HEARUSA INC
Form 10-K/A
May 11, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K/A
(Amendment No. 1)
ANNUAL REPORT
PURSUANT TO SECTIONS 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended DECEMBER 31, 2005

OR

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

For the transition period from ____________________ to _____________________

Commission file number 001-11655

HearUSA, Inc.

Exact Name of Registrant as Specified in Its Charter

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

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

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

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ **No** o

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

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

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

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

As of July 2, 2005, the aggregate market value of the registrant s Common Stock held by non-affiliates (based upon the closing price of the Common Stock on the American Stock Exchange) was approximately $44,699,073.

On March 20, 2006, 31,379,538 shares of the registrant s common stock and 780,358 of exchangeable shares were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of registrant s definitive proxy statement for the 2006 Annual Meeting of the registrant s stockholders (2006 Proxy Statement), to be filed with the Securities and Exchange Commission, are incorporated by reference in Part III hereof.

Explanatory Note

HearUSA, Inc. (the Company) is filing this Amendment No. 1 on Form 10-K/A to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2005, which was filed with the Securities and Exchange Commission on March 31, 2006 (the Original Filing), to correct an error relating to the valuation of the warrant liability appearing on the consolidated balance sheets. For the 2005 fiscal year, the Company originally recorded $1.9 million related to the warrant liability. Due to the fluctuation in the Company s common stock price at the end of 2005 the warrant liability should have been reduced to approximately $1.3 million and the Company should have reduced interest expense by approximately $513,000 in its consolidated statements of operations. Instead the Company recorded an increase of approximately $9,000. The correction of this error resulted in an increase to the previously reported warrant liability balance at October 1, 2005 and an increase of the previously reported interest expense for the quarter ended October 1, 2005 of approximately $76,000. The correction of this error also resulted in a decrease to the previously reported warrant liability balance at December 31, 2005 and decrease of the previously reported interest expense for the quarter ended December 31, 2005 of approximately $598,000. These corrections resulted in a reduction of the net loss applicable to common stockholders previously reported of approximately $1.8 million to approximately $1.3 million for the year ended December 31, 2005.

The following items have been amended as a result of the correction described above:

Part II Item 6 Selected Financial Data

Part II Item 7 Managements Discussion and Analysis

Part II Item 8 Financial Statements and Supplementary Data

Part II Item 9A. Controls and Procedures

Part IV Item 15 Exhibits and Financial Statement Schedules

PART II

Item 6. Selected Financial Data

The following selected financial data of the Company should be read in conjunction with the consolidated financial statements and notes thereto and the following Management s Discussion and Analysis of Financial Condition and Results of Operations. The financial data set forth on the next two pages has been derived from the audited consolidated financial statements of the Company:

CONSOLIDATED STATEMENT OF OPERATIONS DATA:

	Year Ended				
	Restated see Note 22				
	December 31 2005-	December 25 2004	December 27 2003	December 28 2002 (1)	December 29 2001
Net revenues	$ 76,672,003	$ 68,749,542	$ 67,080,108	$ 55,038,793	$ 48,796,110
Total operating costs and expenses	72,957,087	66,411,162	64,812,179	59,350,819	56,995,460
Income (loss) from operations	3,714,916	2,338,380	2,267,929	(4,312,026)	(8,199,350)
Non-operating income (expenses):					
Gain from insurance settlement (2)	430,122				
Interest income	53,921	17,543	20,836	114,152	222,349
Interest expense (including approximately $2,540,000, $2,127,000 and $517,000, in 2005, 2004 and 2003, of non-cash debt discount amortization and approximately $513,000 in non-cash reduction in interest expense for the decrease in the fair value of the warrant liability in 2005)	(4,640,558)	(4,563,729)	(2,828,327)	(1,722,990)	(652,530)
Loss before equity in loss of affiliated company and loss from discontinued operations	(441,599)	(2,207,806)	(539,562)	(5,920,864)	(8,629,531)
Equity in loss of affiliated company				(630,801)	
Loss from continuing operations before income taxes	(441,599)	(2,207,806)	(539,562)	(6,551,665)	(8,629,531)
Income taxes	(78,000)				
Net loss from continuing operations	(519,599)	(2,207,806)	(539,562)	(6,551,665)	(8,629,531)
Loss from discontinued operations	(63,553)	(550,696)	(569,827)	(328,804)	

