FROST PHILLIP MD ET AL
Form 4
September 20, 2010

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
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Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
FROST PHILLIP MD ET AL

(Last) (First) (Middle)

OPKO HEALTH, INC., 4400 BISCAYNE BLVD.

(Street)

MIAMI, FL 33137

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
Opko Health, Inc. [OPK]

3. Date of Earliest Transaction (Month/Day/Year)
09/17/2010

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director __X__ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
CEO & Chairman

6. Individual or Joint/Group Filing(Check Applicable Line)
___ Form filed by One Reporting Person
_X_ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	09/17/2010		P		100	A	$ 2.22	97,858,152	I	See Footnote (1)
Common Stock	09/17/2010		P		4,000	A	$ 2.23	97,862,152	I	See Footnote (1)
Common Stock	09/17/2010		P		2,000	A	$ 2.24	97,864,152	I	See Footnote (1)
Common Stock	09/17/2010		P		1,000	A	$ 2.26	97,865,152	I	See Footnote

									(1)
Common Stock	09/17/2010		P	1,100	A	$ 2.27	97,866,252	I	See Footnote (1)
Common Stock	09/17/2010		P	1,800	A	$ 2.29	97,868,052	I	See Footnote (1)
Common Stock							15,490,546	I	See Footnote (2)

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
FROST PHILLIP MD ET AL OPKO HEALTH, INC. 4400 BISCAYNE BLVD. MIAMI, FL 33137	X	X	CEO & Chairman	
Frost Gamma Investments Trust 4400 BISCAYNE BLVD. MIAMI, FL 33137		X		

Signatures

Phillip Frost, M.D., Individually and as Trustee	09/20/2010
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) The securities are held by Frost Gamma Investments Trust, of which Phillip Frost M.D., is the trustee. Frost Gamma L.P. is the sole and exclusive beneficiary of Frost Gamma Investments Trust. Dr. Frost is one of two limited partners of Frost Gamma L.P. The general partner of Frost Gamma L.P. is Frost Gamma, Inc., and the sole shareholder of Frost Gamma, Inc. is Frost-Nevada Corporation. Dr. Frost is also the sole shareholder of Frost-Nevada Corporation. The reporting person disclaims beneficial ownership of these securities, except to the extent of any pecuniary interest therein and this report shall not be deemed an admission that the reporting person is the beneficial owner of these securities for purposes of Section 16 or for any other purpose.

(2) These securities are owned directly by The Frost Group, LLC. Frost Gamma Investments Trust is a principal member of The Frost Group, LLC. The reporting person disclaims beneficial ownership of these securities, except to the extent of any pecuniary interest therein and this report shall not be deemed an admission that the reporting person is the beneficial owner of these securities for purposes of Section 16 or for any other purpose.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. g statements. We review, modify and change our strategic objectives from time to time based upon changing business conditions. There can be no assurance that we will be able to achieve our strategic objectives and even if these results are achieved risks and uncertainties could cause actual results to differ materially from anticipated results. To a large extent, limited financial resource availability reduces our ability to achieve these strategic objectives. Please see the section of this Form 10-KSB entitled "Risk Factors" for a description of certain risks, among others that may cause our actual results to vary from the forward-looking statements. 10 Sales and Marketing Domestic Operations We sell EECP(R) therapy systems to treatment providers such as hospitals, clinics and physician private practices in the United States through a direct and indirect sales force. Our sales force has consisted of a combination of employees and independent sales representatives managed by a vice president of sales plus in-house administrative support. The efforts of our sales organization are further supported by clinical educators who are responsible for the onsite training of physicians and therapists as new centers are established. This clinical applications group is also engaged in training and certification of new personnel at each site, as well as for updating providers on new clinical developments relating to EECP(R) therapy. Our marketing activities support physician education and physician outreach programs, exhibition at national, international and regional medical conferences, as well as sponsorship of seminars at professional association meetings. These programs are designed to support our field sales organization and increase awareness of EECP(R) therapy in the medical community. Additional marketing activities include creating awareness among third-party payers of the benefits of EECP(R) treatment for patients suffering from CHF as well as angina. We employ service technicians responsible for the repair and maintenance of EECP(R) systems and, in some instances, on-site training of a customer's biomedical engineering personnel. We provide a service arrangement (usually one year) that includes: service by factory-trained service representatives, material and labor costs, emergency and remedial visits, software upgrades, technical phone support and preferred response times. We service our customers after the service arrangement expires either under separately purchased annual service contracts or on a fee-for-service basis. International Operations We distribute our product internationally through a network of independent distributors. It has generally been our policy to appoint distributors with exclusive marketing rights to EECP(R) therapy systems in their respective countries, in exchange for their commitment to meet the duties and responsibilities required of a distributor. Each distribution agreement contains a number of requirements that must be met for the distributor to retain exclusivity, including minimum performance standards. In most cases, distributors must assist us either to obtain an FDA-equivalent marketing clearance, country registration or to establish confirmatory clinical trials, conducted by local key opinion leaders in cardiology, required to obtain Ministry of Health approval, certification or reimbursement. Each distributor is responsible for registering the product and obtaining any required regulatory or clinical approvals, supporting local reimbursement efforts for

