) 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 a few 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 service revenue at the time the in-service and training is completed and the amount related to service arrangements is recognized ratably as service revenue over the related service period, which is generally one year. Costs associated with the provision of in-service and training and the service

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arrangement, including salaries, benefits, travel, spare parts and equipment, are recognized in cost of equipment sales as incurred.

The Company also recognizes revenue generated from servicing EEC(R) 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 EEC(R) 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 EEC(R) systems through our international distributor network are generally covered by a one-year warranty period. For these customers we accrue a warranty reserve for estimated costs to provide warranty parts when the equipment sale is recognized.

The Company has also entered into lease agreements for our EEC(R) 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 EEC(R) system utilized under operating leases is recorded as a component of property and equipment and is amortized to cost of sales over the estimated useful life of the equipment, not to exceed five years. There were no significant minimum rental commitments on these operating leases at May 31, 2007.

### 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 that remain 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 its 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 our 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.

Page 17

Vasomedical, Inc. and Subsidiaries

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### 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 EEC(R) systems at various field locations for demonstration, training,

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evaluation, and other similar purposes at no charge. The cost of these EEC(R) 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 EEC(R) 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 record a provision for excess and obsolete inventory based primarily on existing and anticipated design and engineering changes to its 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.

### Deferred Revenues

The Company records revenue on extended service contracts ratably over the term of the related contract period. Effective September 1, 2003, we prospectively adopted the provisions of EITF 00-21. Upon adoption of the provisions of EITF 00-21 we began to defer revenue related to EEC(R) system sales for the fair value of installation and in-service training to the period when the services are rendered and for warranty obligations ratably over the service period, which is generally one year.

### Warranty Costs

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

Equipment sold to international customers through our distributor network is generally covered by a one-year warranty period. For these customers the Company accrues a warranty reserve for estimated costs of providing a parts only warranty when the equipment sale is recognized.

The factors affecting our warranty liability include the number of units sold and historical and anticipated rates of claims and costs per claim.

### Net Loss per Common Share

Basic loss per share 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

Vasomedical, Inc. and Subsidiaries

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

enactment of changes in the tax laws or rates. The deferred tax asset is continually evaluated for realizability. To the extent our judgment regarding the realization of the deferred tax assets 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 than not" that 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.

Stock-based Employee Compensation

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

Prior to fiscal 2007 the Company accounted for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations ("APB No. 25") and 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 was recognized in the consolidated financial statements in connection with employee stock option grants prior to fiscal 2007.

As new stock options are issued, this may have a material effect on the quarterly and annual financial statements in the form of additional compensation expense. It is not possible to precisely determine the expense impact of adoption since a portion of the ultimate expense that is recorded will likely relate to awards that have not yet been granted. The expense associated with these future awards can only be determined based on factors such as the price for the Company's common stock, volatility of the Company's stock price and risk free interest rates as measured at the grant date.

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

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subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable measure of the fair value of its employee stock options.

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

Page 19

Vasomedical, Inc. and Subsidiaries

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

#### Recently Issued Accounting Standards

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

Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment to FASB Statement No. 115. This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, Fair Value Measurements. The Company does not expect that SFAS 159 will have any significant effect on future financial statements.

The FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes--an Interpretation of FASB Statement No. 109 (FIN 48) in June 2006. This Interpretation primarily relates to tax positions taken or expected to be taken in a tax return and clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. Under this Interpretation the effects of a tax position would be recognized or derecognized depending on what outcome is more likely than not to occur with respect to the position. The Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. It requires that all tax positions be evaluated using the more-likely-than-not recognition threshold, and that the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full

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knowledge of all relevant information for recognition, derecognition, and measurement using consistent criteria. Disclosures are required about the effect of unrecognized tax benefits related to tax positions as well as information about the nature of the uncertainties related to tax positions where it is reasonably possible that changes in the tax provision will occur in the next 12 months of this Interpretation will provide more information about the uncertainty in income tax assets and liabilities. This Interpretation is effective for fiscal years beginning after December 15, 2006. The Company does not expect that FIN 48 will have any significant effect on future financial statements.