Dividends on preferred stock	(700,675)	(708,159)	(626,956)	(696,541)	(812,205)
Net loss applicable to common stockholders	$ (1,283,827)	$ (3,466,661)	$ (1,736,345)	$ (7,577,010)	$ (9,441,736)
Loss per common share Basic and diluted, loss from continuing operations, including dividends on preferred stock	$ (0.04)	$ (0.10)	$ (0.04)	$ (0.32)	$ (0.72)
Basis and diluted, net loss applicable to common stockholders	$ (0.04)	$ (0.11)	$ (0.06)	$ (0.34)	$ (0.72)
Weighted average number of common shares outstanding	31,610,793	30,426,829	30,424,262	22,534,393	13,120,137
Cash dividends per common share	None	None	None	None	None

(1) As discussed in Note 5 Business Acquisitions Notes to the Consolidated Financial Statements included herein, effective June 30, 2002; the Company completed its business combination with Helix.

(2) The gain from insurance settlement is from insurance proceeds and final payment resulting from 2004 hurricane damages and business interruption claims sustained

in Florida
hearing care
centers.

BALANCE SHEET DATA:

	As of				
	December 31 2005	December 25 2004	December 27 2003	December 28 2002 (1)	December 29 2001
Total assets	$ 68,981,545	$ 59,422,361	$ 66,183,350	$ 64,996,870	$ 21,341,522
Working capital deficit	(3,118,353)	(4,898,459)	(2,330,035)	(10,231,372)	(738,562)
Long-term debt:					
Long-term debt, net of current maturities	19,970,099	17,296,125	20,579,977	22,082,389(2)	8,750,999
Convertible subordinated notes and subordinated notes, net of debt discount of $2,077,537, $5,443,879 and $7,423,596	6,222,463	2,056,121	76,404		
Mandatorily redeemable convertible preferred stock		4,709,921	4,600,107		

(1) As discussed in Note 5 Business Acquisitions, Notes to the Consolidated Financial Statements included herein, effective June 30, 2002, the Company completed its business combination with Helix.

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

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

GENERAL

In 2005, the Company initiated a strategic acquisition and divestiture program in order to improve its profitability and accelerate its growth. In June 2005 the Company divested 20 centers located in the states of Washington, Minnesota and Wisconsin. The centers have been presented as discontinued operations in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long Term Assets, and the assets and operating results of these hearing centers for all periods presented have been segregated. (See Note 19 Discontinued Operations, Notes to the Consolidated Financial Statements included herein.) The Company also completed several acquisitions in the second half of 2005.

Also during the year, the Company completed a private placement of subordinated notes in the amount of $5.5 million, the proceeds of which were used to redeem the Series E Convertible Preferred Stock originally issued in August of 2003. (See Note 8 Subordinated Notes and Warrant Liability and Note 9 Mandatorily Redeemable Convertible Preferred Stock, Notes to the Consolidated Financial Statements included herein.)

On December 28, 2005 the Company and Siemens signed a term sheet with the intent to extend their relationship for an additional 5 years. The same day, Siemens provided the Company with an additional $5.0 million to be used to repay existing non-Siemens debts and for acquisitions. (See Note 6a Long-Term Debt, Notes to the Consolidated Financial Statements included herein and Liquidity and Capital Resources and Recent Developments below.).

Overall, the Company s net loss decreased $2.2 million and income from operations increased $1.4 million from 2004 to 2005. These improvements were mostly attributable to the increase in the Company s revenues of $7.9 million during the year combined with a strong control over operating expenses and a decrease in the fair value of the warrant liability due to the Company s fluctuation in stock price. Management expects income from operations to continue improving as the Company s revenues continue to increase.

RESULTS OF OPERATIONS

2005 compared to 2004

Net revenues in 2005 increased approximately $7.9 million or 11.5% from 2004. The increase is comprised of an increase in hearing aids and other products revenues of approximately $8.2 million or 13.0%, partially offset by a reduction in service revenues of approximately $295,000 or 5.3%. The increase in hearing aids and other products revenues is mostly attributable to an increase in the average selling price of approximately 10.3% over the 2004 average selling price, resulting from patients selecting a higher percentage of advanced technology hearing aids, combined with an increase in the number of hearing aids sold of approximately 3.4%. The decrease in service revenues is due to lower revenues from the Company s contract with the Department of Veteran Affairs in 2005 compared to 2004. As part of the overall increase in revenues, approximately $1.4 million relates to the additional week in 2005 compared to 2004 due to the timing of the Company s accounting calendar and approximately $1.3 million was generated from the centers acquired in the second half of 2005. Also part of the overall increase is a favorable impact of $575,000 related to the change in the Canadian exchange rate from 2004 to 2005.