EECP(R) therapy and maintaining an infrastructure to provide post-sales support. Revenues from international operations is 16% of total revenue for the fiscal years ended May 31, 2008 and 2007. Our international marketing activities include, among other things, assisting in obtaining national or third-party healthcare insurance reimbursement approval and participating in medical conferences to create greater awareness and acceptance of EECP(R) therapy by clinicians. International sales may be subject to certain risks, including export/import licenses, tariffs, other trade regulations and local medical regulations. Tariff and trade policies, domestic and foreign tax and economic policies, exchange rate fluctuations and international monetary conditions have not significantly affected our business to date. In addition, there can be no assurance that we will be successful in maintaining our existing distribution agreements or entering into any additional distribution agreements, or that our international distributors will be successful in marketing EECP(R) therapy. 11 Competition Presently, we are aware of at least five direct competitors with an external counterpulsation device on the market. In addition, other companies have received FDA 510(k) clearance for external counterpulsation systems since 1998, although we have not seen these systems commercially in the marketplace. While we believe that these competitors' involvement in the market is limited, there can be no assurance that these companies will not become a significant competitive factor or that other companies will not enter the external counterpulsation market. We view other companies engaged in the development of device-related, biotechnology and pharmacological approaches to the management of cardiovascular disease as potential competitors in the marketplace as well. These include such common and well-established medical devices and treatments as the intra-aortic balloon pump (IABP), ventricular assist devices (VAD), coronary artery bypass graft surgery (CABG), coronary angioplasty, mechanical circulatory support (MCS), transmyocardial laser revascularization (TMR), total artificial hearts, cardiac resynchronization devices, ranolazine and nesiritide (Natrecor(R)); as well as newer technologies currently in FDA-approved clinical trials such as gene therapy and spinal cord stimulation (SCS). There can be no assurance that other companies will not develop new technologies or enter the market intended for EECP(R) therapy systems. Such other companies may have substantially greater financial, manufacturing and marketing resources and technological expertise than those possessed by us and may, therefore, succeed in developing technologies or products that are more efficient than those offered by Vasomedical and that would render our technology and existing products obsolete or noncompetitive. Government Regulations We are subject to extensive regulation by numerous government regulatory agencies, including the FDA and similar foreign agencies. Where applicable, we are required to comply with laws, regulations and standards governing the development, preclinical and clinical testing, manufacturing, quality testing, labeling, promotion, import, export, and distribution of our medical devices. Device Classification FDA regulates medical devices, including the requirements for premarket review, according to their classification. Class I devices are generally lower risk products for which general regulatory controls are sufficient to provide reasonable assurance of safety and effectiveness. Most Class I devices are exempt from the requirement of 510(k) premarket notification clearance; however, 510(k) clearance is necessary prior to marketing a non-510(k) exempt Class I device in the United States. Class II devices are devices for which general regulatory controls are insufficient, but for which there is sufficient information to establish special controls, such as guidance documents or standards, to provide reasonable assurance of safety and effectiveness. A premarket notification clearance is necessary prior to marketing a non-510(k) exempt Class II device in the United States. Class III devices are devices for which there is insufficient information demonstrating that general and special controls will provide reasonable assurance of safety and effectiveness and which are life-sustaining, life-supporting or implantable devices, are of substantial importance in preventing impairment of human health, or pose a potential unreasonable risk of illness or injury. The FDA generally must approve a premarket approval or PMA application prior to marketing a Class III device in the United States. A medical device is considered by FDA to be a preamendments device, and generally not subject to premarket review, if it was commercially distributed before May 28, 1976, the date the Medical Device Amendments of 1976 became law. A postamendments device is one that was first distributed commercially on or after May 28, 1976. Postamendments device versions of preamendments Class III devices are subject to the same requirements as those preamendments devices. FDA may require a PMA for a preamendments Class III device only after it publishes a regulation calling for such PMA submissions. Persons who market preamendments devices must submit a PMA, and have it filed by FDA, by a date specified by FDA in order to continue marketing the device. Prior to the effective date of a regulation requiring a PMA, devices must have a cleared premarket notification or 510(k) for marketing. Certain external counterpulsation devices were commercially distributed prior to May 28, 1976. Our external counterpulsation devices were marketed after 12 1976; however, they were found to be substantially equivalent to a preamendments Class III device and therefore are subject to the same requirements as the preamendments external counterpulsation devices. Premarket Review The 510(k) premarket notification process requires an applicant to give notice to FDA of its intent to introduce its device into commerce. In its premarket notification, the applicant must demonstrate that its new or modified medical device is substantially equivalent to a legally marketed or predicate device marketed before May 28, 1976. Prior to beginning commercialization of the new or modified product it must receive an order from the FDA classifying the device under section 510(k) in the same classification as the predicate device, and as a result, the new device will be cleared for marketing. Modifications to a previously cleared medical device that do not significantly affect its safety and effectiveness or constitute a major change in the intended use can be made without having to submit a new 510(k). In February 1995, the Company received 510(k) clearance to market the second-generation version of its EECP(R) therapy system, the MC2, which incorporated a number of technological improvements over the predicate system. In addition, in December 2000, the Company received 510(k) clearance to market its third generation system, the TS3. The FDA's clearance in these cases was for the use of EECP(R) therapy in the treatment of patients suffering from stable or unstable angina pectoris, acute myocardial infarction and cardiogenic shock. In June 2002, the FDA granted 510(k) market clearance for an upgraded TS3, which incorporated the Company's patented CHF treatment and oxygen saturation monitoring technologies, and provided for a new indication for the use of EECP(R) in CHF, which applied to all then-current models of the Company's EECP(R) therapy systems. Modifications to a previously cleared medical device that do not significantly affect its safety and effectiveness or constitute a major change in the intended use can be made without having to submit a new 510(k). FDA publishes guidance for medical device manufacturers on the types of changes that meet the requirements for a new 510(k) prior to introduction of a device for marketing distribution. Vasomedical followed FDA's guidance on when to submit a new 510(k) for changes to a device and concluded that the changes incorporated into its Model TS4 did not require a new 510(k) prior to its introduction to market. Vasomedical subsequently obtained a 510(k) that applied to the Model TS4 and all of its models in March 2004, when it made changes to the labeling of all of its EECP(R) therapy systems. In November 2004, the Company introduced its Model Lumenair, and again concluded that the changes did not require a new 510(k) at that time. There can be no assurance that the FDA will agree with Vasomedical's conclusions that a new 510(k) was unnecessary on these occasions or in other similar instances, or that our products will not be subject to a regulation requiring a PMA for preamendments Class III external counterpulsation devices. If a device does not receive a clearance order because the FDA determines that the device is not substantially equivalent to a predicate device and thus the device automatically is considered a Class III device, the applicant may ask the FDA to make a risk-based classification to place the device in Class I or II. However, if a timely request for risk-based classification is not made, or if the FDA determines that a Class III designation is appropriate, an approved PMA will be required before the device may be marketed. The more rigorous premarket review process is the PMA process. The FDA approves a PMA if the applicant has provided sufficient valid scientific evidence to prove that the device is safe and effective for its intended use(s). Applications for premarket approval generally contain human clinical data. This process is usually much more complex, time-consuming and expensive than the 510(k) process, and is uncertain. Both 510(k)s and PMAs now require the submission of user fees in most circumstances. There can be no assurance that all the necessary FDA clearances or approvals, including approval of any PMA required by the promulgation of a regulation, will be granted for our products, future-generation upgrades or newly developed products, on a timely basis or at all. Failure to receive, or delays in receipt of such clearances, could have a material adverse effect on our financial condition and results of operations. Clinical Trials If human clinical trials of a device are required, whether to support a 510(k) or PMA application, the trials' sponsor, which is usually the manufacturer of the device, first must obtain the approval of the appropriate institutional review boards. If a trial is of a significant risk device, the sponsor also must obtain an investigational device exemption or IDE from FDA before the trial may begin. A significant risk device is a device that presents a potential for serious risk to the subject and is an implant; is 13 life-sustaining or life-supporting; or is for a use of substantial importance in diagnosing, curing, mitigating, or treating disease, or otherwise preventing impairment of human health. For all clinical testing, the sponsor must obtain informed consent from the patients participating in each trial. The results of clinical testing that a sponsor undertakes may be insufficient to obtain clearance or approval of the tested product. Pervasive and Continuing FDA Regulation We are also subject to other FDA regulations that apply prior to and after a product is commercially released. These include Current Good Manufacturing Practice (CGMP) requirements set forth in FDA's Quality System Regulation (QSR), that require manufacturers to have a quality system for the design, manufacture, packaging, labeling, storage, installation and servicing of medical devices intended for commercial distribution in the United States. This regulation covers various areas including management and organization, device design, purchase and handling of components, production and process controls such as those related to buildings and equipment, packaging and labeling control, distribution, installation, complaint handling, corrective and preventive action, servicing, and records. We are subject to periodic inspection by the FDA for compliance with the CGMP requirements and Quality System Regulation. The FDA also enforces post-marketing controls that include the requirement to submit medical device reports to the agency when a manufacturer becomes aware of information suggesting that any of its marketed products may have caused or contributed to a death or serious injury, or any of its products has malfunctioned and that a recurrence of the malfunction would likely cause or contribute to a death or serious injury. The FDA relies on medical device reports to identify product problems and utilizes these reports to determine, among other things, whether it should exercise its enforcement powers. The FDA also may require postmarket surveillance studies for specified devices. We are subject to the Federal Food, Drug, and Cosmetic Act's, or FDCA's, general controls, including establishment registration, device listing, and labeling requirements. If we fail to comply with any requirements under the FDCA, we, including our officers and employees, could be subject to, among other things, fines, injunctions, civil penalties, and criminal prosecution. We also could be subject to recalls or product corrections, total or partial suspension of production, denial of premarket notification clearance or PMA approval, and rescission or withdrawal of clearances and approvals. Our products could be detained or seized, the FDA could order a recall, repair, replacement, or refund of our devices, and the agency could require us to notify health professionals and others that the devices present unreasonable risks of substantial harm to the public health. The advertising of our products is subject to regulation by the Federal Trade Commission, or FTC. The FTC Act prohibits unfair or deceptive acts or practices in or affecting commerce. Violations of the FTC Act, such as failure to have substantiation for product claims, would subject us to a variety of enforcement actions, including compulsory process, cease and desist orders and injunctions, which can require, among other things, limits on advertising, corrective advertising, consumer redress and restitution, as well as substantial fines or other penalties. Foreign Regulation In most countries to which we seek to export the EECP(R) system, we must first obtain approval from the local medical device regulatory authority. The regulatory review process varies from country to country and can be complex, costly, uncertain, and time-consuming. We are also subject to periodic audits by organizations authorized by foreign countries to determine compliance with laws, regulations and standards that apply to the commercialization of our products in those markets. Examples include auditing by a European Union Notified Body organization (authorized by a member state's Competent Authority) to determine conformity with the Medical Device Directives (MDD) and by an organization authorized by the Canadian government to determine conformity with the Canadian Medical Devices Regulations (CMDR). There can be no assurance that we will obtain desired foreign authorizations to commercially distribute our products in those markets or that we will comply with all laws, regulations and standards that pertain to our 14 products in those markets. Failure to receive or delays in receipt of such authorizations or determinations of conformity could have a material adverse effect on our financial condition and results of operations. Patient Privacy Federal and state laws protect the confidentiality of certain patient health information, including patient records, and restrict the use and disclosure of that protected information. The U.S. Department of Health and Human Services (HHS) published patient privacy rules under the Health Insurance Portability and Accountability Act of 1996 (HIPAA privacy rule) and the regulation was finalized in October 2002. The HIPAA privacy rule governs the use and disclosure of protected health information by "Covered Entities," which are (1) health plans, (2) health care clearinghouses, and (3) health care providers that transmit health information in electronic form in connection with certain health care transactions such as benefit claims. Currently, the HIPAA privacy rule affects us only indirectly in that patient data that we access, collect and analyze may include protected health information. Additionally, we have signed some Business Associate agreements with Covered Entities that contractually bind us to protect protected health information, consistent with the HIPAA privacy rule's requirements. We do not expect the costs and impact of the HIPAA privacy rule to be material to our business. Practice Guidelines Medical professional societies periodically issue Practice Guidelines to their members and make them available publicly. The American College of Cardiology (ACC) and the American Heart Association (AHA) have jointly engaged in developing practice guidelines since 1980 to critically evaluate the use of diagnostic procedures and therapies in the management or prevention of cardiovascular diseases. These guidelines are meant to "improve the effectiveness of care, optimize patient outcomes and affect the overall cost of care favorably by focusing resources on the most effective strategies". Recommendations incorporated into the guidelines are based upon an assessment of the strength of evidence for or against a treatment or procedure and estimates of expected health outcomes stemming from a formal review of peer-reviewed published literature. These guidelines may not be updated for some time. The "ACC/AHA 2002 Guideline Update for the Management of Patients with Chronic Stable Angina" was last issued in 2003. Comments on external counterpulsation appear in a section entitled "Recommendations for Alternative Therapies for Chronic Stable Angina in Patients Refractory to Medical Therapy Who Are Not Candidates for Percutaneous Intervention or Surgical Revascularization" and include a so-called Class IIb recommendation. ACC/AHA guideline classifications I, II and III are used to "provide final recommendations for both patient evaluation and therapy" and a Class IIb rating is defined as "Usefulness/efficacy is less well established by evidence/opinion". The ACC/AHA 2005 Guidelines for the Diagnosis and Management of Chronic Heart Failure in the Adult were issued in 2005. External counterpulsation is listed as one of the devices under investigation in a section entitled "Drugs and Interventions Under Active Investigation". The 2006 Comprehensive Heart Failure Practice Guideline, issued in February 2006 by the Heart Failure Society of America, does not include any comments on the use of external counterpulsation therapy for treating heart failure patients. In summary, while evaluations of the use of EECP(R) therapy in patients with chronic angina and heart failure continue to appear in several oral or poster presentations at major scientific meetings and in peer-reviewed publications each year, there continues to be skepticism in the cardiology community about its broader use. Additional evidence regarding the efficacy of EECP(R) therapy continues to appear, however the evidence may not be sufficient to warrant a modification of practice guidelines to a more favorable recommendation and increased acceptance by the medical community. Reimbursement In addition to regulatory approvals for commercialization by government agencies, reimbursement coverage and payment rates are factors in the sales of our products and we depend in large part on the availability of reimbursement 15 programs. Medicare, Medicaid, as well as private health care insurance and managed-care plans determine eligibility for coverage of a product or therapy based on a number of factors, including the payer's determination that the product is reasonable and necessary for the diagnosis or treatment of the illness or injury for which it is administered according to the scope of clinical evidence available, accepted standards of medical care in practice, the product's cost effectiveness, whether the product is experimental or investigational, impact on health outcomes and whether the product is not otherwise excluded from coverage by law or regulation. The coverage process for Medicare reimbursement is legislated by Congress and administered by the Centers for Medicare and Medicaid Services (CMS), and is highly variable in the commercial market. There may be significant delays in obtaining coverage for newly-approved products, and coverage may be more limited than the purposes for which the product is approved or cleared by FDA. Even when we obtain authorization from the FDA or a foreign authority to begin commercial distribution, there may be limited demand for the device until reimbursement approval has been obtained from governmental and private third-party payers. Moreover, eligibility for coverage does not imply that a product will be reimbursed in all cases or at a rate that allows us to market our EECP(R) systems at a price that will enable us to make a profit or even cover our costs. Reimbursement rates may vary according to the use of the product and the clinical setting in which it is used, may be based on payments allowed for lower-cost products that are already reimbursed, may be incorporated into existing payments for other products or services, and may reflect budgetary constraints and/or imperfections in Medicare or Medicaid data. Even if successful, demand for products may be driven more by the scope of peer-reviewed evidence and acceptance, endorsement by regulatory and clinical bodies, or foreign country authorities than by the reimbursement rates available. Securing coverage at adequate reimbursement rates from government and third party payers can be a time consuming and costly process that could require us to provide supporting scientific, clinical, and cost-effectiveness data for the use of our products to each payer. Our inability to promptly obtain coverage and profitable reimbursement rates from government-funded and private payers for our products could have a material adverse effect on our financial condition and operating results. Our reimbursement strategies are currently focused in the following primary areas: expanding Medicare coverage to include congestive heart failure and mild angina, expanding coverage with other third-party payers, expanding Medicare coverage for angina and obtaining coverage in selected international markets. Current Medicare Coverage in Angina In February 1999, CMS, the federal agency that administers the Medicare program for more than 39 million beneficiaries, issued a national coverage policy under HCPCS code G0166 for the use of the EECP(R) therapy system. Key excerpts from the coverage read as follows: "Although ECP devices are cleared by the Food and Drug Administration (FDA) for use in treating a variety of cardiac conditions, including stable or unstable angina pectoris, acute myocardial infarction and cardiogenic shock, the use of this device to treat cardiac conditions other than stable angina pectoris is not covered, since only that use has developed sufficient evidence to demonstrate its medical effectiveness." "for patients who have been diagnosed with disabling angina (class III or class IV, Canadian Cardiovascular Society Classification or equivalent classification) who, in the opinion of a cardiologist or cardiothoracic surgeon, are not readily amenable to surgical interventions such as balloon angioplasty and cardiac bypass because: 1. their condition is inoperable, or at high risk of operative complications or post-operative failure; 2. their coronary anatomy is not readily amenable to such procedures; or 3. they have co-morbid states, which create excessive risk." The 2008 national average payment rate per hourly session in the physician office setting and the hospital outpatient facility is approximately $156.16 and $109.47, respectively. Reimbursement rates vary throughout the country and range from $98 to $215 per hourly session. The 2007 national average payment rate per hourly session in the physician office setting and the hospital outpatient facility was approximately $147 and $107, respectively. Reimbursement rates varied throughout the country and range from $98 to $215 per hourly session. Under the Medicare program, physician reimbursement of the provision of EECP(R) therapy is higher if the therapy is performed in a physician office setting as compared to a hospital outpatient facility in order to reflect higher costs 16 associated with the physician office. Since January 2000, the national average payment rate has varied considerably. The initial national average payment rate for the physician office setting and the hospital outpatient facility in 2000 was approximately $130 and $112, respectively per hourly session. The average payment rate for the physician office setting climbed to $208 per treatment session in 2003 before being reduced approximately 37% in 2004 to $132 per treatment session. In 2005 the physician rate increased approximately 5% and remained unchanged in 2006. The average payment rate for the hospital outpatient facility declined steadily to 2005 before increasing approximately 2% in 2006. In order to bill and receive payment from Medicare, an individual or entity must be enrolled in the Medicare program for EECP(R) therapy. The physician office setting and the hospital outpatient facility are the only entities currently authorized to receive reimbursement for the EECP(R) therapy under the Medicare program and reimbursement is not permitted to other individuals or entity types, which include, but are not limited to, nurse practitioners, physical therapists, ambulatory surgery centers, nursing homes, comprehensive outpatient rehabilitation facilities, outpatient dialysis facilities, and independent diagnostic testing facilities. For each of these provider types there is statutory authorization and accompanying regulations that govern the terms and conditions of Medicare program participation. If there were any material change in the availability of Medicare coverage, or if the reimbursement level for treatment procedures using the EECP(R) therapy system is determined to be inadequate, it would adversely affect our business, financial condition and results of operations. Moreover, we are unable to forecast what additional legislation or regulation, if any, relating to the health care industry or Medicare coverage and payment level may be enacted in the future, or what effect such legislation or regulation would have on us. Application to Expand Medicare Coverage to include Class II Angina and Class II/III CHF On May 31, 2005, we submitted an application to CMS to expand the national coverage policy for external counterpulsation treatment to patients with Canadian Cardiovascular Class II stable angina and to patients with NYHA Class II and III stable heart failure symptoms with an ejection fraction less than 35%. On June 20, 2005, CMS accepted our application for expansion of reimbursement coverage of EECP(R) therapy to include patients with NYHA Class II/III stable heart failure symptoms with an ejection fraction of less than or equal to 35%, i.e. chronic, stable, mild-to-moderate systolic heart failure as a primary indication, as well as patients with CCSC II, i.e. chronic, stable mild angina. On June 23, 2005, CMS also received a request from a competing manufacturer of external counterpulsation therapy equipment, to reconsider the reimbursement coverage policy. They requested expansion of coverage to include 1) treatment of congestive heart failure, to include NYHA Class II, III with a left ventricular ejection fraction (LVEF) less than or equal to 40%, and acute heart failure; 2) treatment of stable angina to include CCSC II angina; 3) treatment of acute myocardial infarction; 4) treatment of cardiogenic shock. On September 15, 2005, they amended their request to include NYHA Class IV heart failure. On March 20, 2006, CMS issued their Decision Memorandum regarding this reconsideration with the opinion "that the evidence is not adequate to conclude that external counterpulsation therapy is reasonable and necessary for the treatment of: o CCSC II angina o Heart Failure o NYHA Class II/III stable heart failure symptoms with an ejection fraction of less than or equal to 35% o NYHA Class II/III stable heart failure symptoms with an ejection fraction of less than or equal to 40% o NYHA Class IV heart failure o Acute heart failure o Cardiogenic shock o Acute myocardial infarction." They commented in their decision memorandum that they were not able to apply full weight to the evidence generated by the PEECH(TM) trial, as it had not yet been published in a peer-reviewed medical journal by the time they were required to issue a final decision on this application. Moreover, they did not 17 opine on whether they would consider the results of the trial when published to be sufficient evidence to conclude that external counterpulsation therapy is reasonable and necessary for the treatment of NYHA Class II/III stable heart failure symptoms with an ejection fraction of less than or equal to 35%. They did, however, reiterate in the decision memorandum that "Current coverage as described in Section 20.20 of the Medicare National Coverage Determination (NCD) manual will remain in effect" for refractory angina patients. On August 25, 2006, the results of the trial were initially published on line by the Journal of the American College of Cardiology (JACC), and in print in its September 19, 2006 issue. JACC is the official journal of the American College of Cardiology. In the November-December issue of the journal Congestive Heart Failure, a second report of results from the PEECH(TM) trial was published, focusing on the results of a prespecified subgroup analysis in trial patients age 65 and over. This analysis demonstrated a statistically positive response on both co-primary endpoints of the trial in patients receiving EECP(R) therapy versus those who did not, i.e. a significantly larger proportion of patients undergoing EECP(R) therapy met or exceeded prespecified thresholds of improvement in exercise duration and peak oxygen consumption. Moreover, the patients age 65 and older who received EECP(R) therapy demonstrated the greatest differences in exercise duration, peak oxygen consumption and functional class (symptom status) compared with those who did not receive EECP(R) therapy. These papers were submitted to CMS and we were advised to continue to gather more clinical evidence for future submission. We will continue to educate the marketplace that EECP(R) therapy is a therapy for ischemic cardiovascular disease and that patients with a primary diagnosis of heart failure, diabetes, peripheral vascular disease, etc. are also eligible for reimbursement under the current coverage policy, provided the primary indication for treatment with EECP(R) therapy is angina or angina equivalent symptoms and the patient satisfies other listed criteria. Additionally, we will continue to pursue expansion of coverage for EECP(R) therapy with Medicare and other third-party payers as evidence of its clinical utility develops. Expanding Coverage with Other Third-Party Payers Some private insurance carriers continue to adjudicate EECP(R) treatment claims on a case-by-case basis. Since the establishment of reimbursement by the federal government, however, an increasing number of these private carriers now routinely pay for use of EECP(R) therapy for the treatment of angina and have issued positive coverage policies, which are generally similar to Medicare's coverage policy in scope. We estimate that over 300 private insurers are reimbursing for EECP(R) therapy for the treatment of angina today at favorable payment levels and we expect that the number of private insurers and their related health plans that provide for EECP(R) therapy as a covered benefit will continue to increase. In addition, we are aware of two third-party payers that have begun limited coverage of EECP(R) therapy for the treatment of CHF. We intend to pursue a constructive dialogue with many private insurers for the establishment of positive and expanded coverage policies for EECP(R) treatment that include CHF patients. If there were any material change in the availability of third-party private insurers or the adequacy of the reimbursement level for treatment procedures using the EECP(R) therapy system, it would adversely affect our business, financial condition and results of operations. Moreover, we are unable to forecast what additional legislation or regulation, if any, relating to the health care industry or third-party private insurers coverage and payment levels may be enacted in the future or what effect such legislation or regulation would have on us. Reimbursement in International Markets The reimbursement environment for EECP(R) therapy in international markets is fragmented and coverage varies as a mix of available private and public healthcare providers may not yet be aware of coverage of this therapy. Our reimbursement strategy has been opportunistic and responsive to the selling opportunities presented through our distribution partners. During this fiscal 18 year our efforts on behalf of EECP(R) therapy in both the private and public healthcare sectors of selected international markets have been initiated by our distributors, in support of the therapy, in their designated territory. Additionally, efforts have been initiated to obtain coverage in the public sector in certain overseas markets; however, we do not anticipate an impact on financial performance in the next fiscal year, given the long lead times from submission to approval of international dossiers for each reimbursement authority. Patents and Trademarks We own eleven US patents including eight utility and three design patents that expire at various times between 2008 and 2021. In addition, more than 20 foreign patents have been issued that expire at various times from 2008 to 2022. We are also planning to file other patent applications regarding specific enhancements to the current EECP(R) models, future generation products, and methods of treatment in the future. Moreover, trademarks have been registered for the names "EECP(R)" and "Natural Bypass". We pursue a policy of seeking patent protection, both in the US and abroad, for our proprietary technology. We believe that we have a solid patent foundation in the field of external counterpulsation devices and that the number of patents and applications demonstrates our technical leadership, dating back to the mid-1980s. Our patent portfolio focuses on the areas of external counterpulsation control and the overall design and arrangement of the external counterpulsation apparatus, including the console, treatment bed, fluid distribution, and inflatable cuffs. None of our current competitors have a significant patent portfolio in the area of external counterpulsation devices. There can be no assurance that our patents will not be violated or that any issued patents will provide protection that has commercial significance. As with any patented technology, litigation could be necessary to protect our patent position. Such litigation can be costly and time-consuming, and there can be no assurance that we will be successful. The loss or violation of our EECP(R) patents and trademarks could have a material adverse effect upon our business. Employees As of May 31, 2008, we employed 24 full-time and 1 part-time persons with 4 in direct sales, sales and clinical applications support, 9 in manufacturing, quality control and technical service, 3 in marketing and customer support, 2 in engineering, regulatory and clinical research and 7 in administration. None of our employees are represented by a labor union. We believe that our employee relations are good. Manufacturing Under our Supplier Agreement with Living Data Technology Corporation dated June 21, 2007, Living Data is our exclusive supplier for the ECP therapy systems that we market under the registered trademark EECP(R). Living Data has represented to us that it is in compliance in all material respects with all applicable laws, rules and regulations, and has obtained all the necessary licenses, permits, consents and approvals necessary for it to provide the products and services specified under the Supplier Agreement. Under the agreement with Living Data, we continue to manufacture products from our existing inventory, as well as other products, at our leased facility located in Westbury, New York. RISK FACTORS Investing in our common stock involves risk. You should carefully consider the following information about these risks together with the other information contained in this Report. If any of the following risks actually occur, our business could be harmed. This could cause the price of our stock to decline, and you may lose part or all of your investment. 19 Financial Risks We have incurred recurring losses over the past few years and may continue to sustain losses, which could result in a further decline in the value of our common stock. During the last few fiscal years we incurred large operating losses. We currently anticipate that we may continue to sustain operating losses. Our ability to achieve profitability is largely dependent on our ability to reduce operating costs sufficiently, as well as halting the current trend of declining revenue. Our ability to maintain our current base of revenue and increase revenue is largely dependent upon restructuring our sales and marketing efforts in the angina market where reimbursement is currently available and operating in a more efficient manner. Risks Related to Our Business We are materially dependent on medical reimbursement for treatment procedures using EECP(R) therapy on patients with congestive heart failure in order to achieve growth. We are currently dependent on a single product platform which, based on current medical reimbursement policies, provides coverage for a restricted class of heart patients. On May 31, 2005, we submitted an application to CMS to expand the national coverage policy for external counterpulsation treatment to patients with Canadian Cardiovascular Class II stable angina and to patients with New York Heart Association (NYHA) Class II and III stable heart failure symptoms with an ejection fraction less than 35%. The application was accepted by CMS effective June 20, 2005, and CMS announced their decision to maintain the existing coverage as stated prior to the application and not to expand it to include Class II Angina and Class II/III CHF on March 20, 2006. Results of the PEECH(TM) trial have been published in the Journal of the American College of Cardiology in September 2006, and the subgroup analysis of CHF patients age 65 and over has also been published in the November-December 2006 issue of the Journal of Congestive Heart Failure. These two papers have been submitted to CMS for reconsideration of our application. We had met with representatives from CMS in February 2007 and presented our case. CMS has requested additional data from us. We will continue our dialogue with CMS to obtain coverage for heart failure patients. However, there is no assurance that the Company will have sufficient resources to gather the necessary data to be sufficient to support expansion of the Medicare National Coverage Policy for EECP(R) treatment for NYHA class II and III heart failure patients. If we do not receive medical coverage for treatment procedures using EECP(R) therapy on patients with CHF, it will adversely affect our future business prospects. Material changes in the availability of Medicare, Medicaid or third-party reimbursement at adequate price levels could adversely affect our business. Health care providers, such as hospitals and physician private practices, that purchase or lease medical devices such as the EECP(R) therapy system for use on their patients generally rely on third-party payers, principally Medicare, Medicaid and private health insurance plans, to reimburse all or part of the costs and fees associated with the procedures performed with these devices. If there were any material change in the availability of Medicare, Medicaid or other third-party coverage or the adequacy of the reimbursement level for treatment procedures using the EECP(R) therapy system, it would adversely affect our business, financial condition and results of operations. Moreover, we are unable to forecast what additional legislation or regulation, if any, relating to the health care industry or Medicare or Medicaid coverage and payment level may be enacted in the future or what effect such legislation or regulation would have on our business. Even if a device has FDA clearance, Medicare, Medicaid and other third-party payers may deny reimbursement if they conclude that the device is not "reasonable and necessary" according to their criteria. In addition, reimbursement may not be at, or remain at, price levels adequate to allow medical professionals and hospitals to realize an appropriate return on the purchase of our products. Increased acceptance by the medical community is important for growth. While many abstracts and publications are presented each year at major scientific meetings worldwide with respect to EECP(R) treatment efficacy, there is continued skepticism concerning EECP(R) therapy methodology. The American Heart Association and the American College of Cardiology Practice Guidelines 20 currently list EECP(R) as a therapy currently under investigation for treatment of heart failure and have a classification rating of IIb as a treatment for patients who are refractory to medical therapy and are not candidates for percutaneous intervention or revascularization. A classification rating of IIb indicates the usefulness/efficacy of EECP(R) therapy is less well established by evidence/opinion. The medical community utilizes these guidelines when considering the various treatment options for their patients. Certain cardiologists, in cases where the EECP(R) therapy is a viable alternative, still appear to prefer percutaneous coronary interventions (e.g. balloon angioplasty and stenting) and cardiac bypass surgery for their patients. Additional evidence regarding the efficacy of EECP(R) therapy continues to evolve, however the evidence may not be sufficient to warrant a modification of these guidelines to a more favorable recommendation and increased acceptance by the medical community. We are dependent on consistency of favorable research findings about EECP(R) therapy and increasing acceptance of EECP(R) therapy as a safe, effective and cost effective alternative to other available products by the medical community for growth. We face competition from other companies and technologies. We compete with at least five other companies that are marketing external counterpulsation devices. We do not know whether these companies or other potential competitors who may be developing external counterpulsation devices, may succeed in developing technologies or products that are more efficient than those offered by us, and that would render our technology and existing products obsolete or non-competitive. Potential new competitors may also have substantially greater financial, manufacturing and marketing resources than those possessed by us. In addition, other technologies or products may be developed that have an entirely different approach or means of accomplishing the intended purpose of our products. Accordingly, the life cycles of our products are difficult to estimate. To compete successfully, we must keep pace with technological advancements, respond to evolving consumer requirements and achieve market acceptance. As of June 2007, the Company entered into a distribution and supplier agreement with Living Data Technology Corporation, a competitor as of May 31, 2007. This arrangement has subsequently reduced the competitors to at least four other companies. We may not continue to receive necessary FDA clearances or approvals, which could hinder our ability to market and sell our products. If we modify our external counterpulsation devices and the modifications significantly affect safety or effectiveness, or if we make a change to the intended use, we will be required to submit a new premarket notification or 510(k) to FDA. We would be unable to market the modified device until FDA issues a clearance for the 510(k). Additionally, if FDA publishes a regulation requiring a premarket approval application or PMA for external counterpulsation devices, we would then need to submit a PMA, and have it filed by the agency, by the date specified by FDA in its regulation. A PMA requires us to prove the safety and effectiveness of a device to the FDA. The process of obtaining PMA approval is expensive, time-consuming, and uncertain. If FDA were to require a PMA application, we may be required to undertake a clinical study, which likely will be expensive and require lengthy follow-up, to demonstrate the effectiveness of the device. If we did obtain PMA approval, any change after approval affecting the safety or effectiveness of the device will require approval of a PMA supplement. If we offer new products that require 510(k) clearance or PMA approval, we will not be able to commercially distribute those products until we receive such clearance or approval. Regulatory agency approval or clearance for a product may not be received or may entail limitations on the device's indications for use that could limit the potential market for any such product. Delays in receipt of, or failure to obtain or maintain, regulatory clearances and approvals, could delay or prevent our ability to market or distribute our products. Such delays could have a material adverse effect on our business. If we are unable to comply with applicable governmental regulation, we may not be able to continue our operations. We also must comply with Current Good Manufacturing Practice (CGMP) requirements as set forth in the Quality System Regulation (QSR) to receive FDA approval to market new products and to continue to market current products. The 21 QSR imposes certain procedural and documentation requirements on us with respect to manufacturing and quality assurance activities, including packaging, storage, and record keeping. Our products and activities are subject to extensive, ongoing regulation, including regulation of labeling and promotion activities and adverse event reporting. Also, our FDA registered facilities are subject to inspection by the FDA and other governmental authorities. Any failure to comply with regulatory requirements could delay or prevent our ability to market or distribute our products. Violation of FDA statutory or regulatory requirements could result in enforcement actions, such as voluntary or mandatory recalls, suspension or withdrawal of marketing clearances or approvals, seizures, injunctions, fines, civil penalties, and criminal prosecutions, all of which could have a material adverse effect on our business. Most states also have similar postmarket regulatory and enforcement authority for devices. We cannot predict the nature of any future laws, regulations, interpretations, or applications, nor can we predict what effect additional governmental regulations or administrative orders, when and if promulgated, would have on our business in the future. We may be slow to adapt, or we may never adapt to changes in existing requirements or adoption of new requirements or policies. We may incur significant costs to comply with laws and regulations in the future or compliance with laws or regulations may create an unsustainable burden on our business. We may not receive approvals by foreign regulators that are necessary for international sales. Sales of medical devices outside the United States are subject to foreign regulatory requirements that vary from country to country. Premarket approval or clearance in the United States does not ensure regulatory approval by other jurisdictions. If we, or any international distributor, fail to obtain or maintain required pre-market approvals or fail to comply with foreign regulations, foreign regulatory authorities may require us to file revised governmental notifications, cease commercial sales of our products in the applicable countries or otherwise cure the problem. Such enforcement action by regulatory authorities may be costly. In order to sell our products within the European Union, we must comply with the European Union's Medical Device Directive. The CE marking on our products attests to this compliance. Future regulatory changes may limit our ability to use the CE mark, and any new products we develop may not qualify for the CE mark. If we lose this authorization or fail to obtain authorization on future products, we will not be able to sell our products in the European Union. We depend on Living Data for the supply of our ECP therapy systems. Under our Supplier Agreement with Living Data Technology Corporation dated June 21, 2007, Living Data is our exclusive supplier for the ECP therapy systems that we market under the registered trademark EECP(R). With certain exceptions, including the use of existing inventory, we are required to purchase this product from Living Data at specified prices. While we do not foresee any difficulties in timely receiving products at competitive prices, this inability would adversely affect our business. We depend on management and other key personnel. We are dependent on a limited number of key management and technical personnel. The loss of one or more of our key employees may hurt our business if we are unable to identify other individuals to provide us with similar services. We do not maintain "key person" insurance on any of our employees. In addition, our success depends upon our ability to attract and retain additional highly qualified sales, management, manufacturing and research and development personnel. We face competition in our recruiting activities and may not be able to attract or retain qualified personnel. We may not have adequate intellectual property protection. Our patents and proprietary technology may not be able to prevent competition by others. The validity and breadth of claims in medical technology patents involve complex legal and factual questions. Future patent applications may not be issued, the scope of any patent protection may not exclude competitors, and our patents may not provide competitive advantages to us. Our patents may be found to be invalid and other companies may claim rights in or ownership of the patents and other proprietary rights held or licensed by us. Also, our existing patents may not cover products that we develop in the future. Moreover, when our patents expire, the inventions will enter the public domain. There can be no assurance that our patents will not be violated or that any issued patents will provide protection that has commercial significance. Litigation may be necessary to protect our patent position. Such litigation may be costly and time-consuming, and there can be no assurance that we will be successful in such litigation. The loss or violation of certain of our patents and trademarks could have a material adverse effect upon our business. 22 Since patent applications in the United States are maintained in secrecy until such patent applications are issued, our current product development may infringe patents that may be issued to others. If our products were found to infringe patents held by competitors, we may have to modify our products to avoid infringement, and it is possible that our modified products would not be commercially successful. We do not intend to pay dividends in the foreseeable future. We do not intend to pay any cash dividends on our common stock in the foreseeable future. Risks Related to Our Industry Technological change is difficult to predict and to manage. We face the challenges that are typically faced by companies in the medical device field. Our product line has required, and any future products will require, substantial development efforts and compliance with governmental clearance or approval requirements. We may encounter unforeseen technological or scientific problems that force abandonment or substantial change in the development of a specific product or process. We are subject to product liability claims and product recalls that may not be covered by insurance. The nature of our business exposes us to risks of product liability claims and product recalls. Medical devices as complex as ours frequently experience errors or failures, especially when first introduced or when new versions are released. We currently maintain product liability insurance at $7,000,000 per occurrence and $7,000,000 in the aggregate. Our product liability insurance may not be adequate. In the future, insurance coverage may not be available on commercially reasonable terms, or at all. In addition, product liability claims or product recalls could damage our reputation even if we have adequate insurance coverage. We do not know the effects of healthcare reform proposals. The healthcare industry is undergoing fundamental changes resulting from political, economic and regulatory influences. In the United States, comprehensive programs have been suggested seeking to increase access to healthcare for the uninsured, control the escalation of healthcare expenditures within the economy and use healthcare reimbursement policies to balance the federal budget. We expect that the United States Congress and state legislatures will continue to review and assess various healthcare reform proposals, and public debate of these issues will likely continue. There have been, and we expect that there will continue to be, a number of federal and state proposals to constrain expenditures for medical products and services, which may affect payments for products such as ours. We cannot predict which, if any of such reform proposals will be adopted and when they might be effective, or the effect these proposals may have on our business. Other countries also are considering health reform. Significant changes in healthcare systems could have a substantial impact on the manner in which we conduct our business and could require us to revise our strategies. Risks Related to our Securities The application of the "penny stock" rules could adversely affect the market price of our common stock and increase your transaction costs to sell those shares. As long as the trading price of our common shares is below $5 per share, the open-market trading of our common shares will be subject to the "penny stock" rules. The "penny stock" rules impose additional sales practice requirements on broker-dealers who sell securities to persons other than established customers and accredited investors (generally those with assets in excess of $1,000,000 or annual income exceeding $200,000 or $300,000 together with their spouse). For transactions covered by these rules, the broker-dealer must make a special suitability determination for the purchase of securities and have received the purchaser's written consent to the transaction before the purchase. Additionally, for any transaction involving a penny stock, unless 23 exempt, the broker-dealer must deliver, before the transaction, a disclosure schedule prescribed by the Securities and Exchange Commission relating to the penny stock market. The broker-dealer also must disclose the commissions payable to both the broker-dealer and the registered representative and current quotations for the securities. Finally, monthly statements must be sent disclosing recent price information on the limited market in penny stocks. These additional burdens imposed on broker-dealers may restrict the ability or decrease the willingness of broker-dealers to sell our common shares, and may result in decreased liquidity for our common shares and increased transaction costs for sales and purchases of our common shares as compared to other securities. Our common stock is subject to price volatility. The market price of our common stock historically has been and may continue to be highly volatile. Our stock price could be subject to wide fluctuations in response to various factors beyond our control, including, but not limited to: o medical reimbursement; o quarterly variations in operating results; o announcements of technological innovations, new products or pricing by our competitors; o the rate of adoption by physicians of our technology and products in targeted markets; o the timing of patent and regulatory approvals; o the timing and extent of technological advancements; o results of clinical studies; o the sales of our common stock by affiliates or other shareholders with large holdings; and o general market conditions. Our future operating results may fall below the expectations of securities industry analysts or investors. Any such shortfall could result in a significant decline in the market price of our common stock. In addition, the stock market has experienced significant price and volume fluctuations that have affected the market price of the stock of many medical device companies and that often have been unrelated to the operating performance of such companies. These broad market fluctuations may directly influence the market price of our common stock. Additional Information We are subject to the reporting requirements under the Securities Exchange Act of 1934 and are required to file reports and information with the Securities and Exchange Commission (SEC), including reports on the following forms: annual report on Form 10-KSB, quarterly reports on Form 10-QSB, current reports on Form 8-K, and amendments to those reports files or furnished pursuant to Section 13(a) or 15(d) of the Securities Act of 1934.

