HEARUSA INC
Form 10-Q
May 16, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended April 1, 2006

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission file number 001-11655
HearUSA, Inc.
(Exact Name of Registrant as Specified in Its Charter)

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

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

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report

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

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

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

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

On April 25, 2006, 31,379,538 shares of the Registrant s Common Stock and 780,358 exchangeable shares of HEARx Canada, Inc. were outstanding.

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Part I Financial Information

Item 1. Financial Statements

HearUSA, Inc.
Consolidated Balance Sheets

	April 1, 2006	December 31, 2005
	(unaudited)	
ASSETS (Note 4)		
Current assets		
Cash and cash equivalents	$ 4,117,615	$ 6,706,944
Restricted cash and cash equivalents	444,850	431,000
Accounts and notes receivable, less allowance for doubtful accounts of $446,781 and $413,386	5,985,300	6,715,933
Inventories	2,068,548	1,604,943
Prepaid expenses and other	1,557,413	1,627,407
Total current assets	**14,173,726**	**17,086,227**
Property and equipment, net	**3,619,686**	**3,474,381**
Goodwill (Note 3)	**38,956,076**	**36,394,959**
Intangible assets, net	**11,341,185**	**11,440,345**
Deposits and other	**571,666**	**585,633**
Total Assets	**$ 68,662,339**	**$ 68,981,545**
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 7,798,690	$ 8,499,812
Accrued expenses	2,465,513	2,344,419
Accrued salaries and other compensation	2,396,953	2,589,877
Current maturities of long-term debt	5,447,565	5,192,108
Current maturities of convertible subordinated notes, net of debt discount of $1,676,556 and $1,847,853	823,444	652,147
Current maturities of subordinated notes, net of debt discount of $742,591 and $868,345	1,017,409	891,655
Dividends payable	34,950	34,562
Total current liabilities	**19,984,524**	**20,204,580**
Long-term debt (Notes 3 and 4)	**20,130,829**	**19,970,099**
Convertible subordinated notes, net of debt discount of $1,203,082 and $1,565,187 (Note 5)	**3,171,917**	**3,434,813**
Subordinated notes, net of debt discount of $382,007 and $512,350 (Note 6)	**2,477,993**	**2,787,650**
Warrant liability (Note 6)	**1,175,550**	**1,347,217**

Total long-term liabilities	**26,956,289**	**27,539,779**
Commitments and contingencies		
Stockholders equity (Note 7)		
Preferred stock (aggregate liquidation preference $2,330,000; $1 par, 7,500,000 shares authorized)		
Series H Junior Participating (none outstanding)		
Series J (233 shares outstanding)	233	233
Total preferred stock	233	233
Common stock: $.10 par; 75,000,000 shares authorized 31,903,200 and 31,893,200 shares issued	3,190,320	3,189,320
Stock subscription	(412,500)	(412,500)
Additional paid-in capital	122,173,005	121,934,658
Accumulated deficit	(102,982,250)	(103,252,279)
Accumulated other comprehensive income	2,237,859	2,262,895
Treasury stock, at cost: 523,662 common shares	(2,485,141)	(2,485,141)
Total stockholders equity	**21,721,526**	**21,237,186**
Total Liabilities and Stockholders Equity	**$ 68,662,339**	**$ 68,981,545**

See accompanying notes to the consolidated financial statements

HearUSA, Inc.
Consolidated Statements of Operations
Three Months Ended April 1, 2006 and April 2, 2005

