HEARUSA INC
Form 10-K
April 06, 2007

United States
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K
ANNUAL REPORT
PURSUANT TO SECTIONS 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 30, 2006

or

o **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 001-11655
HearUSA, Inc.
Exact Name of Registrant as Specified in Its Charter

Delaware	**22-2748248**
(State of Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*
1250 Northpoint Parkway, West Palm Beach, Florida	**33407**
(Address of Principal Executive Offices)	*(Zip Code)*

Registrant s Telephone Number, Including Area Code
(561) 478-8770

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, par value $0.10 per share	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to item 405 of Regulation S-K is not contained herein and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in PART III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and non-accelerated filer in Rule 12b-2 of the Exchange act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

As of July 2, 2005, the aggregate market value of the registrant s Common Stock held by non-affiliates (based upon the closing price of the Common Stock on the American Stock Exchange) was approximately $34,065,320.

On March 21, 2007, 31,524,841 shares of the registrant s common stock and 760,461 of exchangeable shares were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of registrant s definitive proxy statement for the 2007 Annual Meeting of the registrant s stockholders (2007 Proxy Statement), to be filed with the Securities and Exchange Commission, are incorporated by reference in Part III hereof.

EXPLANATORY NOTE

Included in this Form 10-K for the fiscal year ended December 30, 2006 of HearUSA, Inc. (HearUSA or the Company) is the restatement of consolidated financial statements and related financial information for fiscal years 2005 and 2004 and the first three fiscal quarters of 2006 to correct errors relating to the accounting treatment and disclosures for taxes related to temporary differences and net operating loss carryfowards which were originally established in July of 2002 when the Company acquired Helix Hearing Care of America Corp. (Helix).

At the time of the Helix acquisition, the Company failed to record the deferred income tax liability associated with tradenames acquired in the transaction. The effect of the correction of this error is to increase goodwill and deferred income tax liability by $2.7 million at the time of the Helix acquisition, which is reflected on the consolidated balance sheets for the five years in the period ended December 30, 2006.

Additionally, the deferred income tax assets resulting from Helix s Canadian temporary differences and net operating loss carryforwards totaling approximately $1.2 million at the time of the acquisition were not recorded due to the uncertainty of their utilization. As taxable income occurred in 2005 and 2004 from the Canadian operations, the Company should have recorded deferred income tax expense in each of these years. To correct this error, the Company has recorded deferred income tax expense of $346,000 and $300,000 in 2005 and 2004, respectively, with corresponding decreases in goodwill each year.

Finally, as a part of the Helix acquisition, the Company acquired approximately $12.5 million of tax goodwill from the Helix s US operations. At the time of the acquisition, the book basis of that goodwill exceeded its tax basis. Tax goodwill, unlike certain other types of goodwill, is deductible for tax purposes, thereby creating timing differences between deductions for book and tax bases. Because the point in time that such differences will turn around is unknown, this difference cannot be acquired by deferred income tax assets for purposes of determining a valuation allowance for deferred income tax assets. The Company deducted such goodwill for tax purposes between 2002 and 2006, but failed to record deferred income tax expense and liabilities. To correct this error, the Company has recorded a deferred income tax expense and related increases in deferred income tax liabilities of approximately $1.3 million in 2005, $390,000 in 2004, $390,000 in 2003 and $195,000 in 2002.

The Company has restated its consolidated balance sheets at December 31, 2005 and December 25, 2004 and the Company s consolidated statements of operations, stockholders equity and cash flows for the years ended December 31, 2005 and December 25, 2004 and the notes related thereto. For a more detailed description of these restatements as well as impact on 2002 and 2003, see Note 2, Restatement of Financial Statements, to the accompanying audited consolidated financial statements. The Company has included the restated financial information in this Form 10-K in Item 6, Item 7, Item 8, Schedule II and has reflected the issues in Item 9.

As a result of this restatement, loss per share was increased in 2005, 2004 and 2003 by $0.05, $0.03 and $0.01, respectively. The restatement did not change 2002 earnings per share.

The Company will not file amendments to its previously filed annual reports on Form 10-K or quarterly reports on Form 10-Q for the periods affected by the restatements.

These non-cash adjustments comprising the restatements will not affect the Company s working capital, total net revenues, income from operations, loss from continuing operations before income tax expense and minority interest, or cash flows for the affected periods.

PART I

Item 1. Business

HearUSA, Inc. (HearUSA or the Company), was incorporated in Delaware on April 11, 1986, under the name HEARx Ltd., and formed HEARx West LLC, a fifty-percent owned joint venture with Kaiser Permanente, in 1998. In July of 2002, the Company acquired Helix Hearing Care of America Corp. (Helix) and changed its name from HEARx Ltd. to HearUSA, Inc.

HearUSA has a network of 164 company-owned hearing care centers in eight states and the Province of Ontario, Canada. The Company also sponsors a network of approximately 1,600 credentialed audiology providers that participate in selected hearing benefit programs contracted by the Company with employer groups, health insurers and benefit sponsors in 49 states. The centers and the network providers provide audiological products and services for the hearing impaired.

HearUSA seeks to increase market share and market penetration in its center and network markets. The Company s strategies for increasing market penetration include advertising to the non-insured self-pay market, positioning itself as the leading provider of hearing care to healthcare providers, increasing awareness of physicians about hearing care services and products in the Company s geographic markets and seeking strategic acquisitions. The Company believes it is well positioned to successfully address the concerns of access, quality and cost for the patients of managed care and other health insurance companies, diagnostic needs of referring physicians and, ultimately, the hearing health needs of the public in general.

The Company s goals are to generate annual revenue growth of 15% to 20% and, over time, generate income from operations of 10% to 12%, as a percentage of revenue, through a combination of revenue growth from existing centers and acquisitions of additional centers.

Products

HearUSA s centers provide a complete range of quality hearing aids, with emphasis on the latest digital technology along with assessment and evaluation of hearing. While the centers may order a hearing aid from any manufacturer, the majority of the hearing aids sold by the centers are manufactured by Siemens Hearing Instruments, Inc. (Siemens) and its subsidiaries, Rexton and Electone. The Company has a supply agreement with Siemens for the HearUSA centers in the United States. The Company has agreed to buy certain minimum percentages of the centers hearing aid requirements from Siemens. In exchange, Siemens has agreed to give the Company preferred pricing reductions and additional volume discounts. This agreement was extended until February 10, 2013, on December 30, 2006 (see Note 7 Long-Term Debt, Notes to Consolidated Financial Statements included herein). The centers also sell hearing aids manufactured by other manufacturers including Phonak, Oticon, Starkey, Sonic Innovations and Unitron.

HearUSA s centers also offer a large selection of assistive listening devices and other products related to hearing care. Assistive listening devices are household and personal technology products designed to assist the hearing impaired in day-to-day living, including such devices as telephones and television amplifiers, telecaptioners and decoders, pocket talkers, specially adapted telephones, alarm clocks, doorbells and fire alarms.

The hearing care network providers also provide hearing aids, assistive listening devices and other products related to hearing care as well as audiology services.

Acquisition Program

In 2005, the Company initiated a strategic acquisition program in order to accelerate its growth. The program consists of acquiring hearing care centers located in the Company s core markets in order to benefit from the synergies of minimized staffing and use advertising more efficiently. Acquisitions outside core markets are also considered depending on the size and profitability of the acquisition candidates. The

payment terms on a specific acquisition will typically be a combination of cash and notes payable. The Company may also consider the issuance of the Company s stock to sellers. The source of funds for the cash portion of the acquisition price will be cash on hand or the Siemens acquisition credit line (see Note 7 Long-Term Debt, Notes to Consolidated Financial Statements included herein).

In order to maximize the return on its investment in acquisitions, the Company has established an integration program. This program covers the implementation of our center management system, including the conversion of the acquired center patient database, transfer of vendors to the Company s existing vendors to benefit from better pricing, employee training and marketing programs. The performance of each acquired center is monitored closely for a period of three to six months or until management is fully satisfied that the center has been integrated successfully into the Company.

Managed Care, Institutional Contracts and Benefit Providers

Since 1991, the Company has entered into arrangements with institutional buyers relating to the provision of hearing care products and services. HearUSA believes that contractual relationships with institutional buyers of hearing aids are essential to the success of the Company s business plan. These institutional buyers include managed care companies, employer groups, health insurers, benefit sponsors, senior citizen buying groups and unions. By developing contractual arrangements for the referral of patients, the plan members have access to standardized care and relationships with local area physicians are enhanced. Critical to providing care to members of these groups are the availability of distribution sites, quality control and standardization of products and services. The Company believes its system of high quality, uniform company-owned centers meets the needs of the patients and their hearing benefit providers and that the network providers can expand available distribution sites for these patients. In the past two years, the Company has expanded its managed care contracts into areas serviced by the affiliated network providers.

HearUSA enters into provider agreements with benefit providers for the provision of hearing care using three different arrangements: (a) a discount arrangement on products and services which is payable by the member; (b) a fee for service arrangement which is partially subsidized by the sponsor and the member pays the balance; or (c) a per capita basis, which is a fixed payment per member per month from the benefit provider to HearUSA, determined by the benefit offered to the patient and the number of patients, and the balance, if any, paid by the individual member. When the agreement involves network providers, HearUSA pays the network provider an encounter fee, net of administration fees.

The terms of these provider agreements are generally renegotiated annually, and may be terminated by either party, usually on 90-day notice. The early termination of or failure to renew the agreements could adversely affect the operation of the centers located in the related market area. In addition, the early termination of or failure to renew the agreements that provide for payment to the Company on a per capita basis would cause the Company to lower its estimates of revenues to be received over the life of the agreements and could have an adverse effect on the Company s results of operations.

The Company and its subsidiary, HEARx West, currently receive a per-member-per-month fee for more than 2 million managed care members. In total, HearUSA services over 400 benefit programs for hearing care with various health maintenance organizations, preferred provider organizations, insurers, benefit administrators and healthcare providers.

Sales Development

The Company has a sales development department in order to assist its professionals in developing the necessary skills to perform successfully. By providing training on methods, techniques, trouble shooting, dispensing and

counseling skills, the Company believes this department helps provide a better service to patients and improves key performance indicators such as conversion, binaural fitting rates and reduced return rates.