ITEM 2 - DESCRIPTION OF PROPERTY We have historically owned our 18,000 square foot headquarters and manufacturing facility at 180 Linden Avenue, Westbury, New York 11590. Additionally, we leased approximately 3,500 square feet of additional warehouse space under an operating lease with a non-affiliated landlord that expired in September 2006, which we did not renew. On August 15, 2007, we sold our facility under a five-year leaseback agreement for $1.4 million. The net proceeds from the sale was approximately $425,000, after payment in full of the two secured notes on our facility, brokers fees, closing costs, and the opening of a certificate of deposit in accordance with the provisions of the new lease. The annual rental expense for the lease is approximately $138,600. We believe that our current facility is adequate to meet our current needs and should continue to be adequate for the immediately foreseeable future. 24 ITEM 3 - LEGAL PROCEEDINGS There were no material legal proceedings under applicable rules. ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year. 25 PART II ITEM 5 - MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES Our common stock currently trades on the Over-the-Counter Bulletin Board under the symbol VASO.OB. On May 26, 2006, our common stock ceased trading on the Nasdaq Capital Market tier of the Nasdaq Stock Market and began trading on the NASD Pink Sheets. Effective June 20, 2006, our common stock began trading on the Over-the- Counter Bulletin Board (OTCBB). The number of record holders of common stock as of August 20, 2008, was approximately 1,043, which does not include approximately 17,079 beneficial owners of shares held in the name of brokers or other nominees. The table below sets forth the range of high and low trade prices of the common stock for the fiscal periods specified. Fiscal 2008 Fiscal 2007 ----------- ----------- High Low High Low First Quarter $0.19 $0.06 $0.17 $0.08 Second Quarter $0.13 $0.06 $0.15 $0.08 Third Quarter $0.10 $0.05 $0.12 $0.07 Fourth Quarter $0.09 $0.07 $0.09 $0.07 The last bid price of the Company's common stock on August 20, 2008, was $0.08 per share. Dividend Policy We have never paid any cash dividends on our common stock. While we do not intend to pay cash dividends in the foreseeable future, payment of cash dividends, if any, will be dependent upon our earnings and financial position, investment opportunities and such other factors as the Board of Directors deems pertinent. Stock dividends, if any, also will be dependent on such factors as the Board of Directors deems pertinent. Entry Into A Material Definitive Agreement On June 21, 2007, we entered into a Securities Purchase Agreement with Kerns Manufacturing Corp. (Kerns). Concurrently with our entry into the Securities Purchase Agreement, we also entered into a Distribution Agreement and a Supplier Agreement with Living Data Technology Corporation, an affiliate of Kerns (Living Data). We sold to Kerns, pursuant to the Securities Purchase Agreement, 21,428,572 shares of our common stock at $.07 per share for a total purchase price of $1,500,000, as well a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of $.08 per share (the Warrant). The agreement further provided for the appointment to our Board of Directors of two representatives from Kerns. In furtherance thereof, Mr. Jun Ma and Mr. Simon Srybnik, Chairman of both Kerns and Living Data, have been appointed members of our Board of Directors. Pursuant to the Distribution Agreement, we have become the exclusive distributor in the United States of the AngioNew ECP systems manufactured by Living Data. As additional consideration for such agreement, we agreed to issue an additional 6,990,840 shares of our common stock to Living Data. Pursuant to the Supplier Agreement, Living Data now is the exclusive supplier to us of the ECP therapy systems that we market under the registered trademark EECP(R). The Distribution Agreement and the Supplier Agreement each have an initial term extending through May 31, 2012. Pursuant to a Registration Rights Agreement, we granted to Kerns and Living Data, subject to certain restrictions, "piggyback registration rights" covering the shares sold to Kerns as well as the shares issuable upon exercise of the Warrant and the shares issued to Living Data. ITEM 6 - MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION This Management's Discussion and Analysis or Plan of Operations contains descriptions of our expectations regarding future trends affecting our business. 26 These forward looking statements and other forward-looking statements made elsewhere in this document are made under the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Please read the section titled "Risk Factors" in "Item One - Business" to review certain conditions, among others, which we believe could cause results to differ materially from those contemplated by the forward-looking statements. Except for historical information contained in this report, the matters discussed are forward-looking statements that involve risks and uncertainties. When used in this report, words such as "anticipates", "believes", "could", "estimates", "expects", "may", "plans", "potential" and "intends" and similar expressions, as they relate to the Company or its management, identify forward-looking statements. Such forward-looking statements are based on the beliefs of the Company's management, as well as assumptions made by and information currently available to the Company's management. Among the factors that could cause actual results to differ materially are the following: the effect of business and economic conditions; the effect of the dramatic changes taking place in the healthcare environment; the impact of competitive procedures and products and their pricing; medical insurance reimbursement policies; unexpected manufacturing or supplier problems; unforeseen difficulties and delays in the conduct of clinical trials and other product development programs; the actions of regulatory authorities and third-party payers in the United States and overseas; uncertainties about the acceptance of a novel therapeutic modality by the medical community; and the risk factors reported from time to time in the Company's SEC reports. The Company undertakes no obligation to update forward-looking statements as a result of future events or developments. The following discussion should be read in conjunction with the financial statements and notes thereto included in this Annual Report on Form 10-KSB. Overview Vasomedical, Inc. was incorporated in Delaware in July 1987. Unless the context requires otherwise, all references to "we", "our", "us", "Company", "registrant", "Vasomedical" or "management" refer to Vasomedical Inc. and its subsidiaries. Since 1995, we have been primarily engaged in designing, manufacturing, marketing and supporting EECP(R) enhanced external counterpulsation systems based on our unique proprietary technology currently indicated for use in cases of stable or unstable angina (i.e., chest pain), congestive heart failure (CHF), acute myocardial infarction (i.e., heart attack, (MI)) and cardiogenic shock. The EECP(R) therapy system is a non-invasive, outpatient therapy for the treatment of diseases of the cardiovascular system. The therapy serves to increase circulation in areas of the heart with less than adequate blood supply and helps to restore systemic vascular function. The therapy also increases blood flow and oxygen supply to the heart muscle and other organs and decreases the heart's workload and need for oxygen, while also improving function of the endothelium, the lining of blood vessels throughout the body, lessening resistance to blood flow. We provide hospitals, clinics and physician private practices with EECP(R) equipment, treatment guidance, and a staff training and equipment maintenance program designed to provide optimal patient outcomes. EECP(R) is a registered trademark for Vasomedical's enhanced external counterpulsation systems. For more information, visit www.vasomedical.com. We have Food and Drug Administration (FDA) clearance to market our EECP(R) therapy for use in the treatment of stable and unstable angina, congestive heart failure, acute myocardial infarction, and cardiogenic shock, however, our current marketing efforts are limited to the treatment of chronic stable angina and congestive heart failure. Medicare and other third-party payers currently reimburse for the treatment of angina symptoms in patients with moderate to severe symptoms who are refractory to medications and not candidates for invasive procedures, including patients with serious comorbidities, such as heart failure, diabetes, peripheral vascular disease, etc. Patients with primary diagnoses of heart failure, diabetes, peripheral vascular disease, etc. are also reimbursed under the same criteria, provided the primary indication for treatment with EECP(R) therapy is angina symptoms. During the last two fiscal years ended May 31, 2008 and 2007 we incurred large operating losses. We attempted to achieve profitability by reducing operating costs and halting the trend of declining revenue, to reduce cash usage through bringing our cost structure more into alignment with current revenue by engaging in restructurings during January 2006, March 2007 and April 2007 to substantially reduce personnel and spending on sales, marketing and development projects. In addition, we were seeking to obtain a strategic alliance within the sales and marketing areas and/or to raise additional capital through public or private equity or debt financings. 27 During the first quarter of fiscal year 2008 the following events took place which allowed us to raise additional capital through a private equity financing and by the sale of our facility under a leaseback agreement. o On June 21, 2007, we entered into a Securities Purchase Agreement with Kerns Manufacturing Corp. (Kerns). Concurrently with our entry into the Securities Purchase Agreement, we also entered into a Distribution Agreement and a Supplier Agreement with Living Data Technology Corporation, an affiliate of Kerns (Living Data). We sold to Kerns, pursuant to the Securities Purchase Agreement, 21,428,572 shares of our common stock at $.07 per share for an aggregate of $1,500,000, as well a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of $.08 per share (the Warrant). The agreement further provided for the appointment to our Board of Directors of two representatives of Kerns. In furtherance thereof, Mr. Jun Ma and Mr. Simon Srybnik, Chairman of both Kerns and Living Data, have been appointed members of our Board of Directors. Pursuant to the Distribution Agreement, we have become the exclusive distributor in the United States of the AngioNew ECP systems manufactured by Living Data. As additional consideration for such agreement, we agreed to issue an additional 6,990,840 shares of our common stock to Living Data. Pursuant to the Supplier Agreement, Living Data now is the exclusive supplier to us of the ECP therapy systems that we market under the registered trademark EECP(R). The Distribution Agreement and the Supplier Agreement each have an initial term extending through May 31, 2012. Pursuant to a Registration Rights Agreement, we granted to Kerns and Living Data, subject to certain restrictions, "piggyback registration rights" covering the shares sold to Kerns as well as the shares issuable upon exercise of the Warrant and the shares issued to Living Data. o On August 15, 2007, we sold our facility under a five-year leaseback agreement for $1.4 million. The net proceeds from the sale were approximately $425,000, after payment in full of the two secured notes on our facility, brokers fees, closing costs, and the opening of a certificate of deposit in accordance with the provisions of the new lease. Results of Operations Fiscal Years Ended May 31, 2008 and 2007 Net revenue from sales, leases and service of our EECP(R) systems for the fiscal years ended May 31, 2008 and 2007, was $5,182,768 and $6,354,083, respectively, which represented a decline of $1,171,315, or 18%. We reported a net loss attributable to common stockholders of $676,965 and $1,571,066 for fiscal 2008 and 2007, respectively. The decrease in the net loss was primarily due to the significant decrease in our operating expenses from the comparative prior period, offset slightly by the decrease in revenue. Our net loss per diluted common share was $0.01 for the fiscal year ended May 31, 2008 compared to a net loss of $0.02 per diluted common share for the fiscal year ended May 31, 2007. Revenues Revenue from equipment sales declined approximately 18% to $2,087,365 for the fiscal year ended May 31, 2008 as compared to $2,561,064 for the prior year. The decline in equipment sales is due primarily to a 33% decrease in average sales prices, which is attributable to a large number of system upgrades or trade-ups of older EECP models from existing customers. Although the average sales price decreased domestically and internationally, generating lower revenue per unit, the number of unit sales for new and used equipment increased by approximately 53% within the domestic market while remaining constant for the international market. 28 We believe the decline in the sales price per unit reflects weakened demand in the refractory angina market as existing capacity is more fully utilized, coupled with increased direct and indirect competition. We anticipate that demand for EECP(R) systems will remain soft unless there is greater clinical acceptance for the use of EECP(R) therapy in treating patients with angina or angina equivalent symptoms who meet the current reimbursement guidelines or an expansion of the current CMS national reimbursement policy to include some or all Class II & III heart failure patients. Patients with angina or angina equivalent symptoms eligible for reimbursement under current policies include many with serious comorbidities, such as heart failure, diabetes, peripheral vascular disease and/or others. Despite this, many cardiology clinicians appear to be waiting for approval of reimbursement coverage for heart failure as a primary indication before they will move forward with the treatment of ischemic heart failure patients with angina equivalent symptoms. Reluctance to bill for ischemic heart failure patients under the current coverage guidelines, and failure to get or maintain adequate reimbursement coverage for angina and heart failure would adversely affect our business prospects. We anticipate that a prevailing trend of declining prices will continue in the immediate future as our competition attempts to capture greater market share through pricing discounts. The average price of new systems sales declined by 33% which was mainly due to a large number of system upgrades or trade-ups of older EECP models from existing customers, in fiscal 2008 compared to the prior year and the average sales price of used systems declined 37% in fiscal 2008. We continue to reorganize certain territory responsibilities in our sales department due to vacant and/or unproductive territories. Our revenue from the sale of EECP(R) systems and related products to international distributors in fiscal 2008 decreased approximately 16% to $836,000 compared to $991,000 in the prior year reflecting decreased sales volume. Our revenue from equipment rental and services decreased 18% to $3,095,403 in fiscal 2008 from $3,793,019 in fiscal year 2007. Revenue from equipment rental and services represented 60% of total revenue in fiscal 2008 and fiscal 2007. The decrease in revenue generated from equipment rentals and services is due to a decrease in the service business compared to the prior fiscal year. The decline was also due to a decrease in the rental install base from the prior fiscal year ended May 31, 2007. Gross Profit Gross profit declined to $2,352,398, or 45% of revenues for fiscal 2008 compared to $3,450,970 or 54% of revenues for fiscal 2007. The decrease of gross profit margin as a percentage of revenue for fiscal 2008 compared to the prior fiscal year was due mainly to the higher unabsorbed fixed production cost associated with reduced production volume, and the effects of SFAS No. 151, which decreased the amount of fixed costs absorbed into inventory in fiscal 2008. The decline in gross profit when compared to the prior year in absolute dollars is principally due to the lower sales price per unit from fiscal 2007. Gross profits are dependent on a number of factors, particularly the mix of EECP(R) models sold domestically and internationally and their respective average selling prices, the mix of EECP(R) units sold, rented or placed during the period, the ongoing costs of servicing such units, and certain fixed period costs, including facilities, payroll and insurance. Gross profit margins are generally less on non-domestic business due to the use of distributors resulting in lower selling prices. Consequently, the gross profit realized during the current period may not be indicative of future margins. Selling, General and Administrative Selling, general and administrative ("SG&A") expenses for fiscal 2008 and 2007 were $2,626,045, or 51% of revenues, and $4,051,993, or 64% of revenues, respectively, reflecting a decrease of $1,425,525 or approximately 35%. The decrease in SG&A expenditures in fiscal 2008 resulted primarily from decreased direct expenditures of $576,729 due to reduced sales personnel and associated travel plus lower sales commission due to reduced sales price, offset by minimal increases in other sales related costs. Marketing expenses decreased $451,658 due to reduced expenditures in personnel and their associated costs in the marketing and clinical application support areas, as well as associated travel, plus lower market research, product promotion, advertising, and trade show expenses. Administrative expenses decreased $397,138 as a result of decreased expenditures in personnel and their associated costs, professional fees related to accounting, legal and consulting services, reversal of bad debt reserves, and insurance expenses offset slightly by increases in other administrative expenses. 29 During fiscal 2008 the Company reversed $42,837 of its provision for doubtful accounts compared to fiscal 2007 when the Company recorded a provision for doubtful accounts of $423. The reversal of the provision is primarily a result of the fiscal 2008 decrease in sales in addition to the continuous efforts to ensure collection of accounts receivable. Research and Development Research and development ("R&D") expenses of $474,111 or 9% of revenues for fiscal 2008 decreased by $459,205, or 49%, from $933,316, or 15% of revenues for the fiscal 2007. The decrease is primarily attributable to fewer engineering and clinical personnel and associated expenditures and reduced spending on clinical trials, offset by a slight increase in new product spending. Interest Expense and Financing Costs Interest expense and financing costs decreased to $16,616 for fiscal 2008 from $69,767 for the prior year. Interest expense primarily reflects interest on loans secured to refinance the November 2000 purchase of the Company's headquarters and warehouse facility. The decrease is a direct result of the sale-leaseback agreements for the Company's headquarters and warehouse facility which occurred during the first quarter of fiscal 2008. Interest and Other Income, Net Interest and other income for fiscal 2008 and 2007 were $61,083 and $53,648, respectively. Interest income primarily reflects interest earned on the Company's cash balances. Other income has been derived primarily from the liquidation of equipment and fixtures used in previously leased properties. Gain on Sale of Assets The Gain on Sale of Assets for fiscal 2008 of $44,371 resulted from the Company's sale-leaseback of its facility. Income Tax Expense, Net During fiscal 2008 and 2007 we recorded a provision for income taxes of $18,045 and $20,608, respectively. As of May 31, 2008, the recorded deferred tax assets were $19,819,352, reflecting an increase of $230,000 during the fiscal year ended May 31, 2008, which was offset by a valuation allowance of the same amount. Ultimate realization of any or all of the deferred tax assets is not assured due to significant uncertainties and material assumptions associated with estimates of future taxable income during the carryforward period. In November 2005, we concluded that, based upon the weight of available evidence, it was "more likely than not" that the net deferred tax asset would not be realized and increased the valuation allowance to bring the net deferred tax asset carrying value to zero. Liquidity and Capital Resources Cash and Cash Flow We have financed our operations primarily from working capital and in fiscal 2008 from a private equity financing and by the sale of our facility under a leaseback agreement. At May 31, 2008, we had cash and cash equivalents of $2,653,999 and working capital of $2,851,901 compared to cash and cash equivalents of $850,288 and working capital of $1,320,347 at May 31, 2007. 30 Cash used in operating activities was $32,021 during fiscal 2008, which consisted of a net cash loss after adjustments of $385,491 and cash provided by operating assets and liabilities of $353,470. The changes in the accounts balances primarily reflect lower inventory of $592,427 and increase in deferred revenues - LT and other liabilities of $15,982,which were partially offset by a decrease in accounts receivable of $27,031, a decrease in accounts payable, accrued expenses, deferred revenues - ST, and other current liabilities of $163,246 and lower other current assets of $24,172, as well as deferred distributor costs of $40,490. Net accounts receivable were 14% of revenues for the period ended May 31, 2008, as compared to 12% for the period ended May 31, 2007, and accounts receivable turnover decreased to 7.1 times as of May 31, 2008, as compared to 8.1 times as of May 31, 2007. Standard payment terms on our domestic equipment sales are generally net 30 to 90 days from shipment and do not contain "right of return" provisions. We have historically offered a variety of extended payment terms, including sales-type leases, in certain situations and to certain customers in order to expand the market for our EECP(R) products in the US and internationally. Such extended payment terms were offered in lieu of price concessions, in competitive situations, when opening new markets or geographies and for repeat customers. Extended payment terms cover a variety of negotiated terms, including payment in full - net 120, net 180 days or some fixed or variable monthly payment amount for a six to twelve month period followed by a balloon payment, if applicable.