Total cost of products sold and services in 2005 increased approximately $3.5 million or 18.4%, including a 19.8% increase in hearing aids and other products sold of approximately $3.5 million and a 4.4% increase in services cost of approximately $76,000. Increase in the cost of hearing aids and other products is attributable to the corresponding increase in hearing aids and other products revenues and increase in the number of advanced technology hearing aids sold. Included in the cost of hearing aids

and other products are Siemens preferred pricing reductions of approximately $3.3 million in 2005 and $3.6 million in 2004, respectively. Such pricing reductions from Siemens are accounted for as reductions of cost of products sold and applied, pursuant to the Siemens credit agreement, against the principal and interest payments due to Siemens on Tranches A, B and C of the Siemens loan (See Note 6a Long-Term Debt, Notes to the Consolidated Financial Statements included herein, Liquidity and Capital Resources and Recent Developments, below). The total cost of products sold and services, as a percent of net revenues, increased to 29.7% in 2005 from 28.0% in 2004 due to the increase in advanced technology hearing aids sold, which have lower margins, and special introductory price promotions on new Siemens products. Also, 2004 benefited from higher revenues from the Department of Veteran Affairs which are primarily services with no cost of products sold. Management expects that in 2006 the cost of products sold as a percent of revenues will be consistent with that of 2005.

Center operating expenses in 2005 increased approximately $1.7 million, or 4.8% from 2004. This increase is mainly attributable to the additional week in 2005; an increase in incentive compensation related to additional net revenues and new incentive programs and increased wages due to normal merit increases as well as additional expenses of approximately $449,000 related to the acquired centers discussed above. Total center operating expenses for 2006 will be affected by any center acquisitions.

General and administrative expenses in 2005 increased approximately $1.4 million or 14.1% from 2004. This increase is attributable to increases in wages and other expenses related to new sales and business development departments and normal annual merit increases.

Depreciation and amortization expense in 2005 decreased approximately $98,000 or 4.7%. This net decrease is comprised of a decrease of approximately $533,000 due to certain property and equipment becoming fully depreciated, offset in part by an increase of approximately $435,000 due to the acquisition of approximately $1.2 million in fixed assets and approximately $826,000 in intangible assets during the year.

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

Interest expense in 2005 increased approximately $77,000 or 1.7% over 2004. This increase is attributable to approximately $595,000 of interest (including the non-cash portion of approximately $389,000) on the $5.5 million financing that was completed in August 2005 and approximately $309,000 due to the impact of the higher interest rates on the Siemens Tranche D which is at prime plus 1%. These increases were offset in part by a decrease of interest on other existing balances due to repayments of principal and a non-cash reduction in interest expense that did not exist in 2004 of approximately $513,000 related to a decrease in the fair market value of the warrant liability caused by the decrease in the stock price during 2005 (See Note 8 Subordinated Notes and Warrant Liability, Notes to the Consolidated Financial Statements included herein). The non-cash charge of $2.5 million included in the interest expense is $2.2 million in amortization of the debt discount related to the $7.5 million convertible subordinated notes (See Note 7 Convertible Subordinated Notes, Notes to the Consolidated Financial Statements included herein) and $389,000 in amortization of the debt discount related to the $5.5 million subordinated notes (See Note 8 Subordinated Notes and Warrant Liability, Notes to the Consolidated Financial Statement included herein). These non-cash charges do not impact the liquidity or working capital of the Company. Also included in interest expense is the 2005 interest on the Siemens Tranche A, B and C totaling $389,000 in 2005 as compared with $720,000 in 2004, which were paid through preferred pricing reductions from Siemens (See Note 6a Long-Term Debt, Notes to the Consolidated Financial Statements included herein and Liquidity and Capital Resources below). Management expects interest expense will increase in 2006 over 2005 levels as a result of the additional $5 million loan from Siemens late in 2005 and a full year of 2006 interest relating to the $5.5 million subordinated notes issued in August of 2005. The interest expense could be affected by the use of the Siemens credit facility for acquisitions in 2006. Early payment or conversion of the $7.5 million convertible subordinated notes and/or the $5.5 million subordinated notes would result in acceleration of the debt discount amortization and therefore an increase in non-cash interest expense.