Marketing

HearUSA s marketing plan includes:

Newspaper and Special Events: HearUSA places print ads in its markets promoting different hearing aids at a variety of technology levels and prices along with special limited time events. Advertising also emphasizes the need to seek help for hearing loss as well as the qualitative differences and advantages offered by HearUSA.

Direct Marketing: Utilizing HearUSA s database, HearUSA conducts direct mailings and offers free seminars in its markets on hearing aids and hearing loss.

Physician Marketing: HearUSA attempts to educate both physicians and their patients on the need for regular hearing testing and the importance of hearing aids and other assistive listening devices. HearUSA works to further its image as a provider of highly professional services, quality products, and comprehensive post-sale consumer education.

Telemarketing: HearUSA has a domestic national call center, which supports all HearUSA centers. The national call center is responsible for both inbound calls from consumers and outbound telemarketing. During 2006, the Company implemented a predictive dialer system in order to improve the call center productivity and increase the number of qualified appointments in its centers.

Facilities and Services

Each HearUSA center is staffed by a licensed and credentialed audiologist or hearing instrument specialist and at least one office manager or patient care coordinator. Experienced audiologists supervise the clinical operations. The majority of the Company s centers are conveniently located in shopping or medical centers and the centers are typically 1,000 to 2,500 square feet in size. The Company s goal is to have all centers similar in design and exterior marking and signage, because a uniform appearance reinforces the message of consistent service and quality of care.

Each center provides hearing services that meet or exceed applicable state and federal standards, including:

Comprehensive hearing testing using standardized practice guidelines

Interactive hearing aid selection and fitting processes

Aural rehabilitation and follow up care

Standardized reporting and physician communications

In some markets, a full range of audiovestibular testing is also available to aid in the diagnosis of medical and vestibular disorders.

Each of the 1,600 network providers operates independently from the Company. To ensure compliance with its hearing benefit programs, the Company performs annual credential verification for each of the network providers. The Company also performs random patient surveys on the quality of network providers services.

Revenues

For the fiscal years 2006, 2005 and 2004, HearUSA net revenues were $88,786,193, $76,672,003, and $68,749,542, respectively. During these years the Company did not have revenues from a single customer which totaled 10% or more of total net revenues. Financial information about revenues by geographic area is set out in Note 21 Segments, Notes to Consolidated Financial Statements included herein.

Segments

The Company operates three business segments: the company-owned centers, the network of independent providers and an e-commerce business line. Financial information regarding these business segments is provided in Note 21 Segments, Notes to Consolidated Financial Statements included herein.

Centers

At the end of 2006, the Company owned 164 centers in Florida, New York, New Jersey, Massachusetts, Ohio, Michigan, Missouri, California (through HEARx West) and the Province of Ontario, Canada. These centers offer patients a complete range of services and products, including diagnostic audiological testing, the latest technology in hearing aids and assistive listening devices to improve their quality of life.

The centers owned through HEARx West are located in California. HearUSA is responsible for the daily operation of the centers. All clinical and quality issues are the responsibility of a joint committee comprised of HearUSA and Kaiser Permanente clinicians. HEARx West centers concentrate on providing hearing aids and audiology testing to Kaiser Permanente s members and self-pay patients in the state of California. At the end of 2006, there were 23 full-time and 2 part-time HEARx West centers.

Under the terms of the joint venture agreement between the Company and Kaiser Permanente, HEARx West has the right of first refusal for any new centers in southern California; Atlanta, Georgia; Hawaii; Denver, Colorado; Portland, Oregon; Cleveland, Ohio; Washington, DC and Baltimore, Maryland. In addition, should HearUSA make a center acquisition in any of these markets, HEARx West has the right to purchase such center. Such a sale would be done at arm s length, with HEARx West paying HearUSA an equivalent value for any of the centers it acquires.

Network

The Company sponsors a network (known as the HearUSA Hearing Care Network) of approximately 1,600 credentialed audiology providers that supports hearing benefit programs with employer groups, health insurers and benefit sponsors in 49 states.

Unlike the company-owned centers, the network is comprised of hearing care practices owned by independent audiologists. Through the network, the Company can pursue national hearing care contracts and offer managed hearing benefits in areas outside of the company-owned center markets. The network s revenues are derived mainly from administrative fees paid by employer groups, health insurers and benefit sponsors to administer their benefits. In addition, the network provides Provider Advantage purchasing programs, whereby affiliated providers purchase products through HearUSA volume discounts and the Company receives royalties or rebates.

E-commerce

The Company offers online information about hearing loss, hearing aids, assistive listening devices and the services offered by hearing health care professionals. The Company s web site also offers online purchases of hearing-related products, such as batteries, hearing aid accessories and assistive listening devices. In addition to online product sales, e-commerce operations are also designed as a marketing tool to inform the public and generate referrals for centers and for network providers.

Distinguishing Features

Integral to the success of HearUSA s strategy is increased awareness of the impact of hearing loss and the medical necessity of treatment, in addition to the enhancement of consumer confidence and the

differentiation of HearUSA from other hearing care providers. To this end, the Company has taken the following unique steps:

Joint Commission on Accreditation of Healthcare Organizations

During 1998, the Company distinguished itself as an accredited healthcare organization when it earned its first three-year accreditation by the Joint Commission. The Company most recently was re-accredited in 2005 as a preferred provider organization in hearing care, demonstrating its willingness to provide safe, high quality care and to be measured against high standards of performance. Accreditation means that the Company volunteered to undergo a comprehensive evaluation by a team of physicians and nurses who personally conducted a review to assess provider credentialing, training and orientation, patient rights and care, organizational leadership and ethics, management of information and performance improvement.

Center Management System, Medical Reporting and HearUSA Data Link

The Company has developed a proprietary center management and data system called the Center Management System (CMS). CMS primarily has two functions: to manage patient information and to process point-of-sale customer transactions. The CMS system is operated over a wide area network that links all locations with the corporate office. The Company is developing further capabilities for the wide area network. This system is only used in the company-owned centers. As the Company acquires new centers, a critical part of the integration process is the inclusion of the new center into the CMS. In 2006, we added 31 centers in the CMS.

The Company s corporate system is fully integrated with CMS to provide additional benefits and functionality that can be better supported centrally. Data redundancy is built into the system architecture as data is currently stored both at the regional facilities and at the central facility. The consolidated data repository is constructed to support revenues in excess of $550 million, to accommodate approximately 500 unique business units and to manage 500,000 new patients annually.

One of the outputs of CMS is a computerized reporting system that provides referring physicians the test results and recommended action for every patient examined by HearUSA staff in a company-owned center. To the Company s knowledge, no other dispenser or audiologist presently offers any referring physician similar documentation. Consistent with the Company s mission of making hearing care a medical necessity, this reporting system makes hearing a part of the individual s health profile, and increases awareness of hearing conditions in the medical community. Another unique aspect of CMS is its data mining capability which allows for targeted marketing to its customer base. The national call center also has the ability to access the CMS system and can directly schedule appointments.

Competition

The U.S. hearing care industry is highly fragmented with approximately 11,000 practitioners providing hearing care products and services. The Company competes on the basis of price and service and, as described above, tries to distinguish itself as a leading provider of hearing care to health care providers and the self-pay patient. The Company competes for the managed care customer on the basis of access, quality and cost.

In the Canadian Province of Ontario, the traditional hearing instrument distribution system is made up of small independent practices where associations are limited to two or three centers. Most centers are relatively small and are located in medical centers, professional centers or in small shopping centers.

It is difficult to determine the precise number of the Company s competitors in every market where it has operations, or the percentage of market share enjoyed by the Company. Some competitors are large distributors, including Amplifon of Italy, which owns a network of franchised centers (Miracle Ear and National Hearing Center) and company-owned centers (Sonus) in the United States and Canada, and Beltone Electronics Corp., a hearing aid manufacturer owned by Great Nordic that distributes its products

primarily through a national network of authorized distributors in the United States and Canada. Large discount retailers, such as Costco, also sell hearing aids and present a competitive threat in selected HearUSA markets. All of these companies have greater resources than HearUSA, and there can be no assurance that one or more of these competitors will not expand and/or change their operations to capture the market targeted by HearUSA.

The Company s network business will also face competition by companies offering similar network services. These companies attempt to aggregate demand for hearing products and sell marketing and other services to network participants. In addition, some of these networks are able to offer discounts to managed care payors, insurers and membership organizations. Many independent hearing care providers belong to more than one network. In addition, contract terms for membership are typically short and may be terminated by either party at will. There can be no assurance, however, that the largely fragmented hearing care market cannot be successfully consolidated by the establishment of co-operatives, alliances, confederations or the like, which would then compete more directly with HearUSA s network and its company-owned centers.

Reliance on Manufacturers

The Company s supply agreement with Siemens requires that a significant portion of the company-owned centers sales will be of Siemens devices. Siemens has a well-diversified product line (including Rexton and Electone) with a large budget devoted to research and development. However, there is no guaranty that Siemens technology or product line will remain desirable in the marketplace. Furthermore, if Siemens manufacturing capacity cannot keep pace with the demand of HearUSA and other customers, HearUSA s business may be adversely affected.

In the event of a disruption of supply from Siemens or another of the Company s current suppliers, the Company believes it could obtain comparable products from other manufacturers. Few manufacturers offer dramatic product differentiation. HearUSA has not experienced any significant disruptions in supply in the past.

Regulation

Federal

The practice of audiology and the dispensing of hearing aids are not presently regulated on the federal level in the United States. The United States Food and Drug Administration (FDA) is responsible for monitoring the hearing care industry. The FDA enforces regulations that deal specifically with the manufacture and sale of hearing aids. FDA requires that all dispensers meet certain conditions before selling a hearing aid relating to suitability of the patient for hearing aids and the advisability of medical evaluation prior to being fitted with a hearing aid. The FDA requires that first time hearing aid purchasers receive medical clearance from a physician prior to purchase; however, patients may sign a waiver in lieu of a physician s examination. The FDA has mandated that states adopt a return policy for consumers offering them the right to return their products, generally within 30 days. HearUSA offers all its customers a full 30-day return period and extends the return period to 60 days for patients who participate in the family hearing counseling program. FDA regulations require hearing aid dispensers to provide customers with certain warnings and statements regarding the use of hearing aids. Also, the FDA requires hearing aid dispensers to review instructional manuals for hearing aids with patients before the hearing aid is purchased.