	April 1, 2006	April 2, 2005
	(unaudited)	(unaudited)
Net revenues		
Hearing aids and other products	$ 20,289,349	$ 17,597,626
Services	1,367,965	1,432,959
Total net revenues	21,657,314	19,030,585
Operating costs and expenses		
Hearing aids and other products (Note 4)	6,112,568	4,917,507
Services	372,783	447,775
Total cost of products sold and services	6,485,351	5,365,282
Center operating expenses	9,767,320	9,203,466
General and administrative expenses (including approximately $233,000 non-cash employee stock-based compensation expense in 2006) (Notes 1 and 7)	3,239,204	2,963,956
Depreciation and amortization	492,145	482,907
Total operating costs and expenses	19,984,020	18,015,611
Income from operations	1,673,294	1,014,974
Non-operating income (expense):		
Gain from insurance proceeds	57,157	
Interest income	22,825	12,683
Interest expense (including approximately $726,000 and $568,000 of non-cash debt discount amortization and approximately $172,000 in non-cash reduction in interest expense for the decrease in the fair value of the warrant liability) (Notes 4, 5 and 6)	(1,410,147)	(1,183,617)
Income (loss) from continuing operations before income taxes	343,129	(155,960)
Income taxes	(38,150)	
Net income (loss) from continuing operations	304,979	(155,960)
Loss from discontinued operations (Note 2)		(95,478)
Net income (loss)	304,979	(251,438)
Dividends on preferred stock	(34,950)	(193,630)
Net income (loss) applicable to common stockholders	$ 270,029	$ (445,068)

Net income (loss) from continuing operations, including dividends on preferred stock, applicable to common stockholders basic	$	0.01	$	(0.01)
Net Income (loss) from continuing operations, including dividends on preferred stock, applicable to common stockholders diluted	$	0.01	$	(0.01)
Net income (loss) applicable to common stockholders per common share basic	$	0.01	$	(0.01)
Net income (loss) applicable to common stockholders per common share diluted	$	0.01	$	(0.01)
Weighted average number of shares of common stock outstanding basic		32,159,902		30,516,331
Weighted average number of shares of common stock outstanding diluted		38,825,085		30,516,331

See accompanying notes to the consolidated financial statements

HearUSA, Inc.
Consolidated Statements of Cash Flows
Three Months Ended April 1, 2006 and April 2, 2005

	April 1, 2006 (unaudited)	April 2, 2005 (unaudited)
Cash flows from operating activities		
Net income (loss)	$ 304,979	$ (251,438)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Debt discount amortization	725,682	568,223
Depreciation and amortization	492,145	482,907
Interest on Siemens Tranche C	296,163	206,085
Employee stock-based compensation	232,605	
Provision for doubtful accounts	91,000	99,644
Loss from discontinued operations		95,478
Consulting expense	6,740	6,740
Loss (gain) on the disposition of property and equipment	5,668	(60,437)
Principal payments on long-term debt made through preferred pricing reductions	(730,000)	(730,201)
Decrease in fair value of warrant liability	(171,667)	
Other	(13,552)	
(Increase) decrease in:		
Accounts and notes receivable	634,809	197,612
Inventories	(463,598)	160,832
Prepaid expenses and other	108,894	(565,131)
Increase (decrease) in:		
Accounts payable and accrued expenses	(516,988)	(319,345)
Accrued salaries and other compensation	(192,509)	115,085
Net cash provided by continuing operations	810,371	6,054
Net cash used in discontinued operations		(55,823)
Net cash provided by (used in) operating activities	810,371	(49,769)
Cash flows from investing activities		
Purchase of property and equipment	(445,039)	(189,696)
Capital expenditures from discontinued operations		(10,851)
Business acquisitions	(1,426,846)	
Net cash used in investing activities	(1,871,885)	(200,547)
Cash flows from financing activities		
Principal payments on long-term debt	(421,951)	(206,094)
Principal payments on convertible subordinated notes	(625,000)	
Principal payments on subordinated notes	(440,000)	

Proceeds from the exercise of warrants		1,725,000
Dividends paid on preferred stock	(34,950)	(265,430)
Net cash provided by (used in) financing activities	(1,521,901)	1,253,476
Effects of exchange rate changes on cash	(5,914)	13,900
Net increase (decrease) in cash and cash equivalents	**(2,589,329)**	**1,017,060**
Cash and cash equivalents at beginning of period	**6,706,944**	**2,615,379**
Cash and cash equivalents at end of period	**$ 4,117,615**	**$ 3,632,439**

HearUSA, Inc.
Consolidated Statements of Cash Flows
Three Months Ended April 1, 2006 and April 2, 2005