EITF Issue 05-1, Accounting for the Conversion of an Instrument That Became Convertible upon the Issuer's Exercise of a Call Option. The Task Force reached a consensus that the issuance of equity securities to settle a debt instrument (pursuant to the instrument's original conversion terms) that became convertible upon the issuer's exercise of a call option should be accounted for as a conversion if the debt instrument contained a substantive conversion feature as of its issuance date, as defined herein. That is, no gain or loss should be recognized related to the equity securities issued to settle the instrument. The issuance of equity securities to settle a debt instrument that became convertible upon the issuer's exercise of a call option should be accounted for as a debt extinguishment if the debt instrument did not contain a substantive conversion feature as of its issuance date. That is, the fair value of the equity securities issued should be considered a component of the reacquisition price of the debt. This Issue applies to all conversions within the scope of this Issue that result from the exercise of call options and is effective in interim or annual reporting periods beginning after June 28, 2006 (the Board ratification date of the consensus), irrespective of whether the instrument was entered into prior or subsequent to Board ratification of this Issue. For

Page 20

Vasomedical, Inc. and Subsidiaries

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

instruments issued prior to the effective date of this consensus, the assessment as to whether a substantive conversion feature exists at issuance should be based only on assumptions, considerations, and/or marketplace information available as of the issuance date. The Company does not expect that pronouncement EITF Issue 05-1 will have any significant effect on future financial statements.

EITF Issue 06-1, Accounting for Consideration Given by a Service Provider to a Manufacturer or Reseller of Equipment Necessary for an End-Customer to Receive Service from the Service Provider. The Task Force reached a consensus that if the consideration given by a service provider to a manufacturer or reseller (that is not a customer of the service provider) can be linked contractually to the benefit received by the service provider's customer, a service provider should use the guidance in Issue 01-9 to determine the characterization of the consideration (that is, "cash consideration" or "other than cash" consideration). Issue 01-9 presumes that an entity should characterize "cash consideration" as a reduction of revenue unless an entity meets the requirements of paragraph 9 of Issue 01-9. Under Issue 01-9, "other than cash" consideration should be characterized as an expense. In applying that guidance, the service provider should characterize the consideration given to a third-party manufacturer or reseller based on the form of consideration directed by the service provider to be provided to the service provider's customer. If the form of the consideration is directed to be anything other than "cash consideration" (as defined in Issue 01-9), then the form of the consideration should be characterized as "other than cash" consideration. If the service

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provider does not control the form of the consideration provided to the service provider's customer, the consideration should be characterized as "other than cash" consideration. In reaching this conclusion, Task Force members observed that consideration paid by a service provider that results in a customer receiving a reduced price on equipment purchased from a manufacturer or reseller should be characterized as "other than cash" consideration for purposes of applying Issue 01-9. The consensus in this Issue is effective for the first annual reporting period beginning after June 15, 2007. Earlier application is permitted for financial statements that have not yet been issued. Entities should recognize the effects of applying the consensus in this Issue as a change in accounting principle through retrospective application to all prior periods unless it is impracticable to do so. The Company does not expect that pronouncement EITF Issue 06-1 will have any significant effect on future financial statements.

EITF Issue 06-2, Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, "Accounting for Compensated Absences". An employer may provide its employees with sabbatical leave or other similar benefits. Sabbatical leave involves an employee receiving time off upon working at the employer for a specific period of time. When an employer provides sabbatical leave or another similar benefit, the employer must determine whether such benefit should be accrued based on the guidance in FASB Statement No. 43, Accounting for Compensated Absences. The Task Force reached a consensus that an employee's right to a compensated absence under a sabbatical or other similar benefit arrangement (a) that requires the completion of a minimum service period and (b) in which the benefit does not increase with additional years of service accumulates pursuant to Statement 43 for arrangements in which the individual continues to be a compensated employee and is not required to perform duties for the entity during the absence. Therefore, assuming all of the other conditions of Statement 43 are met, the compensation cost associated with a sabbatical or other similar benefit arrangement should be accrued over the requisite service period. This Issue should be effective for fiscal years beginning after December 15, 2006. An entity should apply the consensus reached in this Issue through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position at the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. Earlier adoption of this guidance is permitted as of the beginning of an entity's fiscal year provided that the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year. The Company does not expect that pronouncement EITF Issue 06-2 will have any significant effect on future financial statements.

EITF Issue 06-3, How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation). The issue concerns whether various non-income

Page 21

Vasomedical, Inc. and Subsidiaries

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

taxes assessed by governmental authorities should be presented gross or net in an entity's income statement. Non-income taxes on which this question has arisen include sales tax, use tax, excise tax, value added tax, and various taxes related to specific industries (e.g., the severance tax in the oil and gas industry and the franchise tax in the cable industry). The Task Force reached a consensus that the scope of this Issue includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited



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to, sales, use, value added, and some excise taxes. The Task Force also reached a consensus that the presentation of taxes on either a gross (included in revenues and costs) or a net (excluded from revenues) basis is an accounting policy decision that should be disclosed pursuant to Opinion 22. In addition, for any such taxes that are reported on a gross basis, a company should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. The disclosure of those taxes can be done on an aggregate basis. The consensus in this Issue should be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006. Earlier application is permitted. The Company does not expect that pronouncement EITF Issue 06-3 will have any significant effect on future financial statements.