In addition, a portion of the Company s revenues comes from participation in Medicare and Medicaid programs. Federal laws prohibit the payment of remuneration in order to receive or induce the referral of Medicare or Medicaid patients, or in return for the sale of goods or services to Medicare or Medicaid patients. Furthermore, federal law limits physicians and other healthcare providers from referring patients to providers of certain designated services in which they have a financial interest. HearUSA believes that all of its managed care and other provider contracts and its relationships with referring physicians are in compliance with these federal laws.

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The Health Insurance Portability and Accountability Act of 1996 (HIPAA) requires the use of uniform electronic data transmission standards for health care claims and payment transactions submitted or received electronically. The Department of Health and Human Services (HHS) adopted regulations establishing electronic data transmission standards that all health care providers must use when submitting or receiving certain health care transactions electronically. In addition, HIPAA required HHS to adopt standards to protect the security and privacy of health-related information. Final regulations containing privacy standards are now effective. HearUSA believes it has taken the necessary steps to be in full compliance with these regulations.

The Federal Trade Commission (FTC) issued the amended Telemarketing Sales Rule on January 29, 2003. The amended rule gave effect to the Telemarketing and Consumer Fraud and Abuse Prevention Act. This legislation gave the FTC and state attorneys generals law enforcement tools to combat telemarketing fraud, gave consumers added privacy protections and defenses against unscrupulous telemarketers, and was intended to help consumers tell the difference between fraudulent and legitimate telemarketing. One significant provision of the Telemarketing Sales Rule was inclusion of the prohibition on calling consumers who have put their telephone numbers on the national Do Not Call registry unless one of several exceptions is applicable to the call or to the consumer. Other FTC guidelines pertinent to the Company involve professional business practices relating to issues such as transmitting the caller s telephone number on caller ID, abandoning calls and speaking to consumers in a non-professional manner.

On July 25, 2003 the Federal Communications Commission issued a revised Final Rule Implementing the Telephone Consumer Protection Act of 1991 (TCPA Rule). The original TCPA Rule, issued in 1992, required telemarketers to honor all requests by a consumer that the telemarketer not make future calls on behalf of a specified seller to that consumer, restricted the use of recorded messages in telemarketing, and prohibited unsolicited commercial facsimile transmissions. The revised TCPA Rule prohibits telemarketing calls to telephone numbers on the national Do Not Call registry unless one of several exceptions is applicable to the call or consumer, and also contains provisions similar to those in the revised Telemarketing Sales Rule regarding the transmission of caller ID and abandoned calls. Among other provisions, the revised TCPA rule prohibits the uses of predictive dialers to place telephone calls to cellular telephones. The Company adheres to policies set forth by the FTC and the FCC, and has established policies and practices to ensure its compliance with FTC and FCC regulations, including the requirements related to the national Do Not Call registry.

In addition, the FTC is responsible for monitoring the business practices of hearing aid dispensers and vendors. The FTC can take action against companies that mislead or deceive consumers. FTC regulations also require companies offering warranties to fully disclose all terms and conditions of their warranties.

The FTC is also engaged in enforcement relating to the protection of sensitive customer data. The FTC has announced a program of enforcement actions to ensure that businesses implement reasonable data security practices to protect sensitive consumer data such as Social Security numbers.

The CAN-SPAM Act of 2003 regulates commercial electronic mail on a nationwide basis. It imposes certain requirements on senders of commercial electronic mail. The Company adheres to the law by properly representing the nature of its commercial email messages in the subject line, not tampering with source and transmission information in the email header, and obtaining email addresses through lawful means. The Company adheres to the specific disclosure requirements of the law by including a physical mail address and a clearly identified and conspicuous opt-out mechanism in all commercial email. The Company honors all consumer requests to stop receiving future commercial emails in a timely manner.

The Company cannot predict the effect of future changes in federal laws, including changes that may result from proposals for federal health care reform, or the impact that changes in existing federal laws or in the interpretation of

those laws might have on the Company. The Company believes it is in material compliance with all existing federal regulatory requirements.

State

State regulations of the hearing care industry exist in every state and are concerned primarily with the formal licensure of audiologists and those who dispense hearing aids, including procedures involving the fitting and dispensing of hearing aids. There can be no assurance that regulations will not exist in jurisdictions in which the Company plans to open centers or will not be promulgated in states in which the Company currently operates centers which may have a material adverse effect upon the Company. Such regulations might include more stringent licensure requirements for dispensers of hearing aids, inspections of centers for the dispensing of hearing aids and the regulation of advertising by dispensers of hearing aids. The Company knows of no current or proposed state regulations with which it, as currently operated, could not comply.

Many states have laws and regulations that impose additional requirements related to telemarketing and to the use of commercial email. These include telemarketing registration requirements and anti-fraud protections related to telemarketing and email. In some cases, state laws and regulations may be more restrictive than federal laws and regulations.

State regulation may include the oversight of the Company s advertising and marketing practices as a provider of hearing aid dispensing services. The Company s advertisements and other business promotions may be found to be in violation of these regulations from time to time, and may result in fines or other sanctions, including the prohibition of certain marketing programs that may ultimately harm financial performance.

The Company employs licensed audiologists and hearing aid dispensers. Under the regulatory framework of certain states, business corporations are not able to employ audiologists or offer hearing services. California has such a law, restricting the employment of audiologists to professional corporations owned by audiologists or similar licensees. The Company believes, however, that because the State of California s Department of Consumer Affairs has indicated that speech-language pathologists may be employed by business corporations, the Company may employ audiologists. The similarity of speech-language pathology to audiology, and the fact that speech-language pathologists and audiologists are regulated under similar statutes and regulations, leads the Company to believe that business corporations and similar entities may employ audiologists. No assurance can be given that the Company s interpretation of California s laws will be found to be in compliance with laws and regulations governing the corporate practice of audiology or, if its activities are not in compliance, that the legal structure of the Company s California operations can be modified to permit compliance.

In addition, state laws prohibit any remuneration for referrals, similar to federal laws discussed above. Generally, these laws follow the federal statutes described above. State laws also frequently impose sanctions on businesses when there has been a breach of security of sensitive customer information.

The Company believes it is in material compliance with all applicable state regulatory requirements. However, the Company cannot predict future state legislation which may affect its operations in the states in which it does business, nor can the Company assure that interpretations of state law will remain consistent with the Company s understanding of those laws as reflected through its operations.

Canada

Laws and regulations for the Province of Ontario, Canada are concerned primarily with the formal licensure of audiologists and dispensers who dispense hearing aids and with practices and procedures involving the fitting and dispensing of hearing aids. All Ontario audiologists must be members of the College of Audiologists and Speech and Language Pathologists of Ontario and hearing aid dispensers practicing in Ontario must be members of the

Association of Hearing Instrument Practitioners. Both audiologists and hearing instrument practitioners are governed by a professional code of conduct. There can be no assurance that regulations will not be promulgated in the Province of Ontario which may have a material adverse effect upon the Company. Such regulations might include more stringent licensure requirements for dispensers of hearing aids, inspections of centers for the dispensing of hearing aids and

the regulation of advertising by dispensers of hearing aids. The Company knows of no current or proposed Ontario regulations with which it, as currently operated, could not comply. The Company employs licensed audiologists and hearing aid dispensers in the Province of Ontario.

Ontario regulations and codes of conduct of audiologists and hearing instrument practitioners may include the oversight of the Company s advertising and marketing practices as a provider of hearing aid dispensing services. The Company s advertisements and other business promotions may be found to be in violation of these regulations from time to time, and may result in fines or other sanctions, including the prohibition of certain marketing programs that may ultimately harm financial performance.

In addition, Ontario regulations and codes of conduct of audiologists and hearing instrument practitioners prohibit any remuneration for referrals. The Company has structured its operations in Canada to assure compliance with these regulations and codes and believes it is in full compliance with Canadian law.

Product and Professional Liability

In the ordinary course of its business, HearUSA may be subject to product and professional liability claims alleging the failure of, or adverse effects claimed to have been caused by products sold or services provided by the Company. The Company maintains insurance at a level which the Company believes to be adequate. A successful claim in excess of the policy limits of the Company s liability insurance, however, could adversely affect the Company. As the distributor of products manufactured by others, the Company believes it would properly have recourse against the manufacturer in the event of a product liability claim; however, there can be no assurance that recourse against a manufacturer by the Company would be successful or that any manufacturer will maintain adequate insurance or otherwise be able to pay such liability.

Seasonality

The Company is subject to regional seasonality, the impact of which is minimal.

Employees

At December 30, 2006, HearUSA had 576 full-time employees and 78 part-time employees

Where to Find More Information

The Company makes information available free of charge on its website (www.hearusa.com). Through the website, interested persons can access the Company s annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K after such material is electronically filed with the SEC. In addition, interested persons can access the Company s code of ethics and other governance documents on the Company s website.

Item 1A. Risk Factors

This Annual Report on Form 10-K, including the management discussion and analysis set out below, contains or incorporates a number of forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Act Exchange of 1934. These forward-looking statements are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate and management s beliefs and assumptions. Any statements that are not statements of historical fact should be considered forward-looking statements and should be read in conjunction with our consolidated financial statements and notes to the consolidated financial statements included in this report as well as the risk factors set forth below. The statements

are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that we are unaware of may become important factors that affect us. If any of the following

risks occur, our business, financial condition and results of operations could be materially and adversely affected.

HearUSA has a history of operating losses and may never be profitable.

HearUSA has incurred net losses in each year since its organization, and its accumulated deficit at December 30, 2006 was approximately $109.5 million. We expect quarterly and annual operating results to fluctuate, depending primarily on the following factors:

- Timing of product sales;
- Level of consumer demand for our products;
- Timing and success of new centers and acquired centers;
- Timing and amounts of payments by health insurance and managed care organizations.

There can be no assurance that HearUSA will achieve profitability in the near or long term or ever.

We may not effectively compete in the hearing care industry.