	April 1, 2006	April 2, 2005
	(unaudited)	(unaudited)
Supplemental disclosure of cash flows information:		
Cash paid for interest	$ 434,000	$ 266,000
Supplemental schedule of non-cash investing and financing activities:		
Principal payments on long-term debt through preferred pricing reductions	$ 730,000	$ 730,201
Issuance of notes payable in exchange for business acquisitions	$ 1,272,000	$

See accompanying notes to consolidated financial statements

HearUSA, Inc

Notes to Consolidated Financial Statements

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three month period ended April 1, 2006 are not necessarily indicative of the results that may be expected for the year ending December 30, 2006. For further information, refer to the audited consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2005.

1. Description of the Company and Summary of Significant Accounting Policies

The Company

HearUSA, Inc. (HearUSA or the Company), a Delaware corporation, was organized in 1986. As of April 1, 2006, the Company has a network of 138 company-owned hearing care centers in eight states and the Province of Ontario, Canada. The Company also sponsors a network of approximately 1,400 credentialed audiology providers that participate in selected hearing benefit programs contracted by the Company with employer groups, health insurers and benefit sponsors in 49 states. The centers and the network providers provide audiological products and services for the hearing impaired.

Basis of consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned and majority controlled subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

Fiscal year

The Company s fiscal year ends on the last Saturday in December and customarily consists of four 13-week quarters for a total of 52 weeks. Every sixth year includes 53 weeks. 2005 included 53 weeks with the additional week included in the first quarter of 2005. The next year with 53 weeks will be 2011.

Net income (loss) per common share

Net income (loss) per common share is calculated in accordance with SFAS No. 128 Earnings Per Share which requires companies to present basic and diluted earnings per share. Net income (loss) per common share basic is based on the weighted average number of common shares outstanding during the year. Net income per common share diluted is based on the weighted average number of common shares and dilutive potential common shares outstanding during the year. Under the if-converted method, securities are assumed to be converted at the beginning of the period and the resulting common shares are included in the denominator of the diluted earnings per share calculation for the entire period presented. Common stock equivalent for convertible subordinated notes and preferred stock, outstanding options and warrants to purchase common stock of 10,142,230 were excluded from the computations of net loss per common share diluted at April 2, 2005 because the effect of their inclusion would be anti-dilutive.

For purposes of computing net income (loss) per common share basic and diluted, for the quarters ended April 1, 2006 and April 2, 2005, the weighted average number of shares of common stock outstanding includes the effect of the 780,358 and 866,347, respectively, exchangeable shares of HEARx Canada, Inc., as if they were outstanding common stock of the Company.

Comprehensive income (loss)

Comprehensive income (loss) is defined to include all changes in equity except those resulting from investments by owners and distributions to owners. The Company s other comprehensive income (loss) represents a foreign currency translation adjustment.

HearUSA, Inc
Notes to Consolidated Financial Statements

Components of comprehensive income (loss) are as follows:

	Three Months Ended	
	April 1, 2006	April 2, 2005
Net income (loss) for period	$ 304,979	$ (251,438)
Other comprehensive income:		
Foreign currency translation adjustments	(25,036)	86,099
Comprehensive loss for the period	$ 279,943	$ (165,339)

Stock-based compensation

On January 1, 2006, we adopted Financial Accounting Standards No. 123(R), Share-Based Payment , (SFAS 123(R)), that addresses the accounting for share-based payment transactions in which a Company receives employee services in exchange for either equity instruments of the enterprise or liabilities that are based on the fair value of the Company s instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions, as we formerly did, using the intrinsic value method as prescribed by Accounting Principles Board, or APB, Opinion No. 25, Accounting for Stock Issued to Employees, , and generally requires that such transactions be accounted for using a fair-value based method and recognized as expenses in our consolidated financial statements.