EITF Issue 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. An endorsement split-dollar life insurance should be recognized as a liability for future benefits in accordance with Statement 106 (if, in substance, a postretirement benefit plan exists) or Opinion 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The consensus in this Issue is effective for fiscal years beginning after December 15, 2007, with earlier application permitted. The Company does not expect that pronouncement EITF Issue 06-4 will have any significant effect on future financial statements.

EITF Issue 06-5, Accounting for Purchases of Life Insurance--Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4. A policyholder should consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the insurance contract. When it is probable (as is used in FASB Statement No. 5) that contractual terms would limit the amount that could be realized under the insurance contract, the Task Force agreed that these contractual limitations should be considered when determining the realizable amounts. Those amounts that are recoverable by the policyholder at the discretion of the insurance company should be excluded from the amount that could be realized under the insurance contract. The consensus in this Issue is effective for fiscal years beginning after December 15, 2006. Earlier application is permitted as of the beginning of a fiscal year for periods in which interim or annual financial statements have not yet been issued. The Company does not expect that pronouncement EITF Issue 06-5 will have any significant effect on future financial statements.

### Results of Operations

#### Three Months Ended August 31, 2007 and 2006

Net revenue from sales, leases and service of our EECF systems for the three-month periods ended August 31, 2007 and 2006, was \$1,340,076 and \$2,081,856, respectively, which represented a decline of \$741,780 or 36%. We reported net loss of \$18,786 compared to a net loss of \$539,457 for the three-month periods ended August 31, 2007 and 2006, respectively. Our net loss per common share was \$0.00 for the three-month period ended August 31, 2007 compared to a net loss of \$0.01 per share for the three-month period August 31, 2006. The decrease in the net loss per common share was primarily due to the significant decrease in our operating expenses from the comparative prior period.

#### Revenues

Revenue from equipment sales declined approximately 54% to \$493,268 for the three-month period ended August 31, 2007 as compared to \$1,073,216 for the same period for the prior year. The decline in equipment sales is due primarily to a 29% decline in the number of equipment shipments and a 35% decrease in average

Vasomedical, Inc. and Subsidiaries

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

sales prices. The overall decrease in average sales prices is primarily due to the decline of equipment sales as well as the reduction in sales price due to competition in both the domestic and international markets, from the prior fiscal year.

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 direct and indirect competition. We anticipate that demand for EEC(R) systems will remain soft unless there is greater clinical acceptance for the use of EEC(R) therapy in treating patients with angina or angina equivalent symptoms who meet the current reimbursement guidelines or an expansion of the current CMS national reimbursement policy to include some or all Class II & III heart failure patients. Patients with angina or angina equivalent symptoms eligible for reimbursement under current policies include many with serious co-morbidities, such as heart failure, diabetes, peripheral vascular disease and/or others. Despite this, many cardiology clinicians appear to be waiting for approval of reimbursement coverage for heart failure as a primary indication before they will move forward with the treatment of ischemic heart failure patients with angina equivalent symptoms. Reluctance to bill for ischemic heart failure patients under the current coverage guidelines, and failure to get or maintain adequate reimbursement coverage for angina and heart failure would adversely affect our business prospects. We anticipate that a prevailing trend of declining prices will continue in the immediate future as our competition attempts to capture greater market share through pricing discounts. The average price of new systems sales declined by 20%, in the three month period ended August 31, 2007, compared to prior year and the average sales price of used systems declined 46% three month period ended August 31, 2007. We continue to reorganize certain territory responsibilities in our sales department due to the reduction in our sales force and vacant and/or unproductive territories.

Our revenue from the sale of EEC(R) systems and related products to international distributors in the three month period ended August 31, 2007 decreased approximately 66% to \$155,991 compared to \$455,178 in the three month period ending August 31, 2006 reflecting decreased sales volume.