The hearing care industry is highly fragmented and barriers to entry are low. Approximately 11,000 practitioners provide testing and dispense products and services that compete with those sold and provided by HearUSA. We also compete with small retailers, as well as large networks of franchisees and distributors established by larger companies, such as those manufacturing and selling Miracle Ear and Beltone products. Some of the larger companies have far greater resources than HearUSA and could expand and/or change their operations to capture the market targeted by HearUSA. Large discount retailers, such as Costco Wholesale Corporation, also sell hearing aids and present a competitive threat in our markets. In addition, it is possible that the hearing care market could be effectively consolidated by the establishment of cooperatives, alliances or associations that could compete more successfully for the market targeted by us.

We are dependent on manufacturers who may not perform.

HearUSA is not a hearing aid manufacturer. We rely on major manufacturers to supply our hearing aids and to supply hearing enhancement devices. A significant disruption in supply from any or all of these manufacturers could materially adversely affect our business. Our strategic and financial relationship with Siemens Hearing Instruments, Inc. requires us to purchase from Siemens a significant portion of our requirements of hearing aids at specified prices for a period of five years. Although Siemens is the world s largest manufacturer of hearing devices, there can be no assurance that Siemens technology and product line will remain desirable in the marketplace. Furthermore, if Siemens manufacturing capacity cannot keep pace with the demand of HearUSA and other customers, our business may be adversely affected.

We may not be able to access funds under our credit facility with Siemens if we cannot maintain compliance with the restrictive covenants contained therein and in our supply agreement with Siemens.

On December 30, 2006, HearUSA and Siemens Hearing Instruments Inc. entered into a second amended and restated credit agreement pursuant to which HearUSA obtained a $50 million secured credit facility from Siemens, replacing the February 10, 2006 credit facility extended to the Company by Siemens. As of December 30, 2006, an aggregate of $29.7 million in loans was outstanding under the credit facility. To continue to access the credit facility, we are required to comply with the terms of the amended credit facility, including compliance with restrictive covenants.

There can be no assurance that we will be able to comply with these restrictive covenants in the future and, accordingly, may be unable to access the funds provided under the credit facility. If we are unable to comply with these restrictive covenants, we may be found in default by Siemens and face other penalties under the credit agreement. In addition, we have entered into an amended and restated supply agreement with Siemens, which imposes certain purchase

requirements on us. If we fail to comply with the supply agreement, Siemens may declare us in default of the credit agreement and all loans would be immediately due and payable.

We rely on qualified audiologists, without whom our business may be adversely affected.

HearUSA currently employs approximately 250 licensed hearing professionals, of whom approximately 220 are audiologists and 30 are licensed hearing aid specialists. If we are not able to attract and retain qualified audiologists, we will be less able to compete with networks of hearing aid retailers or with the independent audiologists who also sell hearing aids and our business may be adversely affected. Many audiologists are obtaining doctorate degrees, and the increased educational time required at the doctoral level is further restricting the pool of audiologists available for employment.

We may not be able to maintain existing agreements or enter into new agreements with health insurance and managed care organizations, which may result in reduced revenues.

HearUSA enters into provider agreements with health insurance companies and managed care organizations for the furnishing of hearing care in exchange for fees. The terms of most of these agreements are to be renegotiated annually, and these agreements may be terminated by either party, usually on 90 days or less notice at any time. There is no certainty that we will be able to maintain these agreements on favorable terms or at all. If we cannot maintain these contractual arrangements or enter into new arrangements, there will be a material adverse effect on our revenues and results of operations. In addition, the early termination of or failure to renew the agreements that provide for payment to HearUSA on a per-patient-per-month basis would cause us to lower our estimates of revenues to be received over the life of the agreements. This could have a material adverse effect on our results of operations.

We depend on our joint venture for our California operations and may not be able to attract sufficient patients to our California centers without it.

HEARx West LLC, our joint venture with Kaiser Permanente, operates 25 full-service centers in California. Since their inception, HEARx West centers have derived approximately two-thirds of their revenues from sales to Kaiser Permanente members, including revenues through an agreement between the joint venture and Kaiser Permanente s California division servicing its hearing benefited membership. If Kaiser Permanente does not perform its obligations under the agreement, or if the agreement is not renewed upon expiration, the loss of Kaiser patients in the HEARx West centers would adversely affect our business. In addition, HEARx West centers would be adversely affected by the loss of the ability to market to Kaiser members and promote the business within Kaiser s medical centers, including the referral of potential customers by Kaiser.

We rely on the efforts and success of managed care companies that may not be achieved or sustained.

Many managed care organizations, including some of those with whom we have contracts, have experienced and are continuing to experience significant difficulties arising from the widespread growth and reach of available plans and benefits. If the managed care organizations are unable to attract and retain covered members in our geographic markets, we may be unable to sustain the operations of our centers in those geographic areas. There can be no assurance that we can maintain all of our centers. We will close centers where warranted and such closures could have a material adverse effect on us.

We may not be able to maintain JCAHO accreditation, and our revenues may suffer.

HearUSA has a three-year accreditation from the Joint Committee on Accreditation of Healthcare Organizations (JCAHO) that extends to 2008. This status distinguishes HearUSA from other hearing care providers and is widely

used in our marketing efforts. If we are not able to maintain our accredited status, we will not be able to distinguish HearUSA on this basis and our revenues may suffer. Also, there is no assurance that HearUSA can achieve JCAHO accreditation for acquired centers or the network business.

We are exposed to potential product and professional liability that could adversely affect us if a successful claim is made in excess of insurance policy limits.

In the ordinary course of its business, HearUSA may be subject to product and professional liability claims alleging that products sold or services provided by the company failed or had adverse effects. We maintain liability insurance at a level which we believe to be adequate. A successful claim in excess of the policy limits of the liability insurance could materially adversely affect our business. As the distributor of products manufactured by others, we believe we would properly have recourse against the manufacturer in the event of a product liability claim. There can be no assurance, however, that recourse against a manufacturer by HearUSA would be successful, or that any manufacturer will maintain adequate insurance or otherwise be able to pay such liability.

Risks Relating to HearUSA Common Stock

The price of our common stock is volatile and could decline.

The price of HearUSA common stock could fluctuate significantly, and you may be unable to sell your shares at a profit. There are significant price and volume fluctuations in the market generally that may be unrelated to our operating performance, but which nonetheless may adversely affect the market price for HearUSA common stock. The price of our common stock could change suddenly due to factors such as:

- the amount of our cash resources and ability to obtain additional funding;
- economic conditions in markets we are targeting;
- fluctuations in operating results;
- changes in government regulation of the healthcare industry;
- failure to meet estimates or expectations of the market; and
- rate of acceptance of hearing aid products in the geographic markets we are targeting.

Any of these conditions may cause the price of HearUSA common stock to fall, which may reduce business and financing opportunities available to us and reduce your ability to sell your shares at a profit, or at all.

HearUSA might fail to maintain a listing for its common stock on the American Stock Exchange, making it more difficult for stockholders to dispose of or to obtain accurate quotations as to the value of their HearUSA stock.

HearUSA common stock is presently listed on the American Stock Exchange. The American Stock Exchange will consider delisting a company s securities if, among other things,

- the company fails to maintain stockholder s equity of at least $2,000,000 if the company has sustained losses from continuing operations or net losses in two of its three most recent fiscal years;
- the company fails to maintain stockholder s equity of $4,000,000 if the company has sustained losses from continuing operations or net losses in three of its four most recent fiscal years; or
- the company has sustained losses from continuing operations or net losses in its five most recent fiscal years.

HearUSA may not be able to maintain its listing on the American Stock Exchange, and there may be no public market for the HearUSA common stock. In the event the HearUSA common stock were delisted from the American Stock Exchange, trading, if any, in the common stock would be conducted in the over-the-counter market. As a result, you would likely find it more difficult to dispose of, or to obtain accurate quotations as to the market value of, your HearUSA common stock.

If penny stock regulations apply to HearUSA common stock, you may not be able to sell or dispose of your shares.

If HearUSA common stock were delisted from the American Stock Exchange, the penny stock regulations of the Securities and Exchange Commission might apply to transactions in the common stock. A penny stock generally includes any over-the-counter equity security that has a market price of less than $5.00 per share. The Commission regulations require the delivery, prior to any transaction in a penny stock, of a disclosure schedule prescribed by the Commission relating to the penny stock. A broker-dealer effecting transactions in penny stocks must make disclosures, including disclosure of commissions, and provide monthly statements to the customer with information on the limited market in penny stocks. These requirements may discourage broker-dealers from effecting transactions in penny stocks. If the penny stock regulations were to become applicable to transactions in shares of HearUSA common stock, they could adversely affect your ability to sell or otherwise dispose of your shares.

Conversion of outstanding HearUSA convertible instruments and exercise of outstanding HearUSA options and warrants could cause substantial dilution.

As of December 30, 2006, outstanding convertible note, convertible subordinated notes, warrants and options of HearUSA included:

- $6.25 million in convertible subordinated notes, convertible into 3,571,429 shares of common stock, assuming any interest is paid in cash;

- Convertible note with Siemens, convertible into 6,450,084 shares of common stock;

- Warrants to purchase 5,114,853 shares of common stock and

- Options to purchase 5,423,423 shares of common stock.

To the extent outstanding subordinated notes are converted, options or warrants are exercised or additional shares of capital stock are issued, stockholders will incur additional dilution.

Future sales of shares may depress the price of HearUSA common stock.

If substantial stockholders sell shares of HearUSA common stock into the public market, or investors become concerned that substantial sales might occur, the market price of HearUSA common stock could decrease. Such a decrease could make it difficult for HearUSA to raise capital by selling stock or to pay for acquisitions using stock. In addition, HearUSA employees hold a significant number of options to purchase shares, many of which are presently exercisable. Employees may exercise their options and sell shares soon after such options become exercisable, particularly if they need to raise funds to pay for the exercise of such options or to satisfy tax liabilities that they may incur in connection with exercising their options.

Because of the HearUSA rights agreement and the related rights plan for the exchangeable shares, a third party may be discouraged from making a takeover offer which could be beneficial to HearUSA and its stockholders.