We adopted SFAS 123(R) using the modified prospective transition method which requires the application of accounting standard as of January 1, 2006. Our consolidated financial statements as of and for the first quarter of 2006 reflect the impact of adopting SFAS 123(R). In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). (See Note 7 - Stock-based Benefit Plans)

Stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that are ultimately expected to vest. Stock-based compensation expense recognized in the consolidated statement of operations during the first quarter of 2006 included compensation expense for stock-based payment awards granted prior to, but not yet vested, as of December 31, 2005 based on grant date fair value estimated in accordance with the pro forma provisions of SFAS 148, Accounting for Stock-Based Compensation-Transition and Disclosures. , and compensation expense for the stock-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with SFAS 123(R). This additional expense is non-cash and does not affect the Company s cash flows.

Reclassifications

Certain amounts in the 2005 consolidated financial statements have been reclassified in order to conform to the 2006 presentation.

2. Discontinued Operations

In June 2005, the Company sold the assets of a group of hearing care centers in the states of Minnesota, Washington and Wisconsin, including goodwill, customer list and selected assets with a net book value of approximately $735,000, for approximately $1.1 million in cash, resulting in a gain on disposition of assets of approximately $365,000.

The assets sold and related operating results have been presented as discontinued operations and the consolidated financial statements have been reclassified to segregate the assets and operating results for all periods presented in accordance with SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets . The assets and operating expenses of these hearing care centers sold were reported under the center segment.

HearUSA, Inc
Notes to Consolidated Financial Statements

Net revenues, pre-tax net losses and net loss from discontinued operations applicable to common stockholders basic and diluted of the discontinued operations for the three months April 2, 2005 were approximately as follows:

		Three months ended April 2, 2005
Net revenues of discontinued operations	$	1,038,000
Pre-tax net losses of discontinued operations	$	95,478
Net loss from discontinued operations applicable to common stockholders basic and diluted	$	(0.00)

3. Business Acquisitions

During 2006, the Company acquired the assets of five hearing care centers in New Jersey, California and Florida in three separate transactions. Consideration paid was cash of approximately $1.4 million and notes payable in the amount of approximately $1.3 million. The acquisitions resulted in additions to goodwill of approximately $2.6 million, fixed assets of approximately $16,000 and customer lists and non-compete agreements of approximately $88,000. The notes payable bear interest at rates varying from 5% to 6.5% and are payable in quarterly installments of $77,400 plus accrued interest, through March 2010. In connection with these acquisitions, the Company drew approximately $890,000 from its acquisition line of credit with Siemens (Tranche B). This draw was made after the end of the quarter.

4. Long-term Debt (also see Notes 5 and 6)

Long-term debt consists of the following:

	April 1, 2006 (unaudited)	**December 31, 2005**
Notes payable to a Siemens see (a) below:		
Tranche A	$ 1,509,851	$ 2,239,851
Tranche B (Note 3)		
Tranche C (includes $1,596,831 and $1,298,865 of accrued interest)	21,039,223	20,875,256
Total notes payable to Siemens	22,549,074	23,115,107
Notes payable to others (Note 3)	3,029,320	2,047,100
	25,578,394	**25,162,207**
Less current maturities	5,447,565	5,192,108
	$ 20,130,829	**$ 19,970,099**

The approximate aggregate maturities on long-term debt obligations for the twelve months ended are as follows:

	Payable in Cash	Payable Through Preferred Pricing	Total Amount
First quarter of 2007	$ 2,528,000	$ 2,920,000	$ 5,448,000

First quarter of 2008	2,178,000	2,920,000	5,098,000
First quarter of 2009	1,771,000	2,920,000	4,691,000
First quarter of 2010	1,692,000	2,920,000	4,612,000
First quarter of 2011 and thereafter	1,684,000	4,045,000	5,729,000
Total	9,853,000	15,725,000	25,578,000

Approximately $15.7 million of long-term debt can be repaid through preferred pricing reductions from Siemens, including $2.9 million in less than 1 year.

On February 10, 2006, the Company entered into an Amended and Restated Credit Agreement (the Amended Credit Agreement), Amended and Restated Supply Agreement (the Amended Supply Agreement) and an Amended and Restated Security Agreement with Siemens Hearing Instruments, Inc. (Siemens). Pursuant to the amended agreements, the parties will continue their strategic relationship for an additional five-year term. The parties restructured the then outstanding $23.1 million indebtedness of the Company to Siemens under the original credit agreement. The new facility is for a total of $26 million of which $23.1 million is outstanding at April 1, 2006. The new facility is structured in three tranches.