The decline in revenue was also partially due to a 16% decrease in revenue from equipment rental and services for the three-month period ended August 31, 2007, from the same three-month period in the prior year. Revenue from equipment rental and services represented 63% of total revenue in the first quarter of fiscal 2008 compared to 48% in the first quarter of fiscal 2007. The decrease in revenue resulted primarily from a 14% decrease in service related revenue and a 97% decline in rental revenue. The decline in rental revenue was due to a decrease in the rental install base from the prior period ended August 31, 2006.

Gross Profit

The gross profit declined to \$684,739 or 47% of revenues for the three month period ended August 31, 2007, compared to \$1,117,246 or 54% of revenues for the three month period ended August 31, 2006. The decline in gross profit primarily reflects the reduced sales volume.

Gross profits are dependent on a number of factors, particularly the mix of

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

### Selling, General and Administrative

Selling, general and administrative ("SG&A") expenses for the three-months ended August 31, 2007 and 2006, were \$583,612 or 44% of revenues and \$1,323,826 or 64% of revenues, respectively reflecting a decrease of \$740,214 or approximately 56%. The decrease in SG&A expenditures in the first quarter of fiscal 2008 compared to fiscal 2007 resulted primarily from a decrease of \$259,841 due to reduced sales personnel and associated travel plus lower sales

Page 23

### Vasomedical, Inc. and Subsidiaries

#### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

commission due to reduced sales volume. Marketing expenses decreased \$163,525 due to reduced personnel in the marketing and clinical application support areas, as well as associated travel, plus lower market research, product promotion, advertising, and trade show expenses. Administrative expenses decreased \$316,848 as a result of decreased expenditures in professional fees related to accounting and outside consulting, along with reduced personnel and their associated costs.

### Research and Development

Research and development ("R&D") expenses of \$139,175 or 10% of revenues for the three months ended August 31, 2007, decreased by \$189,320 or 58%, from the prior three months ended August 31 2006, which was \$328,495 or 16% of revenues. The decrease is primarily attributable to fewer engineering personnel, lower new product development spending, and reduced spending on clinical trials.

### Provision for Doubtful Accounts

During the three-month period ended August 31, 2007, the Company reduced its provision for doubtful accounts by \$25,456 and recorded a provision for doubtful accounts of \$1,681, during the three-month period ended August 31, 2006. The change in the provision is a primarily a result of the decrease in sales volume.

### Interest Expense and Financing Costs

Interest expense and financing costs decreased to \$16,666 in the three-month period ended August 31, 2007, from \$18,889 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. The slight decrease is a result of the loans to finance the cost of implementation of a new management information system being paid in full during fiscal 2007.

### Interest and Other Income, Net

Interest and other income for the three-month periods ended August 31, 2007 and 2006, were \$12,331 and \$20,738, respectively. Interest income primarily

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reflects interest earned on the Company's cash balances.

### Income Tax Expense, Net

During the three-month periods ended August 31, 2007 and 2006, state income taxes were \$6,296 and \$4,550, respectively.

As of August 31, 2007, the recorded deferred tax assets were \$19,589,352, reflecting no change during the first quarter of fiscal 2008. The deferred tax asset was offset by a valuation allowance of the same amount.

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

### Liquidity and Capital Resources

Page 24

Vasomedical, Inc. and Subsidiaries

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### Cash and Cash Flow

At August 31, 2007, we had cash of \$2,791,016 and working capital of \$3,205,795 as compared to cash and cash equivalents of \$850,288 and working capital of \$1,320,347 at May 31, 2007. Our cash and cash equivalents increased \$1,940,728 in the first quarter of fiscal year 2008.

Cash provided by operating activities was \$104,996 for the three months ended August 31, 2007. The net loss of 18,786 after adjustments for non-cash items provided cash of \$86,907. The changes in the account balances primarily reflect a decrease in accounts receivable of \$316,234, lower inventory of \$216,928, which were partially offset by a increase in other current assets of \$ 202,549 and a decrease in accounts payable, accrued expenses, and other current liabilities of \$198,822 and a decrease in other liabilities of \$94,915. Net accounts receivable were 33% of revenues for the three-month period ended August 31, 2007, as compared to 48% for the three-month period ended August 31, 2006, and accounts receivable turnover improved to 8 times for the three-months period August 31, 2007, as compared to 5 times for the three-months period ended August 31, 2006.

Standard payment terms on our domestic equipment sales are generally net 30 to 90 days from shipment and do not contain "right of return" provisions. We have historically offered a variety of extended payment terms, including sales-type leases, in certain situations and to certain customers in order to expand the market for our EECP(R) 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 three-month periods ended August 31, 2007 and 2006, there were no revenues 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

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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 EEC(R) program. As we are creating a new market for the EEC(R) therapy and recognizing the challenges that some customers may encounter, we have opted, at times, on a customer-by-customer basis, to recover our equipment instead of pursuing other legal remedies, which has resulted in our recording of a reserve or a write-off.