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

The Company has net operating loss carryforwards of approximately $76 million for U.S. income tax purposes and approximately $2.5 million of operating loss carryforwards in Canada.

During 2005 and 2004, HEARx West generated net income of approximately $2.3 million and $1.4 million, respectively. The HEARx West members deficit decreased from approximately $3.2 million at the end of 2004 to approximately $876,000 at the end of 2005. According to the Company s agreement with the Permanente Federation, the Company included in its statement of operations 100% of the losses incurred by the venture since its inception and will receive 100% of the net income of the venture until the members deficit is eliminated. At such time as the members deficit is eliminated and if the venture continues to be profitable, the Company will begin recording a minority interest, corresponding to 50% of the venture s net income, as an expense in the Company s consolidated statement of operations and with a corresponding liability on its consolidated balance sheet. Based on the 2005 performance of the venture, it is expected that the Company will begin recording and paying a minority interest in 2006.

2004 compared to 2003

Net revenues in 2004 increased approximately $1.7 million or 2.5%. The increase in hearing aid and other product revenues during 2004 compared to 2003 is primarily attributable to an increase of approximately $1.9 million due to the Company s new contract with the Department of Veteran Affairs. A decrease of approximately $631,000 in service revenues resulted from decreases in repairs and testing. A decrease of approximately 5.0% in the number of hearing aids sold during the year was offset by an increase in the average selling price of approximately 4.9% as patients selected a higher percentage of high end technology hearing aids. Approximately $485,000 of the overall increase in revenues relates to a favorable change in the average Canadian exchange rate from 2003 to 2004.

Cost of products sold in 2004 decreased approximately $264,000 or 1.4%. Included in the cost of products sold are Siemens preferred pricing reductions of approximately $3,641,000 in 2004 and $3.9 million in 2003, respectively. Such pricing reductions from Siemens are accounted for as reductions of cost of products sold for financial reporting purposes and applied, pursuant to the Siemens credit agreement, against the principal and interest payments due to Siemens on Tranches A, B and C of the Siemens loan (see Note 6a., Notes to the Consolidated Financial Statements, Liquidity and Capital Resources and Recent Developments below.) The cost of products sold, as a percent of net revenues, was essentially unchanged at 28.0% and 28.3% in 2004 and 2003, respectively.

Center operating expenses in 2004 increased approximately $2.3 million, or 7.1% from 2003. This increase is mainly attributable to an increase in compensation and marketing in 2004 compared to 2003 of approximately $1.3 million and $905,000, respectively. The increase in compensation is attributable in part to annual increases to employees and new employees at the center level and in part to increases in commissions. The increase in commissions is due to changes to some of the compensation programs at the end of the second quarter of 2003 and increases in revenues in regions and/or sectors with higher commission rates. The increase in marketing is attributable to increases in the frequency in the Company s advertising to the private pay sector and additional mailers to members of managed care companies in 2004 compared to the prior year.

General and administrative expenses in 2004 decreased approximately $252,000, or 2.4%. This decrease is mainly attributable to a reduction of expenses of approximately $159,000 resulting from a volume discount for telephone expense, and a reduction of professional fees of approximately $576,000. These decreases were offset by an increase in wages and fringe benefits of approximately $291,000, due to an increase in salaries and in additional employees, and an increase in public and shareholder relations expense of approximately $174,000.

Depreciation and amortization expense in 2004 decreased approximately $712,000 or 25.6%. This decrease is due to certain property and equipment being fully depreciated.

Interest expense in 2004 increased approximately $1.7 million or 61% over 2003. This increase is attributable to approximately $2.9 million of interest (including the non-cash portion of approximately $2.1 million) on the $7.5 million financing that was completed in December 2003. These increases were offset by a decrease of interest on other existing balances due to repayments of principal during 2003 and the beginning of 2004. The non-cash charge of $2.1 million included in the interest expense is the amortization of the debt discount resulting from the intrinsic value of the beneficial conversion option and the proceeds allocated to the warrants to purchase 2,642,750 shares of the Company s common stock based on relative fair values of the $7.5 million financing in December 2003. This non-cash charge does not impact the liquidity or working capital of the Company.