HearUSA, Inc
Notes to Consolidated Financial Statements

Tranche A, with a principal balance at the closing date of approximately $2.2 million and interest of 10% per annum, is payable in quarterly installments of $730,000 plus interest thereon which began in the first quarter of 2006. These quarterly payments are subject to rebate credits as described below. This note is a consolidation of the old Tranches A, B and C.

Tranche B is a revolving credit line established to accommodate funding for certain acquisitions by the Company. Pursuant to the Amended Credit Agreement, the Company may borrow under Tranche B up to the $26 million limit, less any amounts then outstanding under Tranche A and Tranche C.

Tranche C, which is a consolidation of the old Tranches D, E and F, has a principal balance on the closing date of approximately $20.9 million at an interest rate of prime plus 1% per annum, and is payable in quarterly installment payments of $730,000 plus interest commencing with the fourth quarter of 2006. Quarterly payments are subject to rebate credits as described below. Additional loans may be made to the Company under Tranche C for certain acquisitions. In addition, the Company is required to make monthly installments of principal and interest of $130,000 which began February 2006. These monthly installment payments are intended to repay approximately $6.6 million of the Tranche C principal balance.

The remaining principal balance of Tranche C, as well as Tranche A and Tranche B, with interest, will continue to be eligible for repayment utilizing rebates (preferred pricing reductions) on purchases of hearing aids from Siemens, provided that the Company purchases under the Amended Supply Agreement certain percentages of hearing aids it sells. The Amended Credit Agreement also contemplates that the Company will reduce the Tranche C loan balance by making annual payments in an amount equal to 20% of Excess Cash Flow (as that term is defined in the Amended Credit Agreement), and by paying Siemens 25% of any proceeds from equity offerings the Company may complete. The payment for 2006 based on 2005 excess cash flow is approximately $300,000 and was made in April 2006.

The following table shows the preferred pricing reductions received from Siemens pursuant to the supply agreement and the application of such pricing reductions against principal and interest payments on Tranches A, B and C during each of the quarters ended 2006 and 2005:

	April 1, 2006	April 2, 2005
Preferred pricing reductions recorded as a reduction of cost of products sold	$ 779,000	$ 832,000
Portion applied against quarterly principal payments	$ (730,000)	$ (730,000)
Portion applied against quarterly interest payments	(49,000)	(102,000)
	$ (779,000)	$ (832,000)

In connection with the Amended Credit Agreement, HearUSA and Siemens entered into the Amended Supply Agreement, pursuant to which HearUSA agreed to purchase from Siemens certain minimum percentages of HearUSA company-owned centers hearing aid purchases for a period of five years at specified prices. If the Company fails to purchase the required minimum under the Amended Supply Agreement, Siemens could declare a breach of the Amended Credit Agreement and Siemens would have the right to declare all amounts outstanding under the credit facility immediately due and payable.

Pursuant to the agreements with Siemens, a change of control of the Company (as defined) will constitute an event of default upon which Siemens may cancel its commitments under the credit agreement and declare the entire outstanding amounts under the credit facilities to be immediately due and payable.

Substantially all of the Company s assets collateralize the Siemens notes payable.

5. Convertible Subordinated Notes

In December 2003, the Company completed a private placement of $7.5 million five-year convertible subordinated notes with warrants to purchase 2,642,750 shares of the Company s common stock. The remaining warrants to purchase 500,000 shares were exercisable after May 31, 2005 at $1.75 per share.

HearUSA, Inc
Notes to Consolidated Financial Statements

Since December 2005 the notes can be converted at $1.75 per share and the lender warrants can be exercised for up to 2,142,750 shares at $1.75 per share. The quoted closing market price of the Company s common stock on the commitment date was $2.37 per share. The notes bear interest at 11 percent annually for the first two years and then at 8 percent through the remainder of their term. The Company recorded a debt discount of approximately $7,488,000 consisting of intrinsic value of the beneficial conversion of approximately $4,519,000 and the portion of the proceeds allocated to the warrants issued to the lenders of approximately $2,969,000, using a Black-Scholes option pricing model, based on the relative fair values of the lender warrants and the notes. The debt discount is being amortized as interest expense over the five-year term of the note using the effective interest method. The notes are subordinate to the Siemens notes payable.