Investing activities provided net cash of \$1,310,857 during the three-month period ended August 31, 2007, which represented proceeds received from the building sale, net of related costs.

Our financing activities provided net cash of \$524,875 during the three-month period ended August 31, 2007, reflecting proceeds, net of related expenses, of \$1,375,890 from the Securities Purchase Agreement, which was offset by loan repayments on the building of \$851,015.

The following table presents the Company's expected cash requirements for contractual obligations outstanding as of August 31, 2007.

	Total	Due as of 8/31/08	Due as of 8/31/09 and 8/31/10	Due as of 8/31/11 and 8/31/12
Operating Leases	\$750,800	\$138,618	\$294,092	\$318,090
Total Contractual Cash Obligations	\$750,800	\$138,618	\$294,092	\$318,090

Liquidity

During the first quarter of fiscal 2008 the following events took place, which allowed us to raise additional capital through a private equity financing and by the sale of our facility under a leaseback agreement.

Vasomedical, Inc. and Subsidiaries

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

- o On June 21, 2007 we entered into a Securities Purchase Agreement with Kerns Manufacturing Corp. ("Kerns"). Concurrently with our entry into the Securities Purchase Agreement, we also entered into a Distribution Agreement and a Supplier Agreement with Living Data Technology Corporation, an affiliate of Kerns ("Living Data").

We sold to Kerns, pursuant to the Securities Purchase Agreement, 21,428,572 shares of our common stock at \$.07 per share for an aggregate of \$1,500,000 as well a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of \$.08 per share (the "Warrant"). We also have an option to sell an additional \$1 million of our common stock to Kerns. The agreement further provided for the appointment to our Board of Directors of two representatives of Kerns. In furtherance thereof, Mr. Jun Ma and Mr. Simon Srybnik, Chairman of both Kerns and Living Data, have been

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appointed members of our Board of Directors. On July 10, 2007, Mr. Benham Movaseghi, Treasurer of Kerns, was also appointed to our Board of Directors. Pursuant to the Distribution Agreement, we have become the exclusive distributor in the United States of the AngioNew ECP systems manufactured by Living Data. As additional consideration for such agreement, we agreed to issue an additional 6,990,840 shares of our common stock to Living Data. Pursuant to the Supplier Agreement, Living Data now will be the exclusive supplier to us of the ECP therapy systems that we market under the registered trademark EECP(R). The Distribution Agreement and the Supplier Agreement each have an initial term extending through May 31, 2012.

Pursuant to a Registration Rights Agreement, we granted to Kerns and Living Data, subject to certain restrictions, "piggyback registration rights" covering the shares sold to Kerns as well as the shares issuable upon exercise of the Warrant and the shares issued to Living Data.

- o On August 15, 2007 we sold our facility under a five-year leaseback agreement for \$1.4 million. The net proceeds from the sale was approximately \$425,000 after payment in full of the two secured notes on our facility, brokers fees, closing costs, and the opening of a certificate of deposit in accordance with the provisions of the new lease.

Based on our current operations and the amounts received from the above transactions, we believe that we have sufficient working capital to continue our operations through at least May 31, 2008.

### Effects of Inflation

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

Page 26

Vasomedical, Inc. and Subsidiaries

### ITEM 3 - CONTROLS AND PROCEDURES

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of August 31, 2007, our disclosure controls and procedures are effective to provide reasonable assurances that such disclosure controls and procedures satisfy their objectives and that the information required to be disclosed by us in the reports we file under the Exchange Act is recorded, processed, summarized and reported within the required time periods. There were no changes during the fiscal quarter ended August 31, 2007 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.

Page 27

Vasomedical, Inc. and Subsidiaries

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PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

None.

ITEM 2 - UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3 - DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5 - OTHER INFORMATION

None.

ITEM 6 - EXHIBITS

Exhibits

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

Page 28

Vasomedical, Inc. and Subsidiaries

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

VASOMEDICAL, INC.

By: /s/ John C.K. Hui

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John C.K. Hui  
Chief Executive Officer, Director, and  
Chief Technology Officer (Principal Executive  
Officer)

/s/ Tricia Efstathiou

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Tricia Efstathiou  
Chief Financial Officer (Principal Financial  
and Accounting Officer)

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Date: October 12, 2007