LIQUIDITY AND CAPITAL RESOURCES

On December 7, 2001, the Company obtained a secured credit facility from Siemens comprised of (a) a $10,875,000 secured five-year term loan credit facility (the Tranche A Loan); (b) a $25,000,000 secured five-year revolving loan credit facility (the Tranche B Loan); (c) a $3,000,000 secured five-year term loan facility (the Tranche C Loan) and (d) a $13,000,000 secured five-year term loan credit facility (the Tranche D Loan). On March 14, 2003, the Company obtained an additional $3,500,000 secured five-year term loan from Siemens bearing interest at a rate of 10% annually (the Tranche E Loan). The Tranche E Loan was obtained pursuant to an amendment to the Company s credit agreement with Siemens and is otherwise subject to the terms and conditions of the credit agreement and related security agreement. On December 28, 2005, the Company obtained an additional $5,000,000, bearing interest at prime plus 1% and having a five-year term (the Tranche F Loan). At December 31, 2005 approximately $23.1 million, representing principal on the Tranche A, B, C, D, E and F Loans was outstanding. See Recent Developments below for a discussion of the amended and restated Siemens agreements.

The Siemens credit agreement imposes certain financial and other covenants on the Company which are customary for loans of this size and nature, including restrictions on the conduct of the Company s business, the incurrence of indebtedness, merger or sale of assets, the modification of material agreements, changes in capital structure, making certain payments and paying dividends. If the Company cannot maintain compliance with these covenants, Siemens may terminate future funding under the credit facility and declare all then outstanding amounts under the facility immediately due and payable. In addition, a material breach of the supply agreement between the Company and Siemens may be declared to be a breach of the credit agreement and Siemens would have the right to declare all amounts outstanding under the credit facility immediately due and payable. Any non-compliance with the supply agreement could have a material adverse effect on the Company s financial condition and continued operations. As of December 31, 2005, the Company was in compliance with the credit facility s covenants and the supply agreement.

During 2005, the working capital deficit decreased $1.8 million to $3.1 million as of December 31, 2005 from $4.9 million as of December 27, 2004. The decrease in the deficit is attributable to an excess of approximately $4.0 million in cash from operations and financing activities over cash used for investing activities offset by an increase in current maturities of long-term debt, convertible subordinated notes and subordinated notes of approximately $2.8 million. The working capital deficit of $3.1 million includes approximately $3.0 million representing the current maturities of the long-term debt to Siemens which may be repaid through preferred pricing reductions and approximately $652,000 ($2.5 million in current maturities, net of $1.5 million of debt discount) related to the $7.5 million convertible subordinated notes that can be repaid by either cash or stock, at the option of the Company. In 2005, the Company generated income from operations of approximately $3.7 million compared to $2.3 million in 2004. Cash and cash equivalents as of December 31, 2005 were approximately $6.7 million.

Net cash from operating activities in 2005 increased approximately $1.5 million compared to 2004, which is mainly attributable to the reduction of $2.2 million in the Company s net loss from 2004 to 2005, partially offset by a reduction in interest expense of approximately $513,000 related to a decrease in the fair value of the warrant liability during 2005, which did not exist in 2004. Reductions in cash flows in 2005 from 2004 resulted from the timing in the collection of our December 2005 capitation payment of approximately $575,000 from Kaiser Permanente, collected in early January 2006 as opposed to December in 2004**,** and

the payment of January rents before the end of the fiscal year in 2005 compared to after fiscal year end in 2004, due to the timing of the Company s accounting calendar**.** These reductions were however offset by corresponding increases in cash flows from increases in accounts payable and accrued salaries, due to timing in payments.

Other sources of funds in 2005 were the proceeds from the divestiture of some centers of approximately $1.1 million, the exercise of warrants of approximately $1.8 million and the issuance of long-term debt of $5 million to Siemens in December 2005 and of approximately $5.2 million (net of $330,000 issuing cost) to purchasers of subordinated notes in August of 2005**.** Proceeds from the issuance of the subordinated notes were used to redeem the $4.9 million Series E Convertible Preferred Stock. 2004 did not benefit from any other significant sources of funds.

During 2005, the Company initiated an acquisition program and used cash of approximately $1.6 million to complete the acquisition of several centers during the second half of the year. No acquisitions were made in 2004. Also, additional funds were used in 2005 compared to 2004 (increase from $343,000 in 2004 to approximately $1.2 million in 2005) to upgrade audiological and call center equipment and software as well as for leasehold improvements related to center upkeep and maintenance.