During fiscal 2008 and 2007, there were no revenues generated from sales in which initial payment terms were greater than 90 days and we offered no sales-type leases during either period. In general, reserves are calculated on a formula basis considering factors such as the aging of the receivables, time past due, and the customer's credit history and their current financial status. In most instances where reserves are required, or accounts are ultimately written-off, customers have been unable to successfully implement their EECP(R) program. As we are creating a new market for the EECP(R) therapy and recognizing the challenges that some customers may encounter, we have opted, at times, on a customer-by-customer basis, to recover our equipment instead of pursuing other legal remedies, which has resulted in our recording of a reserve or a write-off. Investing activities provided net cash of $1,310,857 during the fiscal year ended May 31, 2008,I which represented proceeds received from the building sale, net of related costs. Our financing activities provided net cash of $524,875 during the fiscal year ended May 31, 2008, reflecting proceeds, net of related expenses, of $1,375,890 from the Securities Purchase Agreement, which was offset by loan repayments on the building of $851,015. Liquidity During the last two fiscal years ended May 31, 2008 and 2007, we incurred large operating losses. The Company attempted to achieve profitability by reducing operating costs and halting the trend of declining revenue, to reduce cash usage by bringing its cost structure more into alignment with current revenue by engaging in restructurings during January 2006, March 2007 and April 2007 to substantially reduce personnel and spending on sales, marketing and development projects. In addition, the Company was seeking to obtain a strategic alliance within the sales and marketing areas and/or to raise additional capital through public or private equity or debt financings. During the first quarter of fiscal year 2008 the following events took place which allowed us to raise additional capital through a private equity financing and by the sale of our facility under a leaseback agreement. o On June 21, 2007, we entered into a Securities Purchase Agreement with Kerns Manufacturing Corp. (Kerns). Concurrently with our entry into the Securities Purchase Agreement, we also entered into a Distribution Agreement and a Supplier Agreement with Living Data Technology Corporation, an affiliate of Kerns (Living Data). We sold to Kerns, pursuant to the Securities Purchase Agreement, 21,428,572 shares of our common stock at $.07, per share for a total purchase price of $1,500,000, as well a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of $.08 per share (the Warrant) . The agreement further provided for the appointment to our Board of Directors of two representatives from Kerns. In furtherance thereof, Mr. Jun Ma and Mr. Simon Srybnik, Chairman of both Kerns and Living Data, have been appointed members of our Board of Directors. Pursuant to the Distribution Agreement, we 31 have become the exclusive distributor in the United States of the AngioNew ECP systems manufactured by Living Data. As additional consideration for such agreement, we agreed to issue an additional 6,990,840 shares of our common stock to Living Data. Pursuant to the Supplier Agreement, Living Data now is the exclusive supplier to us of the ECP therapy systems that we market under the registered trademark EECP(R). The Distribution Agreement and the Supplier Agreement each have an initial term extending through May 31, 2012. Pursuant to a Registration Rights Agreement, we granted to Kerns and Living Data, subject to certain restrictions, "piggyback registration rights" covering the shares sold to Kerns as well as the shares issuable upon exercise of the Warrant and the shares issued to Living Data. o On August 15, 2007, we sold our facility under a five-year leaseback agreement for $1.4 million. The net proceeds from the sale were approximately $425,000 after payment in full of the two secured notes on our facility, brokers fees, closing costs, and the opening of a certificate of deposit in accordance with the provisions of the new lease. Based on the above transactions, we believe that we have sufficient working capital to continue our operations through at least May 31, 2009. Off-Balance Sheet Arrangements As part of our on-going business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities (SPES), which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of May 31, 2008, we are not involved in any unconsolidated SPES. Related Party Transactions As previously described, on June 21, 2007, we entered into a Securities Purchase Agreement with Kerns Manufacturing Corp. (Kerns). Concurrently with our entry into the Securities Purchase Agreement, we also entered into a Distribution Agreement and a Supplier Agreement with Living Data Technology Corporation, an affiliate of Kerns (Living Data). We sold to Kerns, pursuant to the Securities Purchase Agreement, 21, 428,572 shares of our common stock at $.07 per share, for an aggregate of $1,500,000 as well a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of $.08 per share (the Warrant). The agreement further provided for the appointment to our Board of Directors of two representatives from Kerns. In furtherance thereof, Mr. Jun Ma and Mr. Simon Srybnik, Chairman of both Kerns and Living Data, have been appointed members of our Board of Directors. Pursuant to the Distribution Agreement, we have become the exclusive distributor in the United States of the AngioNew ECP systems manufactured by Living Data. As additional consideration for such agreement, we agreed to issue an additional 6,990,840 shares of our common stock to Living Data. Pursuant to the Supplier Agreement, Living Data now will be the exclusive supplier to us of the ECP therapy systems that we market under the registered trademark EECP(R). The Distribution Agreement and the Supplier Agreement each have an initial term extending through May 31, 2012. Pursuant to a Registration Rights Agreement, we granted to Kerns and Living Data, subject to certain restrictions, "piggyback registration rights" covering the shares sold to Kerns as well as the shares issuable upon exercise of the Warrant and the shares issued to Living Data. 32 On July 10, 2007, the Board of Directors appointed Mr. Behnam Movaseghi, Treasurer and Chief Financial Officer of Kerns Manufacturing Corporation, to our Board of Directors. As affiliates of Living Data and Kerns, Mr. Ma, Mr. Movaseghi and Mr. Srybnik have each been directly involved in the transactions between Living Data and Kerns, and the Company, with respect to the Securities Purchase Agreement, the Distribution Agreement and the Supplier Agreement, as well as consulting servicesto the Company with no compensation. During fiscal 2008, the Company purchased ECP therapy systems under the Supplier Agreement for $120,000 from Living Data, which was paid in full by the Company as of June 2008. In addition, Living Data purchased $5,000 worth of ECP therapy system components from the Company, which was paid in full by Living Data as of June 2008. During fiscal 2009 Living Data assigned to Vasomedical, Inc. all of its rights and interests under its Distributorship Agreement with a corporation organized and existing under the laws of the People's Republic of China, that manufactures Ambulatory Blood Pressure Monitors, Ambulatory ECG Recorders and Holter & ABPM Combiner Recorders, for $20,000 payable to Living Data based on certain terms and conditions. Vasomedical Inc., also must pay to Living Data 5% of the selling price or 5% of the cost of all goods sold (whichever is higher), and 5% of the cost of all goods transferred but not sold under the Assignment Agreement to Living Data based on sales of this equipment. The Company intends to sell these systems in the United States and other countries subject to obtaining regulatory clearance. During fiscal 2009 Living Data assigned to Vasomedical, Inc. all of its rights and interests under its Distributorship Agreement with a corporation organized and existing under the laws of the People's Republic of China, that manufactures Ultrasound Scanners, for $20,000 payable to Living Data based on certain terms and conditions. Vasomedical Inc., also must pay to Living Data 5% of the selling price or 5% of the cost of all goods sold (whichever is higher), and 5% of the cost of all goods transferred but not sold under the Assignment Agreement to Living Data based on sales of this equipment. The Company intends to sell these systems in the United States and other countries subject to obtaining regulatory clearance. In July of 2008 Vasomedical, Inc. has agreed to purchase ECP therapy systems under its Distributorship Agreement with Living Data for $360,000 payable over 18 months. Further, Kerns is providing the Company, free of charge, part time use of one of its Information Technology (IT) employees as well one of their IT consultants to provide the Company with IT and database support services. In addition, a clinical applications support specialist and a service engineer from Living Data may be used by Vasomedical, Inc. to provide customers with clincial training and technical service. Effects of Inflation We believe that inflation and changing prices over the past three years have not had a significant impact on our revenue or on our results of operations. Critical Accounting Policies Financial Reporting Release No. 60, which was released by the Securities and Exchange Commission, or SEC, in December 2001, requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. Note B of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-KSB for the year ended May 31, 2008, includes a summary of our significant accounting policies and methods used in the preparation of our financial statements. In preparing these financial statements, we have made our best estimates and judgments of certain amounts included in the financial statements, giving due consideration to materiality. The application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. Our critical accounting policies are as follows: 33 Revenue Recognition The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or service has been rendered, the price is fixed or determinable and collectibility is reasonably assured. In the United States, we recognize revenue from the sale of our EECP(R) systems in the period in which we deliver the system to the customer. Revenue from the sale of our EECP(R) systems to international markets is recognized upon shipment of the product to a common carrier, as are supplies, accessories and spare parts delivered to both domestic and international customers. Returns are accepted prior to the in-service and training subject to a 10% restocking charge or for normal warranty matters, and we are not obligated for post-sale upgrades to these systems. In addition, we use the installment method to record revenue based on cash receipts in situations where the account receivable is collected over an extended period of time and in our judgment the degree of collectibility is uncertain. In most cases, revenue from domestic EECP(R) system sales is generated from multiple-element arrangements that require judgment in the areas of customer acceptance, collectibility, the separability of units of accounting, and the fair value of individual elements. We follow the provisions of Emerging Issues Task Force, or EITF, Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"). The principles and guidance outlined in EITF 00-21 provide a framework to determine (a) how the arrangement consideration should be measured (b) whether the arrangement should be divided into separate units of accounting, and (c) how the arrangement consideration should be allocated among the separate units of accounting. We determined that the domestic sale of our EECP(R) systems includes a combination of three elements that qualify as separate units of accounting: i. EECP(R) equipment sale, ii. provision of in-service and training support consisting of equipment set-up and training provided at the customer's facilities, and iii. a service arrangement (usually one year), consisting of: service by factory-trained service representatives, material and labor costs, emergency and remedial service visits, software upgrades, technical phone support and preferred response times. Each of these elements represent individual units of accounting as the delivered item has value to a customer on a stand-alone basis, objective and reliable evidence of fair value exists for undelivered items, and arrangements normally do not contain a general right of return relative to the delivered item. We determine fair value based on the price of the deliverable when it is sold separately or based on third-party evidence. In accordance with the guidance in EITF 00-21, we use the residual method to allocate the arrangement consideration when it does not have fair value of the EECP(R) system sale. Under the residual method, the amount of consideration allocated to the delivered item equals the total arrangement consideration less the aggregate fair value of the undelivered items. Assuming all other criteria for revenue recognition have been met, we recognize revenue for: i. EECP(R) equipment sales, when delivery and acceptance occurs based on delivery and acceptance documentation received from independent shipping companies or customers, ii. in-service and training, following documented completion of the training, and iii. the service arrangement, ratably over the service period, which is generally one year. In-service and training generally occurs within a few weeks of shipment and our return policy states that no returns will be accepted after in-service and training has been completed. The amount related to in-service and training is recognized as service revenue at the time the in-service and training is completed and the amount related to service arrangements is recognized ratably as service revenue over the related service period, which is generally one year. Costs associated with the provision of in-service and training and the service arrangement, including salaries, benefits, travel, spare parts and equipment, are recognized in cost of equipment sales as incurred. The Company also recognizes revenue generated from servicing EECP(R) systems that are no longer covered by the service arrangement, or by providing sites with additional training, in the period that these services are provided. Revenue related to future commitments under separately priced extended service agreements on our EECP(R) system are deferred and recognized ratably over the service period, generally ranging from one year to four years. Costs associated with the provision of service and maintenance, including salaries, benefits, travel, spare parts and equipment, are recognized in cost of sales as incurred. Amounts billed in excess of revenue recognized are included as deferred revenue in the consolidated balance sheets. 34 Revenues from the sale of EECP(R) systems through our international distributor network are generally covered by a one-year warranty period. For these customers we accrue a warranty reserve for estimated costs to provide warranty parts when the equipment sale is recognized. The Company has also entered into lease agreements for our EECP(R) systems, generally for terms of one year or less, that are classified as operating leases. Revenues from operating leases are generally recognized, in accordance with the terms of the lease agreements, on a straight-line basis over the life of the respective leases. For certain operating leases in which payment terms are determined on a "fee-per-use" basis, revenues are recognized as incurred (i.e., as actual usage occurs). The cost of the EECP(R) system utilized under operating leases is recorded as a component of property and equipment and is amortized to cost of sales over the estimated useful life of the equipment, not to exceed five years. There were no significant minimum rental commitments on these operating leases at May 31, 2008. Accounts Receivable, net The Company's accounts receivable are due from customers engaged in the provision of medical services. Credit is extended based on evaluation of a customer's financial condition and, generally, collateral is not required. Accounts receivable are generally due 30 to 90 days from shipment and are stated at amounts due from customers net of allowances for doubtful accounts, returns, term discounts and other allowances. Accounts that remain outstanding longer than the contractual payment terms are considered past due. Estimates are used in determining the allowance for doubtful accounts based on the Company's historical collections experience, current trends, credit policy and a percentage of its accounts receivable by aging category. In determining these percentages, we look at historical write-offs of our receivables. The Company also looks at the credit quality of its customer base as well as changes in its credit policies. The Company continuously monitors collections and payments from our customers. While credit losses have historically been within expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past. Inventories, net The Company values inventory at the lower of cost or estimated market, cost being determined on a first-in, first-out basis. The Company often places EECP(R) systems at various field locations for demonstration, training, evaluation, and other similar purposes at no charge. The cost of these EECP(R) systems is transferred to property and equipment and is amortized over the next two to five years. The Company records the cost of refurbished components of EECP(R) systems and critical components at cost plus the cost of refurbishment. The Company regularly reviews inventory quantities on hand, particularly raw materials and components, and records a provision for excess and obsolete inventory based primarily on existing and anticipated design and engineering changes to its products as well as forecasts of future product demand. We have adopted the provisions of Statement of Financial Accounting Standards No. 151, "Inventory Costs", on a prospective basis. The statement clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. As a result of adopting SFAS No. 151, we absorbed approximately $158,000 less in fixed production overhead into inventory during fiscal year 2008 as compared to fiscal 2007. Deferred Revenues The Company records revenue on extended service contracts ratably over the term of the related contract period. In accordance with the provisions of EITF 00-21, we began to defer revenue related to EECP(R) system sales for the fair value of installation and in-service training to the period when the services are rendered and for warranty obligations ratably over the service period, which is generally one year. Warranty Costs Equipment sold is generally covered by a warranty period of one year. Under the provisions of EITF 00-21, for certain arrangements, a portion of the overall 35 system price attributable to the first year service arrangement is deferred and recognized as revenue over the service period. As such, we do not accrue warranty costs upon delivery but we rather recognize warranty and related service costs as incurred. Equipment sold to international customers through our distributor network is generally covered by a one-year warranty period. For these customers the Company accrues a warranty reserve for estimated costs of providing a parts only warranty when the equipment sale is recognized. The factors affecting our warranty liability included the number of units sold and historical and anticipated rates of claims and costs per claim. Net Loss per Common Share Basic loss per share is based on the weighted average number of common shares outstanding without consideration of potential common stock. Diluted loss per share is based on the weighted number of common and potential dilutive common shares outstanding. The calculation takes into account the shares that may be issued upon the exercise of stock options and warrants, reduced by the shares that may be repurchased with the funds received from the exercise, based on the average price during the period. Income Taxes Deferred income taxes are recognized for temporary differences between financial statement and income tax bases of assets and liabilities and loss carryforwards for which income tax benefits are expected to be realized in future years. A valuation allowance is established, when necessary, to reduce deferred tax assets to the amount expected to be realized. In estimating future tax consequences, we generally consider all expected future events other than an enactment of changes in the tax laws or rates. The deferred tax asset is continually evaluated for realizability. To the extent our judgment regarding the realization of the deferred tax assets changes, an adjustment to the allowance is recorded, with an offsetting increase or decrease, as appropriate, in income tax expense. Such adjustments are recorded in the period in which our estimate as to the realizability of the asset changed that it is "more likely than not" that all of the deferred tax assets will be realized. The "more likely than not" standard is subjective, and is based upon our estimate of a greater than 50% probability that the deferred tax asset will be realized. Deferred tax assets and liabilities are classified as current or non-current based on the classification of the related asset or liability for financial reporting. A deferred tax asset or liability that is not related to an asset or liability for financial reporting, including deferred tax assets related to carryforwards, are classified according to the expected reversal date of the temporary difference. The deferred tax asset the Company previously recorded, and then reversed fully in fiscal 2006, related primarily to the realization of net operating loss carryforwards, of which the allocation of the current portion, if any, reflected the expected utilization of such net operating losses for the following twelve months. Such allocation was based on the Company's internal financial forecast and may be subject to revision based upon actual results. Stock-based Employee Compensation In December 2004, the FASB issued Statement of Financial Standards No. 123 (revised 2004), Share-Based Payment ("SFAS No. 123 (R)"), which is a revision of SFAS No. 123. SFAS No. 123 (R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally, the approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure of the fair value of share-based payments is no longer an alternative to financial statement recognition. The Company has five stock-based employee compensation plans. Prior to second quarter of fiscal 2007, the Company accounted for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations ("APB No. 25") and adopted the 36 disclosure provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123." Under APB No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Accordingly, no compensation expense has been recognized in the consolidated financial statements in connection with employee stock option grants prior to fiscal 2007. In May 2006, the compensation committee of the board of directors accelerated the vesting provision of all outstanding stock options and warrants so that they were fully vested at May 31, 2006, and as a result the adoption of SFAS No. 123(R) did not have an immediate material effect on the financial statements. However, as new stock options are issued by the Company this may have a material effect on its quarterly and annual financial statements, in the form of additional compensation expense. It is not possible to precisely determine the expense impact of adoption since a portion of the ultimate expense that is recorded will likely relate to awards that have not yet been granted. The expense associated with these future awards can only be determined based on factors such as the price for the Company's common stock, volatility of the Company's stock price and risk free interest rates as measured at the grant date. For purposes of estimating the fair value of each option on the date of grant, the Company utilized the Black-Scholes option-pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable measure of the fair value of its employee stock options. Equity instruments issued to non-employees in exchange for goods, fees and services are accounted for under the fair value-based method of SFAS No. 123 (R). Recently Issued Accounting Pronouncements Not Yet Effective Statements of Financial Accounting Standards (SFAS): SFAS No. 141 (R), "Business Combinations" -- retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. o replaces Statement 141's cost-allocation process and requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, o requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values, o requires that an acquirer evaluate new information and measure a liability at the higher of its acquisition-date fair value or the amount that would be recognized if applying Statement 5, then measuring an asset at the lower of its acquisition-date fair value or the best estimate of its future settlement amount, o requires the acquirer to recognize contingent consideration at the acquisition date, measured at its fair value at that date, SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for 37 financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. The Company does not expect that SFAS No. 157 will have any significant effect on future financial statements. SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment to FASB Statement No. 115. This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, Fair Value Measurements. The Company does not expect that SFAS No. 159 will have any significant effect on future financial statements. Effective for fiscal years beginning after December 15, 2008 SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements" -- changes the way the consolidated income statement is presented. It requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. Previously, net income attributable to the noncontrolling interest generally was reported as an expense or other deduction in arriving at consolidated net income. It also was often presented in combination with other financial statement amounts. Effective for fiscal years beginning after December 15, 2008. SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities - an Amendment of FASB Statement 133 -- enhances required disclosures regarding derivatives and hedging activities, including enhanced disclosures regarding how: (a) an entity uses derivative instruments; (b) derivative instruments and related hedged items are accounted for under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities; and (c) derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. Specifically, Statement SFAS No. 161 requires: o Disclosure of the objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation; o Disclosure of the fair values of derivative instruments and their gains and losses in a tabular format; o Disclosure of information about credit-risk-related contingent features; and o Cross-reference from the derivative footnote to other footnotes in which derivative-related information is disclosed. Effective for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged. The Company does not expect that SFAS No. 161 will have any significant effect on future financial statements. SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts" -- clarifies how SFAS No. 60, "Accounting and Reporting by Insurance Enterprises", applies to financial guarantee insurance contracts issued by insurance enterprises, including the recognition and measurement of premium revenue and claim liabilities. It also requires expanded disclosures about financial guarantee insurance contracts. SFAS No. 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods within those fiscal years, except for disclosures about the insurance enterprise's risk-management activities, which are effective the first period beginning after May 23, 2008. 38 FASB Staff Positions (FSP): FSP APB 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)" -- clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. FSP FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions" -- amends FASB Statement 140 to state that a transferor and transferee shall not separately account for a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. This FSP is effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted. FSP FAS 142-3, "Determination of the Useful Life of Intangible Assets" -- amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets. Paragraph 11(d) of Statement 142 precluded an entity from using its own assumptions about renewal or extension of an arrangement where there is likely to be substantial cost or material modifications. This FSP amends paragraph 11(d) of Statement 142 so that an entity will use its own assumptions about renewal or extension of an arrangement, adjusted for the entity-specific factors in paragraph 11 of Statement 142, even when there is likely to be substantial cost or material modifications. Therefore, in determining the useful life of the asset for amortization purposes, an entity shall consider the period of expected cash flows used to measure the fair value of the recognized intangible asset, adjusted for the entity-specific factors including, but are not limited to, the entity's expected use of the asset and the entity's historical experience in renewing or extending similar arrangements. This FSP shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. FSP FAS 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" -- amends SFAS No. 157, "Fair Value Measurements", to exclude SFAS No. 13, "Accounting for Leases", and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under Statement 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under SFAS No. 141, "Business Combinations", or No. 141 (revised 2007), "Business Combinations", regardless of whether those assets and liabilities are related to leases. FSP FAS 157-2, "Effective Date of FASB Statement No. 157" -- delays the effective date of SFAS No. 157, "Fair Value Measurements", for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the Board and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of SFAS No. 157. This FSP defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. FSP FIN 46(R)-7, "Application of FASB Interpretation No. 46(R) to Investment Companies" -- states that investments accounted for at fair value in accordance with the specialized accounting guidance in the AICPA Audit and Accounting Guide, Investment Companies, are not subject to consolidation according to the requirements of FIN 46(R). 39 FSP SOP 94-3-1 and AAG HCO-1, " Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations " -- makes several changes to the guidance on consolidation and the equity method of accounting in AICPA Statement of Position 94-3, "Reporting of Related Entities by Not-for-Profit Organizations", and the AICPA Audit and Accounting Guide, "Health Care Organizations." This FSP: a. Eliminates the temporary control exception to consolidation that currently exists for certain relationships between not-for-profit organizations and makes two related changes: (1) Amends the definition of majority voting interest in the board of another entity in SOP 94-3 and the health care Guide (2) (2) Conforms the categorization of sole corporate membership in SOP 94-3 to that in the health care Guide b. Confirms the continued applicability to not-for-profit organizations of the consensus guidance on consolidation of special-purpose entity (SPE) lessors in the following EITF Issues: (1) No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions" (2) No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities" (3) No. 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities" c. Requires that not-for-profit organizations apply the guidance in: AICPA Statement of Position 78-9, "Accounting for Investments in Real Estate Ventures", on the equity method of accounting to their noncontrolling interests in for-profit real estate partnerships, limited liability companies (LLCs), and similar entities unless those investments are reported at fair value, where permitted. (1) FSP SOP 78-9-1, "Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5", to help determine whether their interests in for-profit partnerships, LLCs, and similar entities are controlling interests or noncontrolling interests (2) EITF Issue No. 03-16, "Accounting for Investments in Limited Liability Companies," to determine whether an LLC should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether noncontrolling interests in an LLC or a similar entity should be accounted for in accordance with SOP 78-9 and related guidance. FSP SOP 94-3-1 and AAG HCO-1 is effective for fiscal years beginning after June 15, 2008, and to interim periods therein. FSP SOP 07-1-1, -- indefinitely delays the effective date of AICPA Statement of Position 07-1, "Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies." FSP EITF 03-6-1, -- "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities." This FSP provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. The FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. Upon adoption, a company is required to retrospectively adjust its earnings per share data (including any amounts related to interim periods, summaries of earnings and selected financial data) to conform with the provisions in this FSP. Early application of this FSP is prohibited. 