In addition to the 2,642,750 lender warrants issued to the investors in the $7.5 million financing, the Company also issued 117,143 common stock purchase warrants with the same terms as the lender warrants and paid cash of approximately $206,000 to third parties as finder fees and financing costs. These warrants were valued at approximately $220,000 using a Black-Scholes option pricing model. The total of such costs of approximately $426,000 is being amortized as interest expense using the effective interest method over the five year term of the notes.

For the first two years of the term beginning on March 25, 2004, the Company made quarterly payments of interest only. On March 25, 2006, the Company began making twelve equal quarterly payments of principal plus interest. Payments of principal and interest may be made, at the Company s option, in cash or with the Company s common stock. If payments are made using the Company s common stock, the shares to be issued would be computed at 90% of the average closing price for the 20 day trading period immediately preceding the payment date. Approximate annual aggregate amount of maturities of such notes in future years is approximately $1,875,000 for the remainder of 2006 and $2,500,000 in each of 2007 and 2008.

During the first quarter of 2006 and 2005, approximately $703,000 and $779,000, respectively, of interest expense was recorded related to this financing, including a non-cash prepaid finder fees and debt discount amortization charge of approximately $480,000 and $568,000, respectively. The future non-cash debt discount and prepaid finder fees to be amortized as interest expense over the next five years are approximately $1,283,000 for the remainder of 2006, $1,145,000 in 2007 and $435,000 in 2008. In the event the investors convert the debt or the warrants, the Company will be required to expense the remaining debt discount and prepaid financing fees in the period in which the conversion or exercise occurs.

6. Subordinated Notes and Warrant Liability

On August 22, 2005, the Company completed a private placement of $5.5 million three-year subordinated notes (Subordinated Notes) with warrants (Note Warrants) to purchase 1,499,960 shares of the Company s common stock expiring on November 22, 2008. The Note Warrants are exercisable after August 22, 2005 at $2.00 per share and the remaining Warrants to purchase 374,990 shares at $2.00 per share. The quoted closing market price of the Company s common stock on the commitment date was $1.63 per share. The notes bear interest at 7 percent per annum. Proceeds from this financing were used to redeem all of the Company s 1998-E Series Convertible Preferred Stock. The Company agreed to register the common shares underlying the warrant shares during the three year period ending September 2008 and to maintain such registration so that the Warrant holders may sell their shares if the Note Warrants are exercised. The liability created by the Company s agreement to register and keep the underlying shares registered during the three year period has been recorded as a warrant liability of $1.9 million based on the fair value of the warrants, using a Black-Scholes option pricing model. Any gains or losses resulting from the changes in fair value from period to period are recorded as interest expense. As the holders exercise their Note Warrants the applicable portion of the liability will be reclassified to additional paid in capital. The notes are subordinate to the Siemens notes payable.

HearUSA, Inc
Notes to Consolidated Financial Statements

The Company recorded a debt discount of approximately $1.9 million based on the portion of the proceeds allocated to the fair value of the Note Warrants, using a Black-Scholes option pricing model. The debt discount is being amortized as interest expense over the three-year term of the notes using the effective interest method.

In addition to the Note Warrants, the Company also issued 55,000 common stock purchase warrants with the same terms as the Note Warrants and paid cash of approximately $330,000 to third parties as finder fees and financing costs. These warrants were valued at approximately $66,000 using a Black-Scholes option pricing model. The total of such costs of approximately $396,000 is being amortized as interest expense using the effective interest method over the three year term of the notes.

On the date of issuance of the Subordinated Notes, the Company prepaid interest for the first four months of the note. On December 22, 2005, the Company began making quarterly payments of principal corresponding to 8 percent of the original principal amount plus interest and a premium of 2 percent of the principal payment made. Approximate annual aggregate amount of maturities of such notes maturing in future years is $1,320,000 for the remainder of 2006, $1,760,000 in 2007 and $1,540,000 in 2008.