Funds were also used in 2005 for long-term debt repayment of approximately $1.7 million, a reduction of $1.6 million from 2004**.** In 2004, a payment of $1.8 million was made to Siemens as required under the Siemens credit agreement, corresponding to 25% of the proceeds of the $7.5 million convertible subordinated notes issued in December 2003. A $440,000 payment was also made in 2005 related to the 2005 subordinated notes corresponding to the first quarterly payment due to the holders of the notes. The use of funds for dividends on preferred stock reduced from $1.1 million to $770,000 as 2004 included additional payments necessary to pay off accrued and unpaid dividends, in accordance with the Company s agreement with the holders of the Series E Convertible Preferred Stock.

The Company believes that current cash and cash equivalents and cash flow from operations, at current net revenue levels, will be sufficient to support the Company s operational needs through the next twelve months, although there can be no assurance that the Company can maintain compliance with the Siemens loan covenants, that net revenue levels will remain at or higher than current levels or that unexpected cash needs will not arise for which the cash, cash equivalents and cash flow from operations will not be sufficient. In the event of a shortfall in cash, the Company might consider short-term debt, or additional equity or debt offerings. There can be no assurance however, that such financing will be available to the Company on favorable terms or at all. The Company also is continuing its aggressive cost controls and sales and gross margin improvements.

Below is a chart setting forth the Company s contractual cash payment obligations, which have been aggregated to facilitate a basic understanding of the Company s liquidity as of December 31, 2005.

Contractual obligations	Total	Payments due by period (000's) Less than 1 year	1 - 3 years	4 - 5 Years	More Than 5 years
	$	$	$	$	$
Long-term debt (1)	25,162	5,192	9,353	9,362	1,255
Convertible subordinated notes (3)	7,500	2,500	5,000		
Subordinated notes	5,060	1,760	3,300		
Subtotal of obligations recorded on balance sheet	37,722	9,452	17,653	9,362	1,255
Interest to be paid on long-term debt (2)	3,419	1,175	1,546	680	18
Interest to be paid on convertible subordinated notes (3)	928	512	416		
Interest to be paid on subordinated notes	519	300	219		
Operating leases	18,935	5,368	10,759	2,070	738
Employment agreements	3,903	1,135	1,868	900	
Purchase obligations	1,356	756	600		
Total contractual cash obligations	66,782	18,698	33,061	13,012	2,011

(1) Approximately $16.5 million can be repaid through preferred pricing reductions from Siemens, including $3.0 million in less than 1 year and $5.8 in years 1-3, $5.8 in years 4-5 and $1.7 in more than 5 years.

(2) Interest on long-term debt excludes the interest on the new Tranches A, B and C that

can be repaid through preferred pricing reductions from Siemens pursuant to the February 10, 2006 amended and restated credit agreement with them. Interest repaid through preferred pricing reductions was $389,000 in 2005. (See Note 6a Long-Term Debt, Note to the Consolidated Financial Statements included herein).

(3) When due these notes and corresponding interest can be repaid at the option of the Company in common stock

RECENT DEVELOPMENTS

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. Pursuant to the amended agreements the Company will continue its strategic relationship with Siemens for an additional five-year term. We have restructured the 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, including the currently outstanding $23.1 million and is structured in three tranches. The effect of the Amended Credit Facility has been recorded as if it had occurred on December 31, 2005.

The new Tranche A, with a principal balance of approximately $2.2 million and imputed interest of 10% per annum, is payable in three quarterly installments of $747,000 commencing with the first quarter of 2006. The payments are subject to rebate credits as described below.

The new Tranche B is a revolving line of credit 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.

The new Tranche C, with a principal balance on the closing date of approximately $20.9 million and an interest rate of prime plus 1% per annum, is payable in monthly principal and interest installments of $130,000 commencing February 15, 2006. In addition, the Company must make quarterly installment

payments on Tranche C of $730,000 plus interest commencing with the fourth quarter of 2006. The quarterly payments may be satisfied using rebate credits described below. Additional loans may be made to the Company under Tranche C for certain acquisitions. The monthly installment payments are intended to repay approximately $6.6 million of the Tranche C principal balance. The remaining principal balances of Tranche C, as well as Tranche A and Tranche B, with interest, will continue to be eligible for repayment utilizing rebates on purchases of hearing aids from Siemens, provided that the Company purchases, under the Amended Supply Agreement, certain percentages of the 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 defined in the agreement), and by paying to Siemens 25% of proceeds from future equity offerings.