HearUSA has entered into a rights agreement with The Bank of New York, as rights agent. HEARx Canada Inc. has adopted a similar rights plan relating to the exchangeable shares of HEARx Canada Inc. issued in connection with the acquisition of Helix. The rights agreements contain provisions that could delay or prevent a third party from acquiring HearUSA or replacing members of the HearUSA board of directors, even if the acquisition or the replacements would

be beneficial to HearUSA stockholders. The rights agreements could also result in reducing the price that certain investors might be willing to pay for shares of the common stock of HearUSA and making the market price lower than it would be without the rights agreement.

Because HearUSA stockholders do not receive dividends, stockholders must rely on stock appreciation for any return on their investment in HearUSA.

We have never declared or paid cash dividends on any of our capital stock. Payment of dividends is restricted pursuant to our agreement with Siemens. We currently intend to retain any earnings for future growth and, therefore, do not anticipate paying cash dividends in the future. As a result, only appreciation of the price of HearUSA common stock will provide a return to investors who purchase or acquire common stock.

Other Risks Relating to the Business of HearUSA

We may not be able to obtain additional capital on reasonable terms, or at all, to fund our operations.

If capital requirements vary from those currently planned or losses are greater than expected, HearUSA may require additional financing. If additional funds are raised through the issuance of convertible debt or equity securities, the percentage ownership of existing stockholders may be diluted, the securities issued may have rights and preferences senior to those of stockholders, and the terms of the securities may impose restrictions on operations. If adequate funds are not available on reasonable terms, or at all, we will be unable to take advantage of future opportunities to develop or enhance our business or respond to competitive pressures and possibly even to remain in business.

Future acquisitions or investments could negatively affect our operations and financial results or dilute the ownership percentage of our stockholders.

We have initiated a strategic acquisition program. We may have to devote substantial time and resources in order to complete potential acquisitions. We may not identify or complete acquisitions in a timely manner, on a cost-effective basis, or at all. Acquired operations may not be effectively integrated into our operations and may fail.

In the event of any future acquisitions, HearUSA could:

- issue additional stock that would further dilute our current stockholders percentage ownership;
- incur debt;
- assume unknown or contingent liabilities; or
- experience negative effects on reported operating results from acquisition-related charges and amortization of acquired technology, goodwill and other intangibles.

These transactions involve numerous risks that could harm operating results and cause the price of HearUSA common stock price to decline, including:

- potential loss of key employees of acquired organizations;
- problems integrating the acquired business, including its information systems and personnel;
- unanticipated costs that may harm operating results;
- diversion of management s attention from business concerns; and

adverse effects on existing business relationships with customers.

Any of these risks could harm the business and operating results of HearUSA

Increased exposure to currency fluctuations could have adverse effects on our reported earnings.

Most of HearUSA s revenues and expenses are denominated in U.S. dollars. Some of our revenues and expenses are denominated in Canadian dollars and, therefore, we are exposed to fluctuations in the

Canadian dollar. As a result, our earnings will be affected by increases or decreases in the Canadian dollar. Increases in the value of the Canadian dollar versus the U.S. dollar would tend to increase reported earnings (or reduce losses) in U.S. dollar terms, and decreases in the value of the Canadian dollar versus the U.S. dollar would tend to reduce reported earnings (or increase losses).

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

HearUSA s corporate offices, network and national call center are located in West Palm Beach, Florida. The leases on these properties are for ten years and expire in 2016. As of December 30, 2006, the Company operated 42 centers in Florida, 16 in New Jersey, 23 in New York, 7 in Massachusetts, 7 in Ohio, 13 in Michigan, 7 in Missouri, and 25 HEARx West centers in California. HearUSA also operates 24 centers in the Province of Ontario. All of the locations are leased for one to ten year terms pursuant to generally non-cancelable leases (with renewal options in some cases). The Company believes these locations are suitable to serve its patients needs. The network is operated from the Company s corporate office in West Palm Beach. The Company has no interest or involvement in the network providers properties or leases. The e-commerce business is operated from the Company s corporate office in West Palm Beach.

Item 3. Legal Proceedings

The Company has from time to time been a party to lawsuits and claims arising in the normal course of business. In the opinion of management, there are no pending claims or litigation, in which the outcome would have a material effect on the Company s consolidated financial position or results of operations.

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

None

EXECUTIVE OFFICERS OF THE COMPANY

The following sets forth certain information as of the date hereof with respect to the Company s executive officers. The four executive officers named below are serving pursuant to employment agreements signed in August 2005 with 5-year terms expiring in 2010 for Dr. Brown and Mr. Hansbrough and with 3-year terms expiring in 2008 for Mr. Chouinard and Mr. Schofield, unless renewed or extended.

Name and Position	Age	First Served as Executive Officer
Paul A. Brown, M.D. Chairman of the Board	68	1986
Stephen J. Hansbrough President/Chief Executive Officer Director	60	1993
Gino Chouinard Executive Vice President	38	2002

Chief Financial Officer		
Kenneth Schofield	42	2004
Chief Operating Officer		

There are no family relationships among any of the executive officers and directors of the Company.

Paul A. Brown, M.D., holds an A.B. from Harvard College and an M.D. from Tufts University School of Medicine. Dr. Brown founded HearUSA in 1986 and has served as Chairman of the Board since that time and Chief Executive Officer until July 2002. From 1970 to 1984, Dr. Brown was Chairman of the Board and

Chief Executive Officer of MetPath Inc. (MetPath), a New Jersey-based corporation offering a full range of clinical laboratory services to physicians and hospitals, which he founded in 1967 while a resident in pathology at Columbia Presbyterian Medical Center in New York City. MetPath developed into the largest clinical laboratory in the world with over 3,000 employees and was listed on the American Stock Exchange prior to being sold to Corning in 1982 for $140 million. This lab currently is now called Quest Diagnostics (NYS-DGX) with over $5 billion in annual revenues. Dr. Brown is a former Chairman of the Board of Overseers of Tufts University School of Medicine, an Emeritus member of the Board of Trustees of Tufts University, a past member of the Visiting Committee of Boston University School of Medicine and part-time lecturer in pathology and a member of the visiting committee of Columbia University College of Physicians and Surgeons.

Stephen J. Hansbrough, Chief Executive Officer and Director, was formerly the Senior Vice President of Dart Drug Corporation and was instrumental in starting their affiliated group of companies (Crown Books and Trak Auto). These companies along with Dart Drug Stores had over 400 retail locations, generated approximately $550 million in annual revenues and employed over 3,000 people. Mr. Hansbrough subsequently became Chairman and CEO of Dart Drug Stores with annual revenues in excess of $250 million. After leaving Dart, Mr. Hansbrough was an independent consultant specializing in turnaround and start-up operations, primarily in the retail field, until he joined HearUSA in December 1993.

Gino Chouinard, Executive Vice President and Chief Financial Officer, joined HearUSA in July 2002 with its acquisition of Helix. Mr. Chouinard served as Helix s Chief Financial Officer from November 1999 until its acquisition by HearUSA. Mr. Chouinard is a Chartered Accountant who previously worked for Ernst & Young LLP, an international accounting firm, as Manager from 1996 until 1999 and as Senior Accountant from 1994 until 1996.

Kenneth J. Schofield, Chief Operating Officer, joined the Company in May 1997 as the Director of Information Technology and became Vice President, Information Technology in February 1998. He was appointed Chief Operating Officer in August 2004. Before joining the Company, Mr. Schofield served as the Controller for a government contracting company, Teltara, Inc., and the manager of information systems for a privately held group of 25 community newspapers.

PART II

Item 5. Market for Registrant s Common Equity and Related Stockholder Matters

The common stock of the Company is traded on the American Stock Exchange (AMEX) under the symbol EAR and the exchangeable shares of HEARx Canada Inc. are traded on the Toronto Stock Exchange under the symbol HUX. Holders of exchangeable shares may tender their holdings for common stock on a one-for-one basis at any time. As of March 21, 2007, the Company had 31,524,841 shares of common stock and 760,461 of exchangeable shares outstanding. The closing price on March 21, 2007 was $1.83 for the common stock and $1.76 Canadian for the exchangeable shares. The following table sets forth the high and low sales prices for the common stock as reported by the AMEX for the fiscal quarters indicated:

	Common Stock	
Fiscal Quarter	**High**	**Low**
2006		
First	$ 1.56	$ 1.22
Second	$ 1.49	$ 1.19
Third	$ 1.80	$ 1.25
Fourth	$ 2.04	$ 1.31
2005		
First	$ 2.09	$ 1.49
Second	$ 2.00	$ 1.45
Third	$ 1.79	$ 1.50
Fourth	$ 1.76	$ 1.13

As of March 21, 2007, there were 1,171 holders of record of the common stock.

Dividend Policy

HearUSA has never paid and does not anticipate paying any dividends on the common stock in the foreseeable future but intends to retain any earnings for use in the Company s business operations. Payment of dividends is restricted under the terms of the Company s credit agreement with Siemens.