During the first quarter of 2006 approximately $393,000 interest expense was recorded related to this financing, including non-cash prepaid finder fees and debt discount amortization charges of approximately $246,000. The future non-cash debt discount and prepaid finder fees to be amortized as interest expense over the following three years are approximately $604,000 for the remainder of 2006, $496,000 in 2007 and $126,000 in 2008. In the event the Company retires the Subordinated Notes, the Company will be required to expense the debt discount and prepaid financing fees in the period in which the retirement occurs.

At April 1, 2006, the fair value of the Note Warrants, using a Black-Scholes option pricing model, resulted in a decrease of approximately $172,000 which was recorded as a reduction in interest expense.

7. Stock-based Benefit Plans

The 1987 Stock Option Plan

The 1987 Stock Option Plan is administered by the Company s Board of Directors. A maximum of 250,000 shares of common stock were authorized for issuance under this plan. All employees of the Company, other than its then principal stockholder (Dr. Paul A. Brown) were eligible to receive options under this plan at the sole discretion of the Board of Directors. Both incentive and non-incentive stock options could be granted. This plan expired June 2, 1997 and no further option grants can be made under this plan. The expiration of the plan did not affect the outstanding options which remain in full force as if the plan had not expired.

The 1995 Flexible Stock Plan

The 1995 Flexible Stock Plan is also administered by the Company s Board of Directors. An original maximum of 250,000 shares of the Company s common stock were authorized for issuance under this plan. On June 6, 2000 the shareholders approved an increase of 500,000 shares of the Company s common stock available under this plan. The plan authorizes an annual increase in authorized shares equal to 10% of the number of shares authorized as of the prior year. Currently an aggregate of 4,895 shares remain as authorized but not yet subject to a plan grant under the plan. All employees of the Company are eligible to receive incentive stock options, non-qualified stock options, stock appreciation rights, restricted shares, performance shares, and other stock-based awards under this plan at the sole discretion of the Board of Directors. This plan expired in 2005 and no further grants can be made under this plan. The expiration of the plan did not affect the outstanding options granted under this plan which remain in full force in accordance with their terms.

Flexible Stock Plan

The Company s 2002 Flexible Stock Plan, which is stockholder approved, permits the grant of share options and shares to

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officers, employees and certain non-employees for up to 5 million shares of common stock. The Company believes that such awards better align the interests of its employees with those of its shareholders. Option awards are generally granted with an exercise price equal to the market price of the Company s stock at the date of grant; those option awards generally vest based on 4 years of continuous service and have 10-year contractual terms. Share awards generally vest over 4 years. At April 1, 2006, 457,500 shares were available for future grant under the plan.

Impact of the Adoption of SFAS 123(R)

We adopted SFAS 123(R) using the modified prospective transition method on January 1, 2006. Accordingly, for the three-months ended April 1, 2006, we recorded stock-based compensation expense for awards granted prior to, but not yet vested, as of January 1, 2006, as if the fair value method required for pro forma disclosure under SFAS 123(R) were in effect for expense recognition purposes, adjusted for estimated forfeitures. For these awards, we have recognized compensation expense using the straight-line amortization method. For stock-based compensation awards granted after January 1, 2006, we will recognize compensation expense based on the estimated grant date fair value using a Black-Scholes valuation model. For these awards, the Company will continue to recognize compensation expense using the straight-line amortization method. The impact of recording stock-based compensation for the three-months ended April 1, 2006 was $232,605 of additional general and administrative cost. This additional expense is non-cash.

Valuation Assumptions

The fair value of each option award is estimated on the date of grant using a Black-Scholes option pricing model that uses the assumptions in the following table. Expected volatilities are based on historical data to estimate volatility of the Company s stock and other factors. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The determination of the fair value of stock options granted was based on the assumption of no expected dividends on the underlying common stock.

	Three Months Ended	
	April 1, 2006	April 2, 2005