Substantially all of the Company s assets collateralize the notes payable to Siemens. Pursuant to the Amended Supply Agreement, the Company agreed to purchase from Siemens certain minimum percentages of the Company s hearing aid purchases for a period of five years. A material breach of the Amended Supply Agreement may be declared to be 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. Any non-compliance with the Amended Supply Agreement could have a material adverse effect on the Company s financial condition and continued operations.

CRITICAL ACCOUNTING POLICIES

Management believes the following critical accounting policies affect the significant judgments and estimates used in the preparation of the financial statements:

Goodwill

The majority of the Company s goodwill resulted from the combination with Helix. On at least an annual basis, the Company is required to assess whether its goodwill is impaired. The Company elected to perform this analysis on the first day of its fourth quarter. In order to do this, management applied judgment in determining its reporting units , which represent distinct parts of the Company s business. The reporting units determined by management are the centers, the network and e-commerce. The definition of the reporting units affects the Company s goodwill impairment assessments. The annual goodwill impairment assessment involves estimating the fair value of a reporting unit and comparing it with its carrying amount. If the carrying value of the reporting unit exceeds its fair value, additional steps are required to calculate a potential impairment charge. Calculating the fair value of the reporting units requires significant estimates and long-term assumptions. The Company utilized an independent appraisal firm to test goodwill for impairment as of the first day of the Company s fourth quarter during 2005 and 2004, and each of these tests indicated no impairment. The Company estimates the fair value of its reporting units by applying a weighted average of three methods: quoted market price, external transactions, and discounted cash flow. Significant changes in key assumptions about the business and its prospects, or changes in market conditions, stock price, interest rates or other externalities, could result in an impairment charge.

Revenue recognition

Revenues from the sale of audiological products are recognized at the time of delivery. Revenues from hearing care services are recognized at the time those services are performed.

The Company has capitation contracts with certain health care organizations under which the Company is paid an amount for each enrollee of the health maintenance organization to provide to the enrollee a once every three years discount on certain hearing products and services. The amount paid to the Company by the healthcare organization is calculated on a per-capita basis and is referred to as capitation revenue. Capitation revenue is earned as a result of agreeing to provide services to members without regard to the actual amount of service provided; revenue is recorded in the period that the beneficiaries are entitled to hearing care services.

Allowance for doubtful accounts

Certain of the accounts receivable of the Company are from health insurance and managed care organizations and government agencies. These organizations could take up to nine months before paying a claim made by the Company and also impose a limit on the time the claim can be billed. The Company provides an allowance for doubtful accounts equal to the estimated uncollectible amounts. That estimate is based on historical collection experience, current economic and market conditions, and a review of the current status of each customer s trade accounts receivable.

In order to calculate that allowance, the Company first identifies any known uncollectible amounts in its accounts receivable listing and charges them against the existing allowance for doubtful accounts. Then a specific percent per plan and per aging categories is applied against the remaining receivables to estimate the needed allowance. Any changes in the percent assumptions per plan and aging categories results in a change in the allowance for doubtful accounts. For example, an increase of 10% in the percent applied against the remaining receivables would increase the allowance for doubtful accounts by approximately $20,000.

Sales returns

The Company provides to all patients purchasing hearing aids a specific return period of at least 30 days if the patient is dissatisfied with the product. The Company provides an allowance in accrued expenses for returns. The return period can be extended to 60 days if the patient attends the Company s H.E.L.P. program. The Company calculates its allowance for returns using estimates based upon actual historical returns. The cost of the hearing aid is reimbursed to the Company by the manufacturer.