Item 6. Selected Financial Data

The following selected financial data of the Company should be read in conjunction with the consolidated financial statements and notes thereto and the following Management s Discussion and Analysis of Financial Condition and Results of Operations. The financial data set forth on the next two pages has been derived from the audited consolidated financial statements of the Company and includes restated financial information for 2004 and 2005 (see Note 2 Restatement of Consolidated Financial Statements, Notes to Consolidated Financial Statements included herein):

CONSOLIDATED STATEMENT OF OPERATIONS DATA:

	Year Ended				
	December 30 2006	**December 31 2005 As restated**	**December 25 2004 As restated**	**December 27 2003 As restated**	**December 28 2002 As restated**
Net revenues	$ 88,786,193	$ 76,672,003	$ 68,749,542	$ 67,080,108	$ 55,038,793
Total operating costs and expenses	84,977,470	72,957,087	66,411,162	64,812,179	59,350,819
Income (loss) from operations (1 and 2)	3,808,723	3,714,916	2,338,380	2,267,929	(4,312,026)
Non-operating income:					
Gain from insurance settlement(3)	202,936	430,122			
Interest income	151,867	53,921	17,543	20,836	114,152
Interest expense(4)	(5,963,471)	(4,640,558)	(4,563,729)	(2,828,327)	(1,722,990)
Loss from continuing operations before income tax expense, minority interest, equity loss in affiliated company and loss from discontinued operations	(1,799,945)	(441,599)	(2,207,806)	(539,562)	(5,920,864)
Income tax expense	(741,785)	(1,759,148)	(690,396)	(390,000)	(195,000)
Minority interest	(632,606)				
Equity in loss of affiliated company					(630,801)
Net loss from continuing operations	(3,174,336)	(2,200,747)	(2,898,202)	(929,562)	(6,746,665)
Loss from discontinued operations		(63,553)	(550,696)	(569,827)	(328,804)
Net loss before dividends on preferred stock	(3,174,336)	(2,264,300)	(3,448,898)	(1,499,389)	(7,075,469)
Dividends on preferred stock	(137,858)	(700,675)	(708,159)	(626,956)	(696,541)

Net loss applicable to common stockholders	$	(3,312,194)	$	(2,964,975)	$	(4,157,057)	$	(2,126,345)	$	(7,772,010)
Loss per common share Basic and diluted, loss from continuing operations, including dividends on preferred stock	$	(0.10)	$	(0.09)	$	(0.12)	$	(0.05)	$	(0.33)
Basic and diluted, net loss applicable to common stockholders	$	(0.10)	$	(0.09)	$	(0.14)	$	(0.07)	$	(0.34)
Basic and diluted, weighted average number of common shares outstanding		32,224,554		31,610,793		30,426,829		30,424,262		22,534,393
Cash dividends per common share		None		None		None		None		None

(1) Total operating costs and expenses in 2006 include approximately $976,000 of non-cash employee stock-based compensation, which did not exist in prior years.

(2) Total operating costs and expenses include approximately $815,000, $618,000, $478,000, $457,000 and $240,000, in 2006, 2005, 2004, 2003 and 2002, respectively, of intangible asset amortization.

(3) The gain from insurance settlement is from insurance proceeds and final payments resulting from 2005 and 2004 hurricane damages and business interruption claims sustained in Florida hearing care centers.

(4) Interest expense includes approximately $2,694,000, $2,540,000, $2,127,000 and $517,000 in 2006, 2005, 2004 and 2003, respectively, of non-cash debt discount amortization and approximately $319,000 and $513,000 in 2006 and 2005, respectively, of non-cash decreases in interest expense related to a decrease in the fair market value of the warrant liability.

BALANCE SHEET DATA:

			As of		
	December 30 2006	**December 31 2005 As restated**	**December 25 2004 As restated**	**December 27 2003 As restated**	**December 28 2002(1) As restated**
Total assets	$ 83,276,444	$ 71,044,499	$ 61,773,981	$ 68,883,350	$ 67,696,870
Working capital deficit	(14,896,439)(3)	(3,549,353)	(4,898,459)	(2,330,035)	(10,231,372)
Long-term debt:					
Long-term debt, net of current maturities	28,598,869	19,970,099	17,296,125	20,579,977	22,082,389(2)
Convertible subordinated notes and subordinated notes, net of debt discount of $278,046 $2,077,537, $5,443,879 and $7,423,596 in 2006, 2005, 2004 and 2003, respectively	3,761,954	6,222,463	2,056,121	76,404	
Mandatorily redeemable convertible preferred stock			4,709,921	4,600,107	

(1) The Company completed its business combination with Helix effective June 30, 2002.

(2) Includes $110,890 of long-term debt of discontinued operations.

(3) Includes approximately $3.5 million representing the current maturities of the long-term debt to Siemens which may be repaid through preferred pricing reductions and approximately $2.5 million ($3.8 million in current maturities, net of $1.3 million) of debt discount related to the $7.5 million convertible subordinated notes that can be repaid by either cash or stock, at the option of the Company. The Company also drew down $5 million from its Siemens Tranche D Facility early in January 2007 for working capital purposes and repayment of certain debts.

Item 7. Management s Discussion and Analysis of Results of Operations and Financial Condition

GENERAL

In 2006, the Company continued to focus on its acquisition program and closed on 21 transactions representing 31 centers with annual estimated revenues of approximately $15.8 million. Combined with the 2005 acquisitions, the Company has acquired a total of 37 centers, representing $18.9 million of annual estimated revenues. Management s objective for the first year following an acquisition is to maintain at least 90% of the annual estimated revenues for a center. Thereafter, the revenues from that center become part of the baseline for determining year over year changes to net revenues. Revenues resulting from the centers acquired in 2005 and from centers acquired in 2006, combined, were approximately $6.7 million which represents approximately 92% of the estimated annual net revenues related to these specific centers. From centers acquired in 2006, only approximately $5.3 million of revenues was recorded in 2006 due to the timing of the acquisition closings throughout the year.

Also, on December 30, 2006 the Company and Siemens Hearing Instruments, Inc. entered into new credit and supply agreements. The Company and Siemens increased and restructured the credit facility, extended the term of the facility and the supply arrangements, increased the rebates to which the

Company may be entitled upon the purchase of Siemens hearing aids and granted Siemens certain conversion rights with respect to the debt and certain rights upon a change of control of HearUSA (see Note 7 Long-Term Debt, Notes to Consolidated Financial Statements included herein and Liquidity and Capital Resources and Recent Developments, below).

The Company increased net revenues over 2005 by 15.8%, of which 8.7% came from acquisitions and 7.1% from comparable centers. The growth in 2006 exceeds the 2005 growth of 11.5%, as the acquisition program contributed only 1.7% of the growth in that year. This, combined with a strong control over costs contributed to the improvement of the Company s income from operations although that improvement was offset by the impact of the non-cash stock-based compensation expense calculated in accordance with SFAS 123R of approximately $976,000 or 1.1% of total net revenues in 2006 that did not exist in prior years. Income from operations also includes amortization expense of approximately $815,000 of intangible assets associated primarily with our acquisitions, or 0.9% of total net revenues, compared with approximately $618,000 or 0.8% of total net revenues in 2005. The income from operations was $3.8 million, or 4.3% of total net revenues, in 2006 compared to $3.7 million, or 4.8% of total net revenues, in 2005.

The net loss applicable to common stockholders of $3.3 million, or $0.10 per share, includes approximately $976,000 (or $0.03 per share) of non-cash stock-based compensation expense calculated in accordance with SFAS 123R, which did not exist in 2005. The net loss applicable to common stockholders also includes amortization expense of approximately $815,000 of intangible assets associated primarily with our acquisitions (or $0.03 per share), compared with approximately $618,000 (or $0.02 per share) in 2005 and non-cash debt discount amortization, net of warrant liability adjustment, related to prior financings of approximately $2.4 million (or $0.07 per share) in 2006 compared to $2.0 million ($0.06 per share) in 2005, non-cash deferred tax expense of approximately $871,000 (or $0.03 per share) in 2006 compared to approximately $1.7 million (restated) (or $0.05 per share) in 2005. 2006 was also affected by the minority interest expense of approximately $633,000 of the Kaiser Permanente joint venture Hearx West, which first began to be recorded in mid-year in 2006. Management believes this reflects solid progress toward its longer term goals. See Outlook , below.

Management believes that fluctuations in non-cash amortization of intangible assets, non-cash deferred income tax expense and non-cash charges related to debt discount amortization and warrant liability adjustments should be considered in reviewing results of operations as they present meaningful information to both management and the investors, but may not be indicative of the Company s on-going operations and economic performance.

RESULTS OF OPERATIONS

2006 compared to 2005 (in thousands of dollars)

Revenues

Revenues	**2006**	**2005**	**Change**	**% Change**
Hearing aids and other products	$ 82,820	$ 71,445	$ 11,375	15.9%
Services	5,966	5,227	739	14.1%
Total net revenues	$ 88,786	$ 76,672	$ 12,114	15.8%

	2006	2005	Change	% Change(3)
Revenues from centers acquired in 2005(1)	$ 1,341	$	$ 1,341	1.7%
Revenues from centers acquired in 2006	5,331		5,331	7.0%
Total Revenues from acquired centers	6,672		6,672	8.7%
Revenues due to an additional week in 2005		1,400	(1,400)	(1.8)%
Revenues from comparable centers(2)	82,114	75,272	6,842	8.9%
Total net revenues	$ 88,786	$ 76,672	$ 12,114	15.8%

(1) Represents that portion of revenue from the 2005 acquired centers recognized for those acquisitions that had less than one full year of revenues recorded in 2005 due to the timing of their acquisition.

(2) Includes revenues from the network business segment as well as the impact of fluctuation of the Canadian exchange rate.

(3) The revenues from acquired centers percentage changes are calculated by dividing them by the total 2005 net revenues.

The $12.1 million or 15.8% increase in net revenues over 2005 is a result of centers acquired in 2005 and in 2006, which combined, generated approximately $6.7 million in revenues (or 8.7% of increase over 2005 total net revenues) and an increase of approximately $6.8 million (or 8.9% of increase over 2005 total net revenues) in revenues from comparable centers. The comparable center revenues total includes a favorable impact of $608,000 related to fluctuations in the Canadian exchange rate from 2005 to 2006. As indicated above, 2005 benefited from an additional week due to the timing of the Company s accounting calendar. In 2006 there was a 19.6% increase in the number of hearing aids sold over 2005, which increase was partially offset by a 2.7% decrease in the average unit selling price. Service revenues increased approximately $740,000 due to additional network managed care contracts.

The increase in the number of units sold in 2006 is due to the additional number of centers in 2006 from 2005 resulting from the acquisitions made (the weighted average number of centers in 2006 was 146 compared to 132 in 2005), a more efficient marketing campaign and a better response from our patients related to new products released by Siemens at the end of 2005 and the beginning of 2006 and additional revenues from our existing managed care contracts resulting from additional membership in their programs. The decrease in the average selling price was primarily due to lower prices on hearing aids sold in our Florida centers caused by the reinstatement of free hearing aids to the participants in the Florida Medicaid program. These free hearing aids are provided at a very low reimbursement rate to the Company by the state and therefore affect the Company s average selling price. This program which was eliminated three years ago and reinstated on July 1, 2006, now covers two hearing aids instead of one. Revenues in the last six months were affected by this new program as the Company had to service a built up demand. Toward the end of 2006 and early 2007, the demand was decreasing and is now at normal levels.