40 EITF Consensuses (EITF): EITF Issue No. 07-1, "Accounting for Collaborative Arrangements " -- when entities enter into arrangements to participate in a joint operating activity a collaborative arrangement may provide that one participant has sole or primary responsibility for certain activities or that two or more participants have shared responsibility for certain activities. Participants should evaluate whether an arrangement is a collaborative arrangement at the inception of the arrangement based on the facts and circumstances present at that time. Revenue generated and costs incurred by participants from transactions with parties should be reported gross or net on the appropriate line item in each participant's respective financial statements depending on the nature of the participation. Disclosures should include information about the nature and purpose of its collaborative arrangements, the entity's rights and obligations under the collaborative arrangements, the accounting policy for collaborative arrangements, and the income statement classification and amounts attributable to transactions arising from the collaborative arrangement. Effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. EITF Issue No. 07-4, "Application of the Two-Class Method under FASB Statement No. 128, Earnings per Share, to Master Limited Partnerships" --The scope of this issue includes Master Limited Partnerships (MLPs) that are required to make incentive distribution rights (IDR) payments, regardless of whether the IDRs are embedded in the GP (General Partner) interest or are a separate LP (Limited Partner) interest, and the MLPs account for these IDR payments as equity distributions. The consensus is that when the IDR is embedded in the GP interest, undistributed earnings should be allocated to the GP (including the distribution rights of the embedded IDR) and LPs utilizing the distribution formula for available cash specified in the partnership agreement. The undistributed earnings should be allocated to the GP (with respect to the distribution rights of an embedded IDR) based on the contractual participation rights of the IDR to share in current period earnings. Therefore, if the partnership agreement includes a "specified threshold," an MLP should not allocate undistributed earnings to the GP (with respect to the distribution rights of an embedded IDR) once the specified threshold has been met. The final consensus requires that an entity: (a) apply the guidance in this issue in its first fiscal year beginning after December 15, 2008, including interim periods within those fiscal years, and (b) transition to the guidance in this issue by retrospectively applying the guidance to all periods presented. Early application is prohibited. ITEM 7 - FINANCIAL STATEMENTS The consolidated financial statements listed in the accompanying Index to Consolidated Financial Statements are filed as part of this report. ITEM 8 - CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE None. ITEM 8A - CONTROLS AND PROCEDURES Report on Disclosure Controls and Procedures The Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") with the participation of the Company's management ("Management") and through the guidance of an independent internal control consulting firm ("Consultants") conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures. These disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934, within the time periods specified by the SEC rules and forms, is recorded, processed, summarized and reported, and is communicated to Management, as appropriate, to allow for timely decisions based on the required disclosures. Based on this evaluation, the Company's CEO and CFO concluded that the Company's disclosure controls and procedures were effective as of May 31, 2008. 41 ITEM 8A(T) - CONTROLS AND PROCEDURES Report on Internal Control over Financial Reporting Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) of the Exchange Act. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Under the supervision of the Consultants referred to in Item 8A and with the participation of Management, the CEO and CFO, an evaluation was conducted of the effectiveness of the internal control over financial reporting based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework. Based on this evaluation, the Company's CEO and CFO concluded that the Company's internal control over financial reporting was effective as of May 31, 2008. However, Management's assessment identified the following weaknesses in the Information Technology System (IT) at May 31, 2008: (a) Documenting the procedures performed in the change management area of our internal control over Information Technology Systems (IT). During the first quarter of fiscal 2009, we remediated these weaknesses by ensuring that processes were documented properly. (b) Excessive manual adjustments to the inventory module are required. In fiscal 2009, we will be remediating this with our upgraded accounting software. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple errors. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected . This annual report does not include an attestation report of the Company's Registered Public Accounting Firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's Registered Public Accounting Firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only Management's report in this Annual Report. ITEM 8B - OTHER INFORMATION None. 42 PART III ITEM 9 - DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS, CONTROL PERSONS AND CORPORATE GOVERNANCE; COMPLIANCE WITH SECTION 16 (a) OF THE EXCHANGE ACT. The information required by this Item is intended to be included in our definitive Proxy Statement, which will be filed with the Securities and Exchange Commission in connection with our 2008 Annual Meeting of Stockholders and is incorporated herein by reference. ITEM 10 - EXECUTIVE COMPENSATION The information required by this Item is intended to be included in our definitive Proxy Statement, which will be filed with the Securities and Exchange Commission in connection with our 2008 Annual Meeting of Stockholders and is incorporated herein by reference. ITEM 11 - SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS The information required by this Item is intended to be included in our definitive Proxy Statement, which will be filed with the Securities and Exchange Commission in connection with our 2008 Annual Meeting of Stockholders and is incorporated herein by reference. ITEM 12 - CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE The information required by this Item is intended to be included in our definitive Proxy Statement, which will be filed with the Securities and Exchange Commission in connection with our 2008 Annual Meeting of Stockholders and is incorporated herein by reference. ITEM 13 - EXHIBITS (a) Financial Statements and Financial Statement Schedules --- (1) See Index to Consolidated Financial Statements on page F-1 at beginning of attached financial statements. (b) Exhibits -------- (3) (a) Restated Certificate of Incorporation (2) (b) By-Laws (1) (4) (a) Specimen Certificate for Common Stock (1) (b) Certificate of Designation of the Preferred Stock, Series A (3) (c) Certificate of Designation of the Preferred Stock, Series B (7) (d) Form of Rights Agreement dated as of March 9, 1995, between Registrant and American Stock Transfer & Trust Company (5) (e) Certificate of Designation of the Preferred Stock, Series C (8) (f) Certificate of Designation of the Preferred Stock, Series D (15) (g) Form of Stock Purchase Warrant (18) (10) (a) 1995 Stock Option Plan (6) (b) Outside Director Stock Option Plan (6) (c) Employment Agreement dated February 1, 1995, as amended March 12, 1998, and October 10, 2001, between Registrant and John C.K. Hui (4) (9) (13) (d) 1997 Stock Option Plan, as amended (10) (e) 1999 Stock Option Plan, as amended (11) (f) 2004 Stock Option/Stock Issuance Plan (12) (g) Credit Agreement dated February 21, 2002, between Registrant and Fleet National Bank (12) (h) Securities Purchase Agreement dated June 21, 2007 between Registrant and Kerns Manufacturing Corp. (14) (i) Form of Common Stock Purchase Warrant to dated June 21, 2007 (14) (j) Registration Rights Agreement dated June 21, 2007 between Registrant, Kerns Manufacturing Corp. and Living Data Technology Corporation. (14) (k) Purchase and Sale Agreement dated June 1, 2007 between 180 Linden Avenue Corp and 180 Linden Realty LLC.(15) (l) Lease Agreement dated August 15, 2007 between 180 Linden Realty LLC and Registrant(15) 43 (21) Subsidiaries of the Registrant Percentage Name State of Incorporation Owned by Company ---- --------------------- ---------------- Viromedics, Inc. Delaware 61% 180 Linden Avenue Corp. New York 100% (23) Consent of Miller Ellin & Company, LLP (31) Certification Reports pursuant to Securities Exchange Act Rule 13a - 14 (32) Certification Reports pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 ------------------------- (1) Incorporated by reference to Registration Statement on Form S-18, No. 33-24095. (2) Incorporated by reference to Registration Statement on Form S-1, No. 33-46377 (effective 7/12/94). (3) Incorporated by reference to Report on Form 8-K dated November 14, 1994. (4) Incorporated by reference to Report on Form 8-K dated January 24, 1995. (5) Incorporated by reference to Registration Statement on Form 8-A dated May 12, 1995. (6) Incorporated by reference to Notice of Annual Meeting of Stockholders dated December 5, 1995. (7) Incorporated by reference to Report on Form 8-K dated June 25, 1997. (8) Incorporated by reference to Report on Form 8-K dated April 30, 1998. (9) Incorporated by reference to Report on Form 10-K for the fiscal year ended May 31, 1998. (10) Incorporated by reference to Report on Form 10-K for the fiscal year ended May 31, 1999 (11) Incorporated by reference to Report on Form 10-K for the fiscal year ended May 31, 2000. (12) Incorporated by reference to Notice of Annual Meeting of Stockholders dated October 28, 2004. (13) Incorporated by reference to Report on Form 10-K for the fiscal year ended May 31, 2002. (14) Incorporated by reference to Report on Form 8-K dated June 21, 2007. (15) Incorporated by reference to Report on Form 10-KSB for the fiscal year ended May 31, 2007. ITEM 14 - PRINCIPAL ACCOUNTANT FEES AND SERVICES The information required by this Item is intended to be included in our definitive Proxy Statement, which will be filed with the Securities and Exchange Commission in connection with our 2008 Annual Meeting of Stockholders and is incorporated herein by reference. 44 SIGNATURES Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, we have duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on the 25th day of August, 2008. VASOMEDICAL, INC. By: /s/ John C.K. Hui -------------------------------------- John C.K. Hui President, Chief Executive Officer, Chief Technology Officer and Director (Principal Executive Officer) Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on August 25, 2008, by the following persons in the capacities indicated: /s/ John C.K. Hui President, Chief Executive Officer, Chief Technology ----------------------- Officer and Director (Principal Executive Officer) John C.K. Hui /s/ Abraham E. Cohen Chairman of the Board ----------------------- Abraham E. Cohen /s/ Tricia Efstathiou Chief Financial Officer (Principal Financial and ----------------------- Accounting Officer) Tricia Efstathiou /s/Joseph Giacalone Director ----------------------- Joseph Giacalone /s/Photios T. Paulson Director ----------------------- Photios T. Paulson /s/ Martin Zeiger Director ----------------------- Martin Zeiger /s/ Simon Srybnik Director ----------------------- Simon Srybnik /s/ Jun Ma Director ----------------------- Jun Ma /s/ Behnam Movaseghi Director ----------------------- Behnam Movaseghi ----------------------- Director Derek Enlander Vasomedical, Inc. and Subsidiaries INDEX TO CONSOLIDATED FINANCIAL STATEMENTS Page ---- Report of Independent Registered Public Accounting Firm F-1 Financial Statements Consolidated Balance Sheet as of May 31, 2008 F-2 Consolidated Statements of Operations for the years ended May 31, 2008 and 2007 F-3 Consolidated Statement of Changes in Stockholders' Equity for the years ended May 31, 2008 and 2007 F-4 Consolidated Statements of Cash Flows for the years ended May 31, 2008 and 2007 F-5 Notes to Consolidated Financial Statements F-7 i REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM Board of Directors and Shareholders Vasomedical, Inc. and Subsidiaries We have audited the accompanying consolidated balance sheet of Vasomedical, Inc. and Subsidiaries (the "Company") as of May 31, 2008 and the related consolidated statements of operations, changes in stockholders' equity and cash flows for the years ended May 31, 2008 and 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Vasomedical, Inc. and Subsidiaries as of May 31, 2008 and the consolidated results of their operations and their consolidated cash flow for the years ended May 31, 2008 and 2007 in conformity with accounting principles generally accepted in the United States of America. /s/ Miller Ellin & Company, LLP MILLER ELLIN & COMPANY, LLP New York, New York August 20, 2008 F - 1 Vasomedical, Inc. and Subsidiaries CONSOLIDATED BALANCE SHEET May 31, 2008 ASSETS CURRENT ASSETS Cash and cash equivalents $2,653,999 Accounts receivable, net of an allowance for doubtful accounts of $270,183 717,849 Inventories, net 1,652,678 Other current assets 58,933 ---------------- Total current assets 5,083,459 PROPERTY AND EQUIPMENT, net of accumulated depreciation of $2,178,566 57,170 DEFERRED DISTRIBUTOR COSTS, net of accumulated amortization of $101,775 407,101 OTHER ASSETS 213,336 ---------------- $5,761,066 ================ LIABILITIES AND STOCKHOLDERS' EQUITY CURRENT LIABILITIES Accounts payable and accrued expenses $822,244 Sales tax payable 149,304 Deferred revenue 1,132,445 Deferred gain on sale of building 53,245 Accrued professional fees 74,320 ---------------- Total current liabilities 2,231,558 DEFERRED REVENUE 485,608 ACCRUED RENT EXPENSE 8,656 DEFERRED GAIN ON SALE OF BUILDING 168,610 COMMITMENTS AND CONTINGENCIES STOCKHOLDERS' EQUITY Preferred stock, $.01 par value; 1,000,000 shares authorized; none issued and outstanding -- Common stock, $.001 par value; 110,000,000 shares authorized; 93,768,004 shares issued and outstanding 93,768 Additional paid-in capital 48,068,432 Accumulated deficit (45,295,566) ---------------- Total stockholders' equity 2,866,634 ---------------- $5,761,066 ================= The accompanying notes are an integral part of this consolidated financial statement. F - 2 Vasomedical, Inc. and Subsidiaries CONSOLIDATED STATEMENTS OF OPERATIONS Years Ended May 31, 2008 2007 ---------------- ----------------- Revenues Equipment sales $2,087,365 $2,561,064 Equipment rentals and services 3,095,403 3,793,019 ---------------- ----------------- Total revenues 5,182,768 6,354,083 ---------------- ----------------- Cost of Sales and Services Cost of sales, equipment 1,679,632 1,457,279 Cost of equipment rentals and services 1,150,738 1,445,834 ---------------- ----------------- Total cost of sales and services 2,830,370 2,903,113 ---------------- ----------------- Gross profit 2,352,398 3,450,970 ---------------- ----------------- Operating Expenses Selling, general and administrative 2,626,045 4,051,993 Research and development 474,111 933,316 ---------------- ----------------- Total operating expenses 3,100,156 4,985,309 ---------------- ----------------- Loss from operations (747,758) (1,534,339) ---------------- ----------------- Other Income (Expenses) Interest and financing costs (16,616) (69,767) Interest and other income, net 61,083 53,648 Gain on sale of assets 44,371 -- ---------------- ----------------- Total other income (expenses) 88,838 (16,119) ---------------- ----------------- Loss before income taxes (658,920) (1,550,458) Income tax expense, net (18,045) (20,608) ---------------- ----------------- Net loss $(676,965) $(1,571,066) ================= ================= Net loss per common share - basic $(0.01) $(0.02) ================= ================= - diluted $(0.01) $(0.02) ================ ================= Weighted average common shares outstanding - basic 92,211,788 65,198,592 ================ ================= - diluted 92,211,788 65,198,592 ================ ================= The accompanying notes are an integral part of this consolidated financial statement. F - 3 Vasomedical, Inc. and Subsidiaries CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY Additional Total Preferred Stock Common Stock Paid-in- Accumulated Stockholders' Shares Amount Shares Amount Capital Deficit Equity ----- ------ --------- ------- ---------- ------------- ---------- Balance at May 31, 2006 -- $-- 65,198,592 $65,198 $46,148,493 $(43,047,535) $3,166,156 Issuance of stock options in payment of outside director fees 11,445 11,445 Issuance of stock options in payment of salaries to company officers 6,060 6,060 Net loss (1,571,066) (1,571,066) ----- ------ --------- ------- ---------- ------------- ---------- Balance at May 31, 2007 -- $-- 65,198,592 $65,198 $46,165,998 $(44,618,601) $1,612,595 Common stock and warrants (net of expenses incurred) issued pursuant to Securities Purchase Agreement -- -- 21,428,572 21,429 1,354,461 -- 1,375,890 Common stock and warrants issued for Distribution and Supply agreement -- -- 6,990,840 6,991 461,395 -- 468,386 Common stock issued to a Director -- -- 150,000 150 8,850 -- 9,000 Stock based compensation -- -- -- -- 77,728 -- 77,728 Net loss (676,965) (676,965) ----- ------ --------- ------- ---------- ------------- ---------- Balance at May 31, 2008 -- $-- $93,768,004 $93,768 $48,068,432 $(45,295,566) $2,866,634 The accompanying notes are an integral part of this consolidated financial statement. F - 4 Vasomedical, Inc. and Subsidiaries CONSOLIDATED STATEMENTS OF CASH FLOWS Years ended May 31, 2008 2007 ------------- --------------- Cash flows from operating activities Net loss $(676,965) $(1,571,066) ------------- --------------- Adjustments to reconcile net loss to net cash used in operating activities Depreciation and amortization 187,628 315,269 Amortization of deferred gain on sale of building (44,371) -- Provision for doubtful accounts 42,837 (38,178) Amortization of deferred distributor costs 101,776 Reserve for excess and obsolete inventory (83,124) -- Stock based compensation 86,728 17,505 Changes in operating assets and liabilities Accounts receivable (27,031) 147,805 Inventories 592,427 606,580 Other current assets (24,172) 265,408 Other assets -- (1,072) Deferred distributor costs (40,490) -- Accounts payable, accrued expenses and other current liabilities (163,246) (721,970) Other liabilities 15,982 (253,575) ------------- --------------- 644,944 337,772 ------------- --------------- Net cash used in operating activities (32,021) (1,233,294) ------------- --------------- Cash flows provided by (used in) investing activities Proceeds from the building sale 1,400,000 -- Expenses paid for sale of building (89,143) -- Purchase of property and equipment -- (10,593) ------------- --------------- Net cash provided by (used in) investing activities 1,310,857 (10,593) ------------- --------------- Cash flows provided by (used in) financing activities Payments on long term debt and notes payable (851,015) (291,603) Proceeds from Securities Purchase agreement 1,500,000 -- Expenses paid in relation to Securities Purchase Agreement (124,110) -- ------------- --------------- Net cash provided by (used in) financing activities 524,875 (291,603) ------------- --------------- NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS 1,803,711 (1,535,490) ------------- --------------- Cash and cash equivalents - beginning of year 850,288 2,385,778 ------------- --------------- Cash and cash equivalents - end of year $2,653,999 $850,288 ============= =============== The accompanying notes are an integral part of this consolidated financial statement. F - 5 Vasomedical, Inc. and Subsidiaries CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED Years ended May 31, 2008 2007 --------------- ------------- NON-CASH INVESTING AND FINANCING ACTIVITIES WERE AS FOLLOWS: Inventories transferred to)/from property and equipment, attributable to operating leases - net $(44,354) $(24,534) Issuance of note for purchase of insurance policy $-- $192,120 SUPPLEMENTAL DISCLOSURES: Interest paid $16,616 $69,767 Income taxes paid $11,685 $10,079 The accompanying notes are an integral part of this consolidated financial statement. F - 6 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 NOTE A - ORGANIZATION AND PLAN OF OPERATIONS Vasomedical, Inc. was incorporated in Delaware in July 1987. Unless the context requires otherwise, all references to "we", "our", "us", "Company", "registrant", "Vasomedical" or "management" refer to Vasomedical Inc. and its subsidiaries. Since 1995, we have been primarily engaged in designing, manufacturing, marketing and supporting EECP(R) enhanced external counterpulsation systems based on our unique proprietary technology currently indicated for use in cases of stable or unstable angina (i.e., chest pain), congestive heart failure (CHF), acute myocardial infarction (i.e., heart attack, (MI)) and cardiogenic shock. The EECP(R) therapy system is a non-invasive, outpatient therapy for the treatment of diseases of the cardiovascular system. The therapy serves to increase circulation in areas of the heart with less than adequate blood supply and helps to restore systemic vascular function. The therapy also increases blood flow and oxygen supply to the heart muscle and other organs and decreases the heart's workload and need for oxygen, while also improving function of the endothelium, the lining of blood vessels throughout the body, lessening resistance to blood flow. We provide hospitals, clinics and physician private practices with EECP(R) equipment, treatment guidance, and a staff training and equipment maintenance program designed to provide optimal patient outcomes. EECP(R) is a registered trademark for our enhanced external counterpulsation systems. For more information, visit www.vasomedical.com. We have Food and Drug Administration (FDA) clearance to market our EECP(R) therapy for use in the treatment of stable and unstable angina, congestive heart failure, acute myocardial infarction, and cardiogenic shock, however, our current marketing efforts are limited to the treatment of chronic stable angina and congestive heart failure. Medicare and other third-party payers currently reimburse for the treatment of angina symptoms in patients with moderate to severe symptoms who are refractory to medications and not candidates for invasive procedures, including patients with serious comorbidities, such as heart failure, diabetes, and peripheral vascular disease. Patients with primary diagnoses of heart failure, diabetes, and peripheral vascular disease are also reimbursed under the same criteria, provided the primary indication for treatment with EECP(R) therapy is angina symptoms. During the last several years we incurred operating losses. We have attempted to achieve profitability by reducing operating costs and halting the trend of declining revenue, to reduce cash usage through bringing its cost structure more into alignment with current revenues by engaging in restructurings during March 2007 and April 2007 to substantially reduce personnel and spending on sales, marketing and development projects. In addition, the Company was seeking to obtain a strategic alliance within the sales and marketing areas and/or to raise additional capital through public or private equity or debt financings. During the first quarter of fiscal year 2008, the following events took place which allowed us to raise additional capital through a private equity financing and by the sale of our facility under a leaseback agreement. o On June 21, 2007, we entered into a Securities Purchase Agreement with Kerns Manufacturing Corp. (Kerns). Concurrently with our entry into the Securities Purchase Agreement, we also entered into a Distribution Agreement and a Supplier Agreement with Living Data Technology Corporation, an affiliate of Kerns (Living Data). We sold to Kerns, pursuant to the Securities Purchase Agreement, 21,428,572 shares of our common stock at $.07 per share for a total purchase price of $1,500,000, as well as a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of $.08 per share (the Warrant). The agreement further provided for the appointment to our Board of Directors of two representatives of Kerns. In furtherance thereof, Mr. Jun Ma and Mr. Simon Srybnik, Chairman of both Kerns and Living Data, have been appointed members of F - 7 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 our Board of Directors. Pursuant to the Distribution Agreement, we have become the exclusive distributor in the United States of the AngioNew ECP systems manufactured by Living Data. As additional consideration for such agreement, we agreed to issue an additional 6,990,840 shares of our common stock to Living Data. Pursuant to the Supplier Agreement, Living Data now is the exclusive supplier to us of the ECP therapy systems that we market under the registered trademark EECP(R). The Distribution Agreement and the Supplier Agreement each have an initial term extending through May 31, 2012. Pursuant to a Registration Rights Agreement, we granted to Kerns and Living Data, subject to certain restrictions, "piggyback registration rights" covering the shares sold to Kerns as well as the shares issuable upon exercise of the Warrant and the shares issued to Living Data. o On August 15, 2007, we sold our facility under a five-year leaseback agreement for $1.4 million. The net proceeds from the sale were approximately $425,000, after payment in full of the two secured notes on our facility, brokers fees, closing costs, and the opening of a certificate of deposit in accordance with the provisions of the new lease. NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES A summary of the significant accounting policies consistently applied in the preparation of the consolidated financial statements follows: Principles of Consolidation The consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary and its inactive majority-owned subsidiary. Significant intercompany accounts and transactions have been eliminated. Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant estimates and assumptions relate to estimates of collectibility of accounts receivable, the realizability of deferred tax assets, and the adequacy of inventory and warranty reserves. Actual results could differ from those estimates. Revenue Recognition The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or service has been rendered, the price is fixed or determinable and collectibility is reasonably assured. In the United States, we recognize revenue from the sale of our EECP(R) systems in the period in which we deliver the system to the customer. Revenue from the sale of our EECP(R) systems to international markets is recognized upon shipment, during the period in which we deliver the product to a common carrier, as are supplies, accessories and spare parts delivered to both domestic and international customers. Returns are accepted prior to the in-service and training subject to a 10% restocking charge or for normal warranty matters, and we are not obligated for post-sale upgrades to these systems. In addition, we use the installment method to record revenue based on cash receipts in situations where the account receivable is collected over an extended period of time and in our judgment the degree of collectibility is uncertain. In most cases, revenue from domestic EECP(R) system sales is generated from multiple-element arrangements that require judgment in the areas of customer acceptance, collectibility, the separability of units of accounting, and the fair value of individual elements. We follow the provisions of Emerging Issues Task Force Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"). The principles and guidance outlined in EITF 00-21 provide a framework to determine (a) how the arrangement consideration should be measured (b) whether the arrangement should be divided into separate units of accounting, and (c) how the arrangement consideration should be allocated among the separate units of accounting. We determined that the domestic sale of our EECP(R) systems includes a combination of three elements that qualify as separate units of accounting: F - 8 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 i. EECP(R) equipment sale, ii. provision of in-service and training support consisting of equipment set-up and training provided at the customer's facilities, and iii. a service arrangement (usually one year), consisting of: service by factory-trained service representatives, material and labor costs, emergency and remedial service visits, software upgrades, technical phone support and preferred response times. Each of these elements represent individual units of accounting as the delivered item has value to a customer on a stand-alone basis, objective and reliable evidence of fair value exists for undelivered items, and arrangements normally do not contain a general right of return relative to the delivered item. We determine fair value based on the price of the deliverable when it is sold separately or based on third-party evidence. In accordance with the guidance in EITF 00-21, we use the residual method to allocate the arrangement consideration when it does not have fair value of the EECP(R) system sale. Under the residual method, the amount of consideration allocated to the delivered item equals the total arrangement consideration less the aggregate fair value of the undelivered items. Assuming all other criteria for revenue recognition have been met, we recognize revenue for: i. EECP(R) equipment sales, when delivery and acceptance occurs based on delivery and acceptance documentation received from independent shipping companies or customers, ii. in-service and training, following documented completion of the training, and iii. the service arrangement, ratably over the service period, which is generally one year. In-service and training generally occurs within a few weeks of shipment and our return policy states that no returns will be accepted after in-service and training has been completed. The amount related to in-service and training is recognized as service revenue at the time the in-service and training is completed and the amount related to service arrangements is recognized ratably as service revenue over the related service period, which is generally one year. Costs associated with the provision of in-service and training and the service arrangement, including salaries, benefits, travel, spare parts and equipment, are recognized in cost of equipment sales as incurred. The Company also recognizes revenue generated from servicing EECP(R) systems that are no longer covered by the service arrangement, or by providing sites with additional training, in the period that these services are provided. Revenue related to future commitments under separately priced extended service agreements on our EECP(R) system are deferred and recognized ratably over the service period, generally ranging from one year to four years. Costs associated with the provision of service and maintenance, including salaries, benefits, travel, spare parts and equipment, are recognized in cost of sales as incurred. Amounts billed in excess of revenue recognized are included as deferred revenue in the consolidated balance sheets. Revenues from the sale of EECP(R) systems through our international distributor network are generally covered by a one-year warranty period. For these customers we accrue a warranty reserve for estimated costs to provide warranty parts when the equipment sale is recognized. The Company has also entered into lease agreements for our EECP(R) systems, generally for terms of one year or less, that are classified as operating leases. Revenues from operating leases are generally recognized, in accordance with the terms of the lease agreements, on a straight-line basis over the life of the respective leases. For certain operating leases in which payment terms are determined on a "fee-per-use" basis, revenues are recognized as incurred (i.e., as actual usage occurs). The cost of the EECP(R) system utilized under operating leases is recorded as a component of property and equipment and is amortized to cost of sales over the estimated useful life of the equipment, not to exceed five years. There were no significant minimum rental commitments on these operating leases at May 31, 2008. Shipping and Handling Costs All shipping and handling expenses are charged to cost of sales. Amounts billed to customers related to shipping and handling costs are included as a component of sales. F - 9 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 Research and Development Research and development costs attributable to development are expensed as incurred. Included in research and development costs is amortization expense related to the capitalized cost of EECP(R) systems under loan for clinical trials. Stock-Based Employee Compensation As of June 1, 2006, the Company has adopted Statement of Financial Standards No. 123 (revised 2004), Share-Based Payment ("SFAS No. 123 (R)"), which is a revision of SFAS No. 123. SFAS No. 123 (R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally, the approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure of the fair value of share-based payments is no longer an alternative to financial statement recognition. Prior to first quarter of fiscal 2007, the Company accounted for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations ("APB No. 25") and adopted the disclosure provisions of Statement of

Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123." Under APB No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Accordingly, no compensation expense has been recognized in the consolidated financial statements in connection with employee stock option grants prior to fiscal 2007. During the twelve-month period ended May 31, 2008, the Board of Directors granted non-qualified stock options under the 2004 Stock Option/Stock Issuance Plan to four directors to purchase an aggregate of 600,000 shares of common stock, at an exercise price of $.12 per share, which represented the fair market value of the underlying common stock at the time of the respective grants. These options vested immediately and expire ten years from the date of grant. During the twelve-month period ended May 31, 2008, the Company's Board of Directors granted 150,000 shares of common stock under the 2004 Plan to one director of the Company having a fair market value of $0.06 per share at the time of the respective grant. Stock-based compensation expense recognized under SFAS 123(R) for the fiscal year ended May 31, 2008 was $81,406, which comprised the fair value of the stock options issued during the year. For purposes of estimating the fair value of each option on the date of grant, the Company utilized the Black-Scholes option-pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options. F - 10 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 The fair value of the Company's stock-based awards were estimated using the following weighted-average assumptions: Years Ended May 31, 2008 2007 --------------- ------------- Expected life (years) 5 5 Expected volatility 103.25% 99% Risk-free interest rate 4.95% 4.5% Expected dividend yield 0.0% 0.0% Cash and Cash Equivalents Cash and cash equivalents represent cash and short-term, highly liquid investments either in certificates of deposit, treasury bills, money market funds, and investment grade commercial paper issued by major corporations and financial institutions that generally have maturities of three months or less. Dividend and interest income are recognized when earned. The cost of securities sold is calculated using the specific identification method. Certificates of Deposit Included in this caption are all certificates of deposit that have original maturities of greater than three months. Realized and unrealized gains and losses and declines in value, if any, are included in earnings. Dividend and interest income are recognized when earned. The cost of securities sold is calculated using the specific identification method. Accounts Receivable, net The Company's accounts receivable are due from customers engaged in the provision of medical services. Credit is extended based on evaluation of a customer's financial condition and, generally, collateral is not required. Accounts receivable are generally due 30 to 90 days from shipment and are stated at amounts due from customers net of allowances for doubtful accounts, returns, term discounts and other allowances. Accounts that remain outstanding longer than the contractual payment terms are considered past due. Estimates are used in determining the allowance for doubtful accounts based on the Company's historical collections experience, current trends, credit policy and a percentage of its accounts receivable by aging category. In determining these percentages, we look at historical write-offs of our receivables. The Company also looks at the credit quality of its customer base as well as changes in its credit policies. The Company continuously monitors collections and payments from our customers. While credit losses have historically been within expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past. The changes in the Company's allowance for doubtful accounts are as follows: May 31, 2008 ------------------- Beginning balance $364,809 (Reversal)/Provision for losses on accounts receivable (53,142) Direct write-offs, net of recoveries (41,484) ------------------- Ending balance $270,183 =================== Concentrations of Credit Risk We market the EECP(R) system principally to hospitals and physician private practices. We perform credit evaluations of our customers' financial condition F - 11 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 and, as a consequence, believe that our receivable credit risk exposure is limited. Receivables are generally due 30 to 90 days from shipment. For the year ended May 31, 2008, no customer accounted for 10% or more of revenues or accounts receivable. Our revenues were derived from the following geographic areas: Years Ended May 31, ---------------------------------- 2008 2007 -------------- -------------- Domestic (United States) $4,347,222 $5,363,138 Non-domestic (foreign) 835,546 990,945 -------------- -------------- $5,182,768 $6,354,083