RECENT ACCOUNTING PRONOUNCEMENT

In December 2004, SFAS No. 123(R), *Share-Based Payment,* which addresses the accounting for employee stock options, was issued. SFAS No. 123(R) revises the disclosure provisions of SFAS 123, *Accounting for Stock Based Compensation* and supersedes APB Opinion 25, *Accounting for Stock Issued to Employees.* SFAS 123(R) requires that the cost of all employee stock options, as well as other equity-based compensation arrangements, be reflected in the financial statements based on the estimated fair value of the awards. This statement is effective for all public entities beginning the first interim after December 15, 2005. The Company plans to implement SFAS 123 (R) on its effective date. Based on the outstanding number of employee stock options and excluding the impact of any future grants at December 31, 2005, the total stock-based employee compensation expense determined under the fair value method that would be reflected in the financial statements is approximately $1,529,000 in 2005 (See Note 1 Description of the Company and Summary of Significant Accounting Policies- stock-based compensation) and $930,000 in 2006. This additional expense will not affect the Company s operating cash flows.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections- A Replacement of APB Opinion No. 20 and FASB Statement No. 3* (SFAS 154). This statement requires that a voluntary change in accounting principle be applied retroactively with all prior period financial statements presented on the basis of the new accounting principal, unless it is impractical to do so. SFAS 154 also requires that a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for prospectively as a change in estimate, and correction of errors in previously issued financial statements should be termed a restatement . The new standard is effective for accounting changes and a correction of errors made in fiscal years beginning after December 15, 2005. We will adopt this pronouncement in fiscal year 2006.

Item 8. Financial Statements and Supplementary Data

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Report of Independent Registered Public Accounting Firm

Board of Directors
HearUSA, Inc.
West Palm Beach, Florida

We have audited the accompanying consolidated balance sheets of HearUSA, Inc. as of December 31, 2005 and December 25, 2004, and the related consolidated statements of operations, changes in stockholders equity and cash flows for each of the three fiscal years in the period ended December 31, 2005. We have also audited the schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule 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 and schedule 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of HearUSA, Inc. at December 31, 2005 and December 25, 2004, and the results of its operations and its cash flows for each of the three fiscal years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America.

Also in our opinion, the schedule presents fairly, in all material respects, the information set forth therein.

As discussed in Note 22, the Company has restated certain amounts previously reported as of and for the years ended December 31, 2005.

BDO Seidman, LLP
West Palm Beach, Florida
March 17, 2006. (May 10, 2006 as to note 22
and the effects of the restatement)

HearUSA, Inc.
Consolidated Balance Sheets

ASSETS (Note 6)	**Restated see Note 22 December 31, 2005**	**December 25, 2004**
Current assets		
Cash and cash equivalents	$ 6,706,944	$ 2,615,379
Restricted cash and cash equivalents (Note 2)	431,000	435,000
Accounts and notes receivable, less allowance for doubtful accounts of $413,386 and $373,583	6,715,933	5,997,245
Inventories	1,604,943	801,234
Prepaid expenses and other	1,627,407	557,435
Current assets held for sale		77,458
Total current assets	**17,086,227**	**10,483,751**
Property and equipment, net (Notes 3 and 6)	**3,474,381**	**3,346,788**
Goodwill (Notes 4 and 5)	**36,394,959**	**33,210,380**
Intangible assets, net (Notes 4 and 5)	**11,440,345**	**11,094,169**
Deposits and other	**585,633**	**551,148**
Long-term assets held for sale (Note 19)		**736,125**
	$ 68,981,545	**$ 59,422,361**
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 8,499,812	$ 6,644,600
Accrued expenses	2,344,419	2,424,147
Accrued salaries and other compensation	2,589,877	1,982,559
Current maturities of long-term debt (Note 6)	5,192,108	4,152,908
Current maturities of convertible subordinated notes, net of debt discount of $1,847,853 (Note 7)	652,147	
Current maturities of subordinated notes, net of debt discount of $868,345 (Note 8)	891,655	
Dividends payable (Notes 9 and 10C)	34,562	177,996
Total current liabilities	**20,204,580**	**15,382,210**
Long-term debt (Note 6)	**19,970,099**	**17,296,125**
Convertible subordinated notes, net of debt discount of $1,565,187 and $5,443,879 (Note 7)	**3,434,813**	**2,056,121**
Subordinated notes, net of debt discount of $512,350 (Note 8)	**2,787,650**	
Warrant liability (Note 8)	**1,347,217**	
Total long-term liabilities	**27,539,779**	**19,352,246**

Commitments and contingencies (Notes 3,6,7,9,11 and 15)		
Mandatorily redeemable convertible preferred stock (Note 9)		**4,709,921**
Stockholders equity		
Preferred stock (aggregate liquidation preference $2,330,000 and $2,330,000, $1 par, 7,500,000 shares authorized (Note 10)		
Series H Junior Participating (none outstanding)		