Cost of Products Sold and Services

Cost of Products Sold and Services	**2006**	**2005**	**Change**	**%**
Hearing aids and other products	$ 24,942	$ 20,973	$ 3,969	18.9%
Services	1,761	1,794	(33)	(1.8)%
Total cost of products sold and services	$ 26,703	$ 22,767	$ 3,936	17.3%
Percent of total net revenues	30.1%	29.7%	0.4%	1.3%

The cost of products sold as reflected above includes the effect of the preferred pricing reductions pursuant to our agreements with Siemens. The following table reflects the components of the preferred

pricing reductions which are included in the above costs of products sold for hearing aids (See Note 7 Long-term Debt, Notes to Consolidated Financial Statements included herein):

Preferred Pricing Reductions Included Above	**2006**	**2005**	**Change**	**%**
Base required payments on Tranches A and C forgiven	$ 2,922	$ 2,923	$ (1)	0.0%
Required payments of $65 per Siemens unit from acquired centers on Tranche B forgiven	190		190	n/a
Interest expense on Tranches A, B and C forgiven	626	389	237	60.9%
Total preferred pricing reduction	$ 3,738	$ 3,312	$ 426	12.9%
Percent of total net revenues	4.2%	4.3%	(0.1%)	(2.3)%

The increase of total cost of products sold and services, as a percentage of total net revenues, is primarily due to a change in product mix, promotions and the reduction in average selling prices discussed above. Cost of services remained flat from 2005 compared to 2006, as the increase in services net revenues related to network managed care contracts did not include any related cost of services. The increase in the preferred pricing reduction from Siemens is due to the forgiveness of interest on Tranche B which did not exist in 2005 and more interest being forgiven by Siemens in 2006 compared to 2005 as the interest on Tranche C began in the fourth quarter of 2006.

Management expects that in 2007 the total cost of products sold and services, as a percentage of revenues, will decrease due to the additional Siemens discounts and interest forgiveness on Tranches B and C of the new agreements signed in December 2006. While the base payments of $2.9 million will remain the same, the forgiveness of the Tranche B principal payments will increase due to increase in the number of units purchased from Siemens on the center acquisitions made in 2006 and those center acquisitions expected to close in 2007. Also, with the new agreement, all interest (9.5% annual) on Tranches B and C will now be forgiven starting January 1, 2007, as opposed to only some portion in 2006. Management expects the average balance of Tranches B and C combined should be between $27 million and $30 million in 2007, which would result in between $2.6 million and $2.9 million of interest expense being forgiven compared to approximately $626,000 in 2006 assuming certain minimum purchases are met. Considering the above and the additional volume discount of at least $1.25 million per year from the new agreement, the preferred pricing reductions from Siemens in 2007 is expected to exceed $7 million. Total cost of products sold and services, excluding the preferred pricing reduction, should remain constant in 2007 as compared to 2006 as a percentage of total net revenues.

Expenses

Operating expenses	**2006**	**2005**	**Change**	**%**
Center operating expenses	$ 42,281	$ 36,472	$ 5,809	15.9%
Percent of total net revenues	47.6%	47.6%		0.0%
General and administrative expenses	$ 14,005(1)	$ 11,745	$ 2,260	19.2%
Percent of total net revenues	15.8%(1)	15.3%	0.5%	3.3%

Depreciation and amortization	$ 1,988	$ 1,974	$ 14	0.7%
Percent of total net revenues	2.2%	2.6%	(0.4)%	(15.4)%

(1) Includes approximately $976,000 or 1.1% of total net revenues of non-cash stock-based compensation that did not exist in 2005.

The increase in center operating expenses in 2006 is mainly attributable to additional expenses of approximately $3.2 million related to the centers acquired during the last twelve months. In addition, the increase relates to an increase in incentive compensation related to additional net revenues, increased

wages due to normal merit increases and increases in center and managerial staff and additional advertising expenses. As a percent of total net revenues, center operating expenses remained flat at 47.6% in both 2005 and 2006. These increases in dollar were offset by a reduction of one week worth of expenses as 2005 included an extra week. Center operating expenses related to centers acquired in the last twelve months, at 48% of related net revenues, were in line with managements expectations. In 2007, these expenses will be affected by the additional expenses of centers acquired resulting from the trailing effect of the 2006 acquisitions, the 2007 acquisitions and some additional advertising expenses related to a new planned marketing campaign.

The increase in general and administrative expenses is attributable to the recognition of compensation expense related to employee stock-based compensation awards of approximately $976,000 which did not exist in 2005 (see Note 12 Stock-based Benefit Plan, Notes to Consolidated Financial Statements included herein) and increases in wages due to normal merit increases and additional employees. These increases in dollars were offset by a decrease in professional fees of approximately $278,000 and one week less of expenses as discussed above. As a percentage of total net revenues, the Company achieved positive leverage reducing the expense in percentage of total net revenues, however, this improvement was offset by the employee stock-based compensation expense under 123R representing approximately 1.1% of total net revenues in 2006. Management expects general and administrative expenses in 2007 to decrease from 2006 as a percentage of total net revenues.

Depreciation and amortization expense in 2006 remained stable compared to the same period in 2005. Decreases due to certain property and equipment becoming fully depreciated were offset by increases due to the acquisition of fixed assets and intangible assets during 2006. Depreciation was $1.2 million in 2006 compared to $1.4 million in 2005. Amortization expense was $815,000 in 2006 compared to $618,000 in 2005. Most of the amortization expense comes from the amortization of intangible assets related to the acquisitions made by the Company.

The gain from insurance proceeds of approximately $203,000 in 2006 represents insurance proceeds resulting from business interruption claims from 2005 hurricanes sustained in Florida hearing care centers. There was no hurricane affecting the Company s operations in 2006.

Interest Expense	**2006**	**2005**	**Change**	**%**
Notes payable from business acquisitions and others	$ 264	$ 68	$ 196	288.2%
Siemens Tranche C2 Interest paid with monthly payments(1)	345	190	155	81.6%
Siemens Tranches C1,C2 and C3 accrued interest added to loan balance(1)	1,130	964	166	17.2%
Siemens Tranches A, B and C interest forgiven	626	389	237	60.9%
2003 Convertible Subordinated Notes(2)	2,556	2,948	(392)	(13.3)%
2005 Subordinated Notes(3)	1,361	595	766	128.7%
Warrant liability change in value(4)	(319)	(513)	194	37.8%
Total interest expense	$ 5,963	$ 4,641	$ 1,322	28.5%

(1) The loan balances related to these interest expenses have been transferred to the new self-liquidating loan with Siemens under the new December 30, 2006 agreement and will now be forgiven going forward so long as a minimum purchase requirement is met (see Note 7 Long-term Debt, Notes to Consolidated Financial Statements included herein and Liquidity and Capital Resources, below).

(2) Includes $1.8 million in 2006 and $2.2 million in 2005 of non-cash debt discount amortization (see Note 8 Convertible Subordinated Notes, Notes to Consolidated Financial Statements included herein).

(3) Includes $850,000 in 2006 and $389,000 in 2005 of non-cash debt discount amortization (see Note 9 Subordinated Notes and Warranty Liability, Notes to Consolidated Financial Statements included herein).

(4) Relates to the change in value of the warrants related to the 2005 Subordinated Notes and is a non-cash item (see Note 9 Subordinated Notes and Warranty Liability, Notes to Consolidated Financial Statements included herein).

The increase in interest expense in 2006 is attributable to the 2005 subordinated notes, which were issued in August 2005 to repay in full the mandatorily redeemable convertible preferred stock and therefore were outstanding for a full year in 2006 compared to approximately 4 months in 2005, the additional $5 million financing on Tranche C2 from Siemens issued at the end of December 2005 and the issuance of promissory notes related to business acquisitions made during the last six months of 2005 and in 2006. A lower reduction of interest expense in 2006 compared to 2005 related to the warrant liability also contributed to the increase from 2005. This reduction in the warrant liability adjustment was due to an increase in the stock price from last year as well as a decrease in the remaining term of the warrants. These increases were offset in part by reductions in loan balances due to principal payments made during the year as well as amortization of the non-cash debt discount.

Dividends

The increase in interest expense was also partially offset by a reduction in dividend expense of approximately $563,000 due to the payment in full of the mandatorily redeemable convertible preferred stock in August of 2005.

Income Taxes (as restated)

The Company has net operating loss carryforwards of approximately $75 million for U.S. income tax purposes and approximately $281,000 of operating loss carryforwards in Canada. The Company determined that a change in ownership for Internal Revenue Code (IRC) Section 382 purposes may have occurred during the years 2002 to 2006. A change in ownership could limit the annual amount of the net loss carryforwards available for utilization against taxable income in the future. The Company is in the process of analyzing this potential change and determining the amount of limitation, if any.

The Company has temporary timing differences between the financial statement and tax reporting arising primarily from differences in the amortization of intangibles and goodwill and depreciation of fixed assets. In the past the deferred tax assets for both US and Canada purposes have been offset by a valuation allowance because it was determined that the deferred tax assets were not likely to be used. As of December 30, 2006, the Company determined that that the net operating loss carryforwards and timing differences from the Canadian jurisdiction would be realized since the Canadian operations have been generating net income for the past three years and it is estimated that the remaining deferred tax assets will be used in the next few years. Therefore the Company has determined that a valuation allowance is no longer needed on the deferred tax assets of approximately $680,000 related to its Canadian operations ($67,000 of that asset was recorded as a current asset and the balance of $613,000 was applied against the deferred tax liabilities (see Note 15 Income Taxes, Notes to Consolidated Financial Statements included herein). The realization of the tax benefits that arose from the deductibility of temporary timing differences that existed at the time the Canadian operations were acquired of $680,000 have been recorded as a reduction of the goodwill on that acquisition. The Company expects to owe Canadian taxes by 2008.

During the year, the Company also recorded a deferred income tax expense of approximately $871,000 compared to approximately $1.7 million in 2005 (as restated, see Note 2 Restatement of Consolidated Financial Statements, Notes to Consolidated Financial Statement included herein) of which approximately $433,000 and $346,000, respectively, relate to the profitability of the Canadian operations. The remaining deferred income tax expense relates to the realization of a tax benefit on tax deductible goodwill that existed in the Helix s U.S. operations at the time of its acquisition.