=============== =============== Inventories, net The Company values inventory at the lower of cost or estimated market, cost being determined on a first-in, first-out basis. The Company often places EECP(R) systems at various field locations for demonstration, training, evaluation, and other similar purposes at no charge. The cost of these EECP(R) systems is transferred to property and equipment and is amortized over the next two to five years. The Company records the cost of refurbished components of EECP(R) systems and critical components at cost plus the cost of refurbishment. The Company regularly review inventory quantities on hand, particularly raw materials and components, and record a provision for excess and obsolete inventory based primarily on existing and anticipated design and engineering changes to its products as well as forecasts of future product demand. We have adopted the provisions of Statement of Financial Accounting Standards No. 151, "Inventory Costs" (SFAS 151). The statement clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and requires the allocation of fixed production overhead to inventory based on the normal capacity of the production facilities. As a result of adopting SFAS No. 151, we absorbed approximately $158,000 less in fixed production overhead into inventory during fiscal year 2008 as compared to fiscal 2007. Property and Equipment Property and equipment are stated at cost less accumulated depreciation and amortization. Major improvements are capitalized and minor replacements, maintenance and repairs are charged to expense as incurred. Upon retirement or disposal of assets, the cost and related accumulated depreciation are removed from the consolidated balance sheet. Depreciation is provided over the estimated useful lives of the assets, which range from two to thirty-nine years, on a straight-line basis. Accelerated methods of depreciation are used for tax purposes. We amortize leasehold improvements over the useful life of the related leasehold improvement or the life of the related lease, whichever is less. (See Note E.) Deferred Revenue We record revenue on extended service contracts ratably over the term of the related warranty contracts. Under the provisions of EITF 00-21, we began to defer revenue related to EECP(R) system sales for the fair value of installation and in-service training to the period when the services are rendered and for warranty obligations ratably over the service period, which is generally one year. (See Note F.) Warranty Costs Equipment sold is generally covered by a warranty period of one year. Under the provisions of EITF 00-21, for certain arrangements, a portion of the overall system price attributable to the first year service arrangement is deferred and recognized as revenue over the service period. As such, we do not accrue warranty costs upon delivery but rather recognize warranty and related service costs as incurred. F - 12 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 Equipment sold to international customers through our distributor network is generally covered by a one-year warranty period. For these customers, we accrue a warranty reserve for estimated costs of providing a parts only warranty when the equipment sale is recognized. The factors affecting our warranty liability include the number of units sold and the historical and anticipated rates of claims and costs per claim. (See Note G.) Income Taxes Deferred income taxes are recognized for temporary differences between financial statement and income tax bases of assets and liabilities and loss carryforwards for which income tax benefits are expected to be realized in future years. A valuation allowance is established, when necessary, to reduce deferred tax assets to the amount expected to be realized. In estimating future tax consequences, we generally consider all expected future events other than an enactment of changes in the tax laws or rates. The deferred tax asset is continually evaluated for realizability. To the extent our judgment regarding the realization of the deferred tax assets changes, an adjustment to the allowance is recorded, with an offsetting increase or decrease, as appropriate, in income tax expense. Such adjustments are recorded in the period in which our estimate as to the realizability of the asset changed that it is "more likely than not" that all of the deferred tax assets will be realized. The "realizability" standard is subjective and is based upon our estimate of a greater than 50% probability that the deferred tax asset can be realized. Deferred tax assets and liabilities are classified as current or non-current based on the classification of the related asset or liability for financial reporting. A deferred tax asset or liability that is not related to an asset or liability for financial reporting, including deferred tax assets related to carryforwards, are classified according to the expected reversal date of the temporary difference. Fair Value of Financial Instruments The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term maturities of the instruments. The carrying amount of the financing receivables approximates fair value as the interest rates implicit in the leases approximate current market interest rates for similar financial instruments. The carrying amounts of notes payable approximates their fair value as the interest rates of these instruments approximate the interest rates available on instruments with similar terms and maturities. Net Loss Per Common Share Basic loss per share is based on the weighted average number of common shares outstanding without consideration of potential common stock. Diluted loss per share is based on the weighted number of common and potential dilutive common shares outstanding. The calculation takes into account the shares that may be issued upon the exercise of stock options and warrants, reduced by the shares that may be repurchased with the funds received from the exercise, based on the average price during the period. Reclassifications Certain reclassifications have been made to prior years' amounts to conform with the current year's presentation. F - 13 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 The fair value of the Company's stock-based awards were estimated using the following weighted-average assumptions: Years Ended May 31, 2008 2007 ------------ ------------ Expected life (years) 5 5 Expected volatility 103.25% 99% Risk-free interest rate 4.95% 4.5% Expected dividend yield 0.0% 0.0% Recently Issued Accounting Pronouncements Not Yet Effective The Company does not believe that adoption of any relevant accounting pronouncements that have been issued but are not yet effective will have a significant effect on future financial statements. The following is a list of accounting pronouncements issued but not yet effective. Statements of Financial Accounting Standards (SFAS): SFAS 141 (R), "Business Combinations" SFAS 157, Fair Value Measurements SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment to FASB Statement No. 115 SFAS 160, "Noncontrolling Interests in Consolidated Financial Statements" SFAS 161, "Disclosures about Derivative Instruments and Hedging Activities - an Amendment of FASB Statement 133" SFAS 163, "Accounting for Financial Guarantee Insurance Contracts" FASB Staff Positions (FSP): FSP APB 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)" FSP FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions" FSP FAS 142-3, "Determination of the Useful Life of Intangible Assets. FSP FAS 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" FSP FAS 157-2, "Effective Date of FASB Statement No. 157" FSP FIN 46(R)-7, "Application of FASB Interpretation No. 46(R) to Investment Companies" FSP SOP 94-3-1 and AAG HCO-1, " Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations " -- makes several changes to F - 14 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 the guidance on consolidation and the equity method of accounting in AICPA Statement of Position 94-3, "Reporting of Related Entities by Not-for-Profit Organizations", and the AICPA Audit and Accounting Guide, "Health Care Organizations. FSP SOP 07-1-1, -- indefinitely delays the effective date of AICPA Statement of Position 07-1, "Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies." FSP EITF 03-6-1, -- "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" EITF Consensuses (EITF): EITF Issue No. 07-1, "Accounting for Collaborative Arrangements " EITF Issue No. 07-4, "Application of the Two-Class Method under FASB Statement No. 128, Earnings per Share, to Master Limited Partnerships" NOTE C -LOSS PER COMMON SHARE The following table sets forth the computation of basic and diluted loss per share: Years Ended May 31, 2008 2007 --------------- --------------- Numerator: Net loss $(676,695) $(1,571,066) --------------- --------------- Denominator: Basic - weighted average shares 92,211,788 65,198,592 Stock options -- -- Warrants -- -- -------------- -------------- Diluted - weighted average shares 92,211,788 65,198,592 =============== =============== Loss per share - basic $(0.01) $(0.02) ================ =============== - diluted $(0.01) $(0.02) =============== =============== Options and warrants to purchase 12,000,462 and 8,846,876 shares of common stock were excluded from the computation of diluted earnings per share for the years ended May 31, 2008 and 2007, respectively, because the effect of their inclusion would be antidilutive. NOTE D - INVENTORIES, NET Inventories, net of reserves consist of the following: May 31, 2008 ----------------- Raw materials $936,035 Work in process 603,925 Finished goods 112,718 ----------------- $1,652,678 ================= F - 15 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 At May 31, 2008 and 2007 the Company reserves for excess and obsolete inventory of $594,042 and $677,166, respectively. NOTE E - PROPERTY AND EQUIPMENT Property and equipment is summarized as follows: May 31, 2008 ---------------- Office, laboratory and other equipment $1,368,170 EECP(R) systems under operating leases or under loan for clinical trials 719,401 Furniture and fixtures 148,165 ---------------- 2,235,736 Less: accumulated depreciation 2,178,566 ---------------- Property and equipment - net $57,170 ================ Depreciation expense amounted to $140,724 and $300,532 for the years ended May 31, 2008 and 2007, respectively. NOTE F - DEFERRED REVENUE The changes in the Company's deferred revenues are as follows: May 31, 2008 ----------------- Deferred revenue at beginning of year $1,756,351 Additions Deferred extended service contracts 1,849,831 Deferred in-service and training 47,500 Deferred service contract promotion 9,150 Deferred service arrangement obligations 213,750 Recognized as revenue Deferred extended service contracts 2,046,823 Deferred in-service and training 40,000 Deferred service contract promotion 13,950 Deferred service arrangement obligations 157,756 ----------------- Deferred revenue at end of year 1,618,053 Less: current portion 1,132,445 ----------------- Long-term deferred revenue at end of year $485,608 ================= NOTE G - SALE-LEASEBACK In August 2007, the Company sold its warehouse and corporate facility for $1,400,000. Under the agreement, the Company is leasing back the property from the purchaser over a period of five years. The Company is accounting for the leaseback as an operating lease. The gain of $266,226 realized in this transaction has been deferred and is being amortized to income ratably over the term of the lease. At May 31, 2008, the unamortized deferred gain of $221,855 is shown as "Deferred gain on sale of building" in the Company's consolidated balance sheet. The short-term portion of $53,245 is shown in current liabilities and the long-term portion is in other liabilities. The amount recognized as a gain in fiscal 2008 was $44,371. F - 16 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 NOTE H - WARRANTY LIABILITY The changes in the Company's product warranty liability are as follows: May 31, 2008 -------------------- Warranty liability at the beginning of the year $ 15,750 Expense for new warranties issued 39,000 Warranty claims (37,500) -------------------- Warranty liability at the end of the year 17,250 -------------------- Long-term warranty liability at the end of the year $-- ==================== NOTE I - LONG-TERM DEBT The Company purchased its headquarters and warehouse facility with secured notes of $641,667 and $500,000, respectively, under two programs sponsored by New York State. These notes, which bore interest at 7.8% and 6%, respectively, were payable in monthly installments consisting of principal and interest payments over fifteen-year terms, expiring in September 2016 and January 2017, respectively, and were secured by the building. On August 15, 2007, we sold our facility for $1.4 million under a sale with a five-year leaseback agreement. The net proceeds from the sale was approximately $425,000, after payment in full of the two secured notes in the amount of $851,015, brokers fees, closing costs, and the opening of a certificate of deposit in accordance with the provisions of the new lease NOTE J - RELATED-PARTY TRANSACTIONS On June 21, 2007, we entered into a Securities Purchase Agreement with Kerns Manufacturing Corp. (Kerns). Concurrently with our entry into the Securities Purchase Agreement, we also entered into a Distribution Agreement and a Supplier Agreement with Living Data Technology Corporation, an affiliate of Kerns (Living Data). We sold to Kerns, pursuant to the Securities Purchase Agreement, 21, 428,572 shares of our common stock at $.07 per share for a total purchase price of $1,500,000, as well as a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of $.08 per share (the Warrant). The agreement further provided for the appointment to our Board of Directors of two representatives from Kerns. In furtherance thereof, Mr. Jun Ma and Mr. Simon Srybnik, Chairman of both Kerns and Living Data, have been appointed members of our Board of Directors. Pursuant to the Distribution Agreement, we have become the exclusive distributor in the United States of the AngioNew ECP systems manufactured by Living Data. As additional consideration for such agreement, we agreed to issue an additional 6,990,840 shares of our common stock to Living Data. Pursuant to the Supplier Agreement, Living Data now is the exclusive supplier to us of the ECP therapy systems that we market under the registered trademark EECP(R). The Distribution Agreement and the Supplier Agreement each have an initial term extending through May 31, 2012. Pursuant to a Registration Rights Agreement, we granted to Kerns and Living Data, subject to certain restrictions, "piggyback registration rights" covering the shares sold to Kerns as well as the shares issuable upon exercise of the Warrant and the shares issued to Living Data. On July 10, 2007, the Board of Directors appointed Mr. Behnam Movaseghi, Treasurer and Chief Financial Officer of Kerns Manufacturing Corporation, to our Board of Directors. As affiliates of Living Data and Kerns, Mr. Ma, Mr. Movaseghi and Mr. Srybnik have each been directly involved in the transactions between Living Data and Kerns, and the Company, with respect to the Securities Purchase Agreement, the Distribution Agreement and the Supplier Agreement, as well as consulting servicesto the Company with no compensation. F- 17 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 During fiscal 2008, the Company purchased ECP therapy systems under the Supplier Agreement for $120,000 from Living Data, which was paid in full by the Company as of June 2008. In addition, Living Data purchased $5,000 worth of ECP therapy system components from the Company, which was paid in full by Living Data as of June 2008. During fiscal 2009, Living Data assigned to Vasomedical, Inc.all of its rights and interests under its distributorship Agreement with a corporation organized and existing under the laws of the People's Republic of China that manufactures Ambulatory Blood Pressure Monitors, Ambulatory ECG Recorders and Holter & ABPM Combiner Recorders, for $20,000 payable to Living Data based on certain terms and conditions. The Company must also pay to Living Data 5% of the selling price or 5% of the cost of all goods sold (whichever is higher), and 5% of the cost of all goods transferred but not sold under the Assignment Agreement to Living Data based on sales of this equipment. The Company intends to sell these systems in the United States and other countries subject to obtaining regulatory clearance. During fiscal 2009, Living Data assigned to Vasomedical, Inc. all of its rights and interests under its Distributorship Agreement with a corporation organized and existing under the laws of the People's Republic of China, that manufactures Ultrasound Scanners, for $20,000 payable to Living Data based on certain terms and conditions. The Company must also pay to Living Data 5% of the selling price or 5% of the cost of all goods sold (whichever is higher), and 5% of the cost of all goods transferred but not sold under the Assignment Agreement to Living Data based on sales of this equipment. The Company intends to sell these systems in the United States and other countries subject to obtaining regulatory clearance. In July of 2008, Vasomedical, Inc. has agreed to purchase ECP therapy systems under its Distributorship Agreement with Living Data for $360,000 payable over 18 months. Further, Kerns is providing the Company, free of charge, part time use of one of its Information Technology (IT) employees as well one of their IT consultants to provide the Company with IT and database support services. In addition a clinical applications support specialist and a service engineer from Living Data may be used by Vasomedical, Inc. to provide customers with clinical training and technical service. NOTE K - SERIES D PREFERRED STOCK AND WARRANTS On July 19, 2005, we entered into a Securities Purchase Agreement that provided us with gross proceeds of $2.5 million through a private placement of preferred stock with M.A.G. Capital, LLC through its designated funds, Monarch Pointe Fund Ltd., Mercator Momentum Fund III, LP, and Mercator Momentum Fund, LP (the Investors). The agreement provided for a private placement of 25,000 shares of Vasomedical's Series D Preferred Stock at $100 per share. The preferred stock was convertible into shares of Vasomedical's common stock at 85 percent of the volume weighted average price per share for the five trading days preceding any conversion, but not at more than $0.6606 or less than $0.40 per share. The Investors also acquired warrants for the purchase of 1,892,219 shares of common stock. The warrants may be exercised at a price of $0.69 per share for a term of five years, ending July 19, 2010. As of February 28, 2006, all of the Series D Preferred Stock had been converted into 6,112,209 shares of common stock. Under the terms of a Registration Rights Agreement with the Investors, Vasomedical filed a Form S-3 registration statement with the Securities and Exchange Commission (SEC) on August 22, 2005, for 10,787,871 shares of common stock representing up to 8,533,333 shares issuable in connection with conversion of our Series D Convertible Preferred Stock and up to 2,254,538 shares issuable upon the exercise of our common stock purchase warrants. The SEC declared the registration statement effective on September 1, 2005. The total number of shares registered was based on a conversion price of $0.30 per share, which would only have an affect in the event of default by Vasomedical of its obligation to holders of the Series D Convertible Preferred Stock. F - 18 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 These securities were offered and sold to the Investors in a private placement transaction made in reliance upon exemptions from registration pursuant to Section 4(2) of the Securities Act of 1933. The Investors are accredited investors as defined in Rule 501 of Regulation D promulgated under the Securities Act of 1933. Vasomedical applied the funds to working capital. Warrants and Beneficial Conversion Feature The Company applied Emerging Issues Task Force Issue No. 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios"(EITF No. 98-5) and Emerging Issues Task Force (EITF 00-27) Application of Issue No. 98-5 to Certain Convertible Instruments in accounting for the preferred stock issuance. EITF No. 98-5 provides that detachable warrants issued with convertible securities are valued separately, and that the beneficial conversion feature of the convertible security be measured and recognized over the minimum period over which the shareholders can realize the return. The Task Force reached a consensus that convertible preferred securities with a non-detachable conversion feature that is in-the-money at the commitment date represents an embedded beneficial conversion feature that should be recognized as a dividend and recorded to additional paid-in capital. That amount should be calculated at the commitment date as the difference between the allocated portion of the gross proceeds to the convertible preferred stock and the fair value of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible (intrinsic value method). The beneficial conversion feature is treated analogous to a dividend and is recognizable immediately over the minimum period during which the preferred shareholders can realize that return. The imputed dividend will increase the Company's loss for the purpose of computing the loss-per-share applicable to common shareholders. The beneficial conversion feature is calculated at its intrinsic value at the commitment date (that is, the difference between the total gross proceeds allocated to the preferred stock as compared to the total market value of the common stock into which the Preferred Stock is convertible on the commitment date). The computed value of the beneficial conversion feature is treated as a deemed dividend immediately with a corresponding increase to paid-in capital. No additional amount will be recognized at the conversion date in recognition of an increase in the fair value of the stock conversion. In circumstances in which convertible securities are issued with detachable warrants, the Task Force noted that in order to determine the amount to be allocated to the beneficial conversion feature, the issuer must first allocate the proceeds between the convertible instrument and the detachable warrants using the relative fair value method of APB Opinion Number 14. The investors and consultants acquired detachable warrants for the purchase of 1,892,219 and 362,319 shares of common stock, respectively, which were valued at $345,071 and $66,087, respectively. The warrants may be exercised at a price of $0.69 per share for a term of five years, ending July 18, 2010. For purposes of estimating the intrinsic fair value of these warrants as of July 19, 2005, we utilized the Black-Scholes option-pricing model. We estimated the fair value of the warrants using the following weighted-average assumptions: Expected life (years) 2.5 Expected volatility 66% Risk-free interest rate 4.16% Expected dividend yield 0.0% We determined the intrinsic fair value of the convertible preferred stock as of July 19, 2005, to be $2,941,176 based on the number of common shares that could be acquired as of the date of closing times $0.63, the closing price of the common stock on the date preceding the close of the transaction. In applying EITF No. 98-5, we then allocated the gross proceeds of $2,500,000 between the warrants and preferred stock based on intrinsic value of each instrument. As a F - 19 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 result, we allocated $2,154,929 of gross proceeds to the convertible preferred stock and $345,071 to the detachable warrants. The beneficial conversion feature of $786,247 was then determined by subtracting the allocated proceeds of convertible preferred stock from the intrinsic fair value of convertible preferred stock. The beneficial conversion feature was immediately recognized as a preferred stock dividend, as the preferred stock can be converted immediately. Dividends By the placement of the convertible preferred stock described above, we became obligated to pay a cash dividend monthly on the outstanding shares of convertible preferred stock. The dividend rate was the higher of (i) the prime rate as reported by the Wall Street Journal on the first day of the month, plus three percent or, (ii) 8.5% times $100 per share, but in no event greater than 10% annually. For the fiscal year ended May 31, 2006, cash dividends of $91,623 were paid. Preferred stock dividends for the fiscal 2006 are summarized as follows: Amount ------ Cash dividends paid $91,623 Beneficial conversion feature 786,247 ------------- $877,870 ============= NOTE L - STOCKHOLDERS' EQUITY AND WARRANTS Common stock The Company issued 200,000 shares of common stock in lieu of cash for $126,000 in consultant services associated with the issuance of the Series D Convertible Preferred Stock. These issue costs were treated as a reduction in the paid-in capital associated with the preferred stock issuance. On July 19, 2005, we granted warrants for the purchase of 2,254,538 shares of common stock to investors and consultants associated with the issuance of Series D Preferred Stock, (See Note I). The warrants may be exercised at a price of $0.69 per share for a term of five years, ending July 19, 2010. The remaining 200,000 warrants expired in October 2006. On June 21, 2007, a five-year warrant to purchase 4,285,714 shares of our common stock at an initial exercise price of $.08 per share to Kerns under the Securities Purchase Agreement. Warrants Warrant activity for the years ended May 31, 2007 and 2008 is summarized as follows: Employees Consultants Total Weighted Average Price Balance at May 31, 2006 -- 2,454,538 2,454,538 $0.71 Warrants expired -- (200,000) (200,000) $0.91 -------------- ------------------ ----------------------- ---------------- Balance at 2007 -- 2,254,538 2,254,538 $0.69 -------------- ------------------ ----------------------- ---------------- Warrants issued 4,285,714 4,285,714 $0.08 -------------- ------------------ ----------------------- ---------------- Number of shares exercisable -- 6,540,252 6,540,252 $0.29 ============== =================== ======================= ================ F - 20 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 NOTE M - OPTION PLANS 1995 Stock Option Plan In May 1995, the Company's stockholders approved the 1995 Stock Option Plan for officers and employees of the Company for which the Company reserved an aggregate of 1,500,000 shares of common stock. In December 1997, the Company's Board of Directors terminated the 1995 Stock Option Plan with respect to new option grants. In fiscal 2007, options to purchase 286,000 shares of common stock at an exercise price of $3.43750 under the