The Company also recorded a tax recovery of approximately $129,000 in 2006 related to its share of income taxes paid on the taxable income generated by HEARx West for 2004 and 2005. The Company has

determined in December 2006 that it was eligible to file unitary tax return in the State of California and is in the process of filing amended returns for refunds of taxes paid in 2004 and 2005.

Minority Interest

During 2006 and 2005, HEARx West generated net income of approximately $3.2 million and $2.3 million, respectively. The HEARx West accumulated deficit of approximately $1.9 million at the end of 2005 was eliminated by the end of the second quarter of 2006. According to the Company s agreement with the Permanente Federation, the Company had included in its consolidated statements of operations 100% of the losses incurred by the venture since its inception and received 100% of the net income of the venture until the accumulated deficit was eliminated. During the second quarter of 2006, the Company began recording a minority interest, equal to 50% of the venture s net income that exceeded the accumulated deficit, as a non-operating expense in the Company s consolidated statements of operations and with a corresponding liability on its consolidated balance sheets. The minority interest for the year was approximately $633,000.

2005 compared to 2004 (in thousands of dollars)

Revenues

Revenues	**2005**	**2004**	**Change**	**% Change**
Hearing aids and other products	$ 71,445	$ 63,228	$ 8,217	13.0%
Services	5,227	5,522	(295)	(5.3)%
Total net revenues	$ 76,672	$ 68,750	$ 7,922	11.5%

	2005	**2004**	**Change**	**% Change(3)**
Total Revenues from centers acquired in 2005(1)	$ 1,217	$	$ 1,217	1.8%
Revenues due to an additional week in 2005	1,400		1,400	2.0%
Revenues from comparable centers(2)	74,055	68,750	5,305	7.7%
Total net revenues	$ 76,672	$ 68,750	$ 7,922	11.5%

(1) Acquisition program began in mid-2005.

(2) Includes revenues from the network business segment as well as the impact of fluctuation of the Canadian exchange rate.

(3) The revenues from acquired centers percentage change is calculated by dividing them by the total 2004 net revenues.

The increase in total net revenues is comprised of an increase in hearing aids and other products revenues of approximately $8.2 million or 13.0%, partially offset by a reduction in service revenues of approximately $295,000 or 5.3%. The increase in hearing aids and other products revenues is mostly attributable to an increase in the average selling price of approximately 10.3% over the 2004 average selling price, resulting from patients selecting a higher percentage of advanced technology hearing aids, combined with an increase in the number of hearing aids sold of approximately 3.4%. The decrease in service revenues is due to lower revenues from the Company s contract with the Department of Veteran Affairs in 2005 compared to 2004. As part of the overall increase in revenues, approximately $1.4 million relates to the additional week in 2005 compared to 2004 due to the timing of the Company s accounting calendar and approximately $1.2 million was generated from the centers acquired in the second half of 2005. Also part of the overall increase is a favorable impact of $575,000 related to the change in the Canadian exchange rate from 2004 to 2005.

Cost of Products Sold and Services

Cost of Products Sold and Services	**2005**	**2004**	**Change**	**%**
Hearing aids and other products	$ 20,973	$ 17,512	$ 3,461	19.8%
Services	1,794	1,718	76	4.4%
Total cost of products sold and services	$ 22,767	$ 19,230	$ 3,537	18.4%
Percent of total net revenues	29.7%	28.0%	1.7%	6.1%

The cost of products sold as reflected above includes the effect of the preferred pricing reductions pursuant to our agreements with Siemens. The following table reflects the components of the preferred pricing reductions which are included in the above costs of products sold for hearing aids (see Note 7 Long-term Debt, Notes to Consolidated Financial Statements included herein):

Preferred Pricing Reductions Included Above	**2005**	**2004**	**Change**	**%**
Base required payments on Tranches A and C forgiven	$ 2,923	$ 2,921	$ 2	0.0%
Interest expense on Tranches A, B and C forgiven	389	720	(331)	(46.0)%
Total preferred pricing reduction	$ 3,312	$ 3,641	$ (329)	(9.0)%
Percent of total net revenues	4.3%	5.3%	(1.0)%	(18.9)%

The increase in the cost of hearing aids and other products is attributable to the corresponding increase in hearing aids sold and other products revenues and increase in the number of advanced technology hearing aids sold. The cost of services remained flat with last year as the decrease in the service revenues is due to the VA contract with lower revenues which bear no cost of services. The total cost of products sold and services, as a percent of net revenues, increased to 29.7% in 2005 from 28.0% in 2004 due to the increase in advanced technology hearing aids sold, which have lower margins, and special introductory price promotions on new Siemens products. The percentage was lower as the preferred pricing was approximately $331,000 less due to lower loan balances causing less interest expense being foregiven.

Expenses

Operating Expenses	**2005**	**2004**	**Change**	**%**
Center operating expenses	$ 36,472	$ 34,891	$ 1,581	4.5%
Percent of total net revenues	47.6%	50.8%	(3.2)%	(6.3)%
General and administrative expenses	$ 11,745	$ 10,218	$ 1,527	14.9%

Percent of total net revenues	15.3%	14.9%	0.4%	2.7%
Depreciation and amortization	$ 1,974	$ 2,072	$ (98)	(4.7)%
Percent of total net revenues	2.6%	3.0%	(0.4)%	(13.3)%

The increase in center operating expenses is mainly attributable to the additional week in 2005, representing approximately $547,000, additional expenses of approximately $449,000 related to the acquired centers discussed above, an increase in incentive compensation related to additional net revenues and new incentive programs and increased wages due to normal merit increases . The increase in general and administrative expenses is attributable to the additional week in 2005, representing approximately $211,000 of additional expenses and to increases in wages and other expenses related to new sales and business development departments and normal annual merit increases. The net decrease in depreciation and amortization is due to certain property and equipment becoming fully depreciated, partially offset by increases due to the acquisition of fixed assets and intangible assets during the year.

The gain from insurance settlement of approximately $430,000 in 2005 is from insurance proceeds and final payment resulting from 2004 hurricane damages and business interruption claims sustained in Florida hearing care centers.

Interest Expense	**2005**	**2004**	**Change**	**%**
Notes payable from business acquisitions and others	$ 68	$ 79	$ (11)	(13.9)%
Siemens Tranche E Interest paid with monthly payments	190	245	(55)	(22.4)%
Siemens Tranches C1, C2 and C3 accrued interest added to loan balance	964	656	308	47.0%
Siemens Tranches A, B and C interest forgiven	389	720	(331)	(46.0)%
2003 Convertible Subordinated Notes(1)	2,948	2,864	84	2.9%
2005 Subordinated Notes(2)	595		595	n/a
Warrant liability change in value(3)	(513)		(513)	n/a
Total interest expense	$ 4,641	$ 4,564	$ 77	1.7%

(1) Includes $2.2 million in 2005 and $2.1 million in 2004 of non-cash debt discount amortization (see Note 8 Convertible Subordinated Notes, Notes to Consolidated Financial Statements included herein).

(2) Includes $389,000 in 2005, none in 2004, of non-cash debt discount amortization (see Note 9 Subordinated Notes and Warrant Liability, Notes to Consolidated Financial Statement included herein).

(3) Relates to the change on value of the warrants related to the 2005 Subordinated Notes and is a non-cash item (see Note 9 Subordinated Notes and Warrant Liability, Notes to Consolidated Financial Statement included herein).

Interest expense increased approximately $595,000 (including the non-cash portion of approximately $389,000) due to the $5.5 million subordinated notes financing completed in August 2005 and approximately $308,000 due to the impact of the higher interest rates on the Siemens Tranche D which was at prime plus 1%. These increases were offset in part by a decrease of interest on other existing balances due to repayments of principal during the year. 2005 was also positively affected with the non-cash reduction in interest expense that did not exist in 2004 of approximately $513,000 related to a decrease in the fair market value of the warrant liability caused by the decrease in the stock price during 2005 (see Note 9 Subordinated Notes and Warrant Liability, Notes to Consolidated Financial Statements included herein).

Dividends

The redemption of the Series E Convertible Preferred Stock in September 2005 resulted in a $142,500 decrease in dividends on preferred stock which was offset by the premium of $135,000 paid for redeeming such preferred stock before the expiration of its term.

Income Taxes (as restated)

During 2005, the Company recorded a deferred income tax expense of approximately $1.7 million compared to approximately $690,000 in 2004 (as restated, see Note 2 Restatement of Consolidated Financial Statements, Notes to

Consolidated Financial Statements included herein) of which approximately $346,000 and approximately $300,000, respectively, relate to the profitability of the Canadian operations. The remaining deferred income tax expense relates to the realization of a tax benefit on tax deductible goodwill that existed in Helix s U.S. operations at the time of its acquisition.

LIQUIDITY AND CAPITAL RESOURCES

Siemens Transaction

On December 30, 2006, the Company entered into a Second Amended and Restated Credit Agreement, Amended and Restated Supply Agreement, Amendment No. 1 to Amended and Restated Security Agreement and an Investor Rights Agreement with Siemens Hearing Instruments, Inc.

Pursuant to these agreements, the parties have increased and restructured the credit facility, extended the term of the credit facility and the supply arrangements, increased the rebates to which the company may be entitled upon the purchase of Siemens hearing aids and granted Siemens certain conversion rights with respect to the debt. On the closing date, Siemens agreed to transfer $2.2 million of accounts payable to the newly available credit and subsequently the Company drew down an additional $5 million in cash in January 2007.

The credit facility has been increased from $26 million to $50 million and its term extended to February 2013. The first $30 million of the line is still structured in three tranches and all of it now bears interest at 9.5%. Tranche B is a revolver established to accommodate funding for acquisitions by the Company. The Company may borrow under Tranche B up to a $30 million limit, less any amounts then outstanding under Tranche A and Tranche C. At the time of the closing, there was outstanding under Tranche B approximately $3.5 million of principal and accrued interest. Required quarterly payments of principal corresponding to $65 per Siemens unit sold by the acquired centers plus imputed interest thereon under Tranche B are subject to rebate credits described below. On the closing date, there was outstanding under Tranche C a principal balance of approximately $24 million and accrued interest of approximately $61,000. Th