1995 Stock Option Plan were retired or cancelled. In fiscal 2008, there was no activity under the 1995 Stock Option Plan. Outside Director Stock Option Plan In May 1995, the Company's stockholders approved an Outside Director Stock Option Plan (the OD Plan) for non-employee directors of the Company, for which the Company reserved an aggregate of 300,000 shares of common stock. In December 1997, the Company's Board of Directors terminated the OD Plan with respect to new option grants. In fiscal 2007, options to purchase 28,250 shares of common stock at an exercise price of $1.77 under the OD Plan were retired unexercised. In fiscal 2008, there was no activity under the OD Plan. 1997 Stock Option Plan In December 1997, the Company's stockholders approved the 1997 Stock Option Plan (the 1997 Plan) for officers, directors, employees and consultants of the Company for which the Company has reserved an aggregate of 1,800,000 shares of common stock. The 1997 Plan provides that a committee of the Board of Directors of the Company will administer it and that the committee will have full authority to determine the identity of the recipients of the options and the number of shares subject to each option. Options granted under the 1997 Plan may be either incentive stock options or non-qualified stock options. The option price shall be 100% of the fair market value of the common stock on the date of the grant (or in the case of incentive stock options granted to any individual principal stockholder who owns stock possessing more than 10% of the total combined voting power of all voting stock of the Company, 110% of such fair market value). The term of any option may be fixed by the committee but in no event shall exceed ten years from the date of grant. Options are exercisable upon payment in full of the exercise price, either in cash or in common stock valued at fair market value on the date of exercise of the option. The term for which options may be granted under the 1997 Plan expired on August 6, 2007. In January 1999, the Company's Board of Directors increased the number of shares authorized for issuance under the 1997 Plan by 1,000,000 shares to 2,800,000 shares. In May 2006, the Board of Directors accelerated the vesting period for all unvested options to May 31, 2006. In fiscal 2007, the Board of Directors granted non-qualified stock options under the 1997 plan to a Director to purchase 150,000 shares of common stock at an exercise price of $0.09 per share (which represent the fair market value of the underlying common stock at the time of the respective grants). These options expire 10 years from grant date. In fiscal 2007, there were no options to purchase shares of common stock under the 1997 Plan. In fiscal 2007, options to purchase 494,167 shares of common stock under the 1997 Plan at exercise prices ranging from $0.88 to $1.91 were retired or cancelled. In fiscal 2008, the Board of Directors did not grant any non-qualified stock options under the 1997 plan, and there were no options to purchase shares of common stock under the 1997 plan. In fiscal 2008, options to purchase 714,601 shares of common stock under the 1997 Plan at exercise prices ranging from $0.88 to $1.91 were retired or cancelled. F - 21 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 1999 Stock Option Plan In July 1999, the Company's Board of Directors approved the 1999 Stock Option Plan (the 1999 Plan), for which the Company reserved an aggregate of 2,000,000 shares of common stock. The 1999 Plan provides that a committee of the Board of Directors of the Company will administer it and that the committee will have full authority to determine the identity of the recipients of the options and the number of shares subject to each option. Options granted under the 1999 Plan may be either incentive stock options or non-qualified stock options. The option price shall be 100% of the fair market value of the common stock on the date of the grant (or in the case of incentive stock options granted to any individual principal stockholder who owns stock possessing more than 10% of the total combined voting power of all voting stock of the Company, 110% of such fair market value). The term of any option may be fixed by the committee but in no event shall exceed ten years from the date of grant. Options are exercisable upon payment in full of the exercise price, either in cash or in common stock valued at fair market value on the date of exercise of the option. The term for which options may be granted under the 1999 Plan expires July 12, 2009. In July 2000, the Company's Board of Directors increased the number of shares authorized for issuance under the 1999 Plan by 1,000,000 shares to 3,000,000 shares. In December 2001, the Board of Directors of the Company increased the number of shares authorized for issuance under the 1999 Plan by 2,000,000 shares to 5,000,000 shares. In May 2006, the Board of Directors accelerated the vesting period for all unvested options to May 31, 2006. In fiscal 2007, the Board of Directors granted non-qualified stock options under the 1999 Plan to directors to purchase an aggregate of 450,000 shares of common stock, at an exercise price of $0.09 per shares (which represented the fair market value of the underlying common stock at the time of the respective grants). In fiscal 2007, there were no options to purchase shares of common stock under the 1999 Plan. In fiscal 2007, options to purchase 996,279 shares of common stock under the 1999 Plan at exercise prices ranging from $0.20 to $5.00 were retired or cancelled. In fiscal 2008, the Board of Directors did not grant any non-qualified stock options under the 1999 Plan. In fiscal 2008, there were no options to purchase shares of common stock under the 1999 Plan. In fiscal 2008, options to purchase 1,006,500 shares of common stock under the 1999 Plan at exercise prices ranging from $0.20 to $5.00 were retired or cancelled. At May 31, 2008, there were 1,068,532 shares available for future grants under the 1999 Plan. 2004 Stock Option and Stock Issuance Plan In October 2004, the Company's stockholders approved the 2004 Stock Option and Stock Issuance Plan (the 2004 Plan), for which the Company reserved an aggregate of 2,500,000 shares of common stock. The 2004 Plan is divided into two separate equity programs: (i) the Option Grant Program under which eligible persons ("Optionees") may, at the discretion of the board of directors, be granted options to purchase shares of common stock; and (ii) the Stock Issuance Program under which eligible persons ("Participants") may, at the discretion of the board or directors, be issued shares of common stock directly, either through the immediate purchase of such shares or as a bonus for services rendered to the Corporation. Options granted under the 2004 Stock Plan shall be non-qualified or incentive stock options and the exercise price is the fair market value of the common stock on the date of grant except that for incentive stock options it shall be 110% of the fair market value if the Optionee owns 10% or more of our common stock. The term of any option may be fixed by the board of directors or committee but in no event shall exceed ten years from the date of grant. Stock options granted under the 2004 Plan may become exercisable in one or more installments in the manner and at the time or times specified by the committee. Options are exercisable upon payment in full of the exercise price, either in cash or in common stock valued at fair market value on the date of exercise of the option. The term for which options may be granted under the 2004 Plan expires July 12, 2014. F- 22 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 Under the stock issuance program, the purchase price per share shall be fixed by the board of directors or committee but cannot be less than the fair market value of the common stock on the issuance date. Payment for the shares may be made in cash or check payable to us, or for past services rendered to us and all shares of common stock issued thereunder shall vest upon issuance unless otherwise directed by the committee. The number of shares issuable is also subject to adjustments upon the occurrence of certain events, including stock dividends, stock splits, mergers, consolidations, reorganizations, recapitalizations, or other capital adjustments. The term for which shares may be issued under the 2004 Plan expires July 12, 2014. The 2004 Plan provides that a committee of the Board of Directors of the Company will administer it and that the committee will have full authority to determine and designate the individuals who are to be granted stock options or qualify to purchase shares of common stock under the 2004 Stock Plan, the number of shares to be subject to options or to be purchased and the nature and terms of the options to be granted. The committee also has authority to interpret the 2004 Plan and to prescribe, amend and rescind the rules and regulations relating to the 2004 Plan. In May 2006, the Board of Directors accelerated the vesting period for all unvested options to May 31, 2006. In fiscal 2007, the Company's Board of Directors granted non-qualified stock options under the 2004 Plan to an officer to purchase an aggregate of 200,000 shares of common stock, at an exercise price of $0.11 per share (which represented the fair market value of the underlying common stock at the time of the respective grants). These options expire ten years from the date of grant. In fiscal 2007, options to purchase 733,716 shares of common stock under the 2004 Plan at exercise prices ranging from $0.20 to $0.58 were retired or cancelled. In fiscal 2008, the Company's Board of Directors granted non-qualified stock options under the 2004 Plan to four directors to purchase an aggregate of 600,000 shares of common stock, at an exercise price of $0.12 per share (which represented the fair market value of the underlying common stock at the time of the respective grants) and the Company's Board of Directors granted 150,000 shares of common stock under the 2004 Plan to one director of the Company having a fair market value of $0.06 per share at the time of the respective grant. These options expire ten years from the date of grant. In fiscal 2008, options to purchase 236,461 shares of common stock under the 2004 Plan at exercise prices $0.57 and $0.58 were retired or cancelled. At May 31, 2008, there were 593,928 shares available for future grants under the 2004 Plan. Stock option activity under all the plans for the years ended May 31, 2007 and 2008 is summarized as follows: Outstanding Options -- Shares Range of Weighted Available for Number of Exercise Average Grant Shares Price per Share Exercise Price ---------------- ------------------ --------------------- ---------------- Balance at May 31, 2006 749,872 8,012,075 $0.20 - $5.15 $1.20 Options granted (800,000) 800,000 $0.09 - $0.11 $0.10 Options exercised -- -- -- -- Options canceled 1,747,987 (2,219,737) $0.20 - $5.00 $1.28 ---------------- ------------------ --------------------- ---------------- Balance at May 31, 2007 1,697,859 6,592,338 $0.20 - $5.00 $1.04 Common shares granted (150,000) -- -- -- Options granted (600,000) 600,000 $.12 $.12 Options exercised -- -- -- -- Options canceled 714,601 (1,737,128) $.20-$3.96 $1.29 ---------------- ------------------ --------------------- ---------------- Balance at May 31, 2008 1,662,460 5,455,210 $.09-$4.28 $.86 (1) May be issued under the Stock Issuance Program. F - 23 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 The following table summarizes information about stock options outstanding and exercisable at May 31, 2008: Options Outstanding Options Exercisable -- ------------------------------- Weighted Average Weighted Weighted Number Remaining Average Number Average Outstanding at Contractual Exercise Exercisable at Exercise Range of Exercise Prices May 31, 2008 Life (yrs.) Price May 31, 2008 Price ----------------- --------------- -------------- ----------------- ------------- $0.09 - $0.58 2,561,710 7.8 $.21 2,345,044 $.21 $0.71 - $0.95 614,500 3.6 $.88 614,500 $.88 $1.00 - $1.31 1,760,000 5.2 $1.09 1,760,000 $1.09 $1.69 - $2.49 75,000 1.1 $1.69 75,000 $1.69 $2.91 - $4.28 444,000 2.8 $3.57 444,000 $3.57 ----------------- --------------- -------------- ---------------- -------------- 5,455,210 4.4 $.86 5,238,544 $.88 ================= =============== ============== ================= ============= The weighted-average fair value exercise price of options and warrants granted during fiscal years 2008 and 2007 was $0.08 and $0.10, respectively. At May 31, 2008, there were approximately 2,569,074 remaining authorized shares of common stock after reserves for all stock option plans and stock warrants. NOTE N - INCOME TAXES During the fiscal years ended May 31, 2008 and 2007, we recorded a provision for income taxes of $18,045 and $20,608, respectively. As of May 31, 2008, the recorded deferred tax asset was $19,819,352, reflecting an increase of $230,000 during fiscal 2008, which was offset by a valuation allowance of the same amount. The Company's deferred tax assets are summarized as follows: 2008 2007 -------------- -------------- Net operating loss and other carryforwards $17,952,000 $18,120,000 Accrued compensation -- 2,400 Bad debts 91,900 125,000 Other 1,775,452 1,341,952 -------------- -------------- Total gross deferred tax assets 19,819,352 19,589,352 Valuation allowance (19,819,352) (19,589,352) -------------- -------------- Net deferred tax assets $-- $-- =============== ============== At May 31, 2008, the Company had net operating loss carryforwards for Federal and state income tax purposes of approximately $52,800,000, expiring at various dates from 2009 through 2028. In fiscal 2008 $558,968 of net operating loss carryforwards expired. Future expirations of net operating loss carryforwards are as follows: F - 24 Vasomedical, Inc. and Subsidiaries NOTES TO CONSOLIDATED FINANCIAL STATEMENTS May 31, 2008 and 2007 Fiscal Year Amount ------------------ ------------- 2009 $ 470,994 2010 2,454,162 2011 5,449,051 2012 6,084,213 2013 4,386,716 Thereafter 33,954,864 ------------- Total $52,800,000 ============= Under current tax law, the utilization of tax attributes will be restricted if an ownership change, as defined, were to occur. Section 382 of the Internal Revenue Code provides, in general, that if an "ownership change" occurs with respect to a corporation with net operating and other loss carryforwards, such carryforwards will be available to offset taxable income in each taxable year after the ownership change only up to the "Section 382 Limitation" for each year (generally, the product of the fair market value of the corporation's stock at the time of the ownership change, with certain adjustments, and a specified long-term tax-exempt bond rate at such time). The Company's ability to use its loss carryforwards will be limited in the event of an ownership change. The following is a reconciliation of the effective income tax rate to the federal statutory rate: 2008 2007 % % ---------------- --------------- Federal statutory rate (34.0) (34.0) State taxes, net 2.7 1.3 Permanent differences 1.8 2.7 Change in valuation allowance relating to operations 28.6 31.4 Other (1.8) (2.7) ---------------- --------------- (2.7) (1.3) ================= =============== NOTE O - COMMITMENTS AND CONTINGENCIES Leases On August 15, 2007, we sold our facility under a five-year leaseback agreement. Future rental payments under the operating lease are as follows: For the years ended: May 31, 2009 $142,777 May 31, 2010 148,488 May 31, 2011 154,427 May 31, 2012 160,604 May 31, 2013 40,540 ----------------- Total $646,836 ================= F - 25 Litigation The Company is currently, and has been in the past, a party to various routine legal proceedings incident to the ordinary course of business. The Company believes that the outcome of all such pending legal proceedings in the aggregate is unlikely to have a material adverse effect on the business or consolidated financial condition of the Company. NOTE P - 401(K) PLAN In April 1997, the Company adopted the Vasomedical, Inc. 401(k) Plan to provide retirement benefits for its employees. As allowed under Section 401(k) of the Internal Revenue Code, the plan provides tax-deferred salary deductions for eligible employees. Employees are eligible to participate in the next quarter enrollment period after employment. Participants may make voluntary contributions to the plan up to 15% of their compensation. In fiscal year 2008 and 2007, the Company made discretionary contributions of approximately $9,000 and $15,000, respectively, to match a percentage of employee contributions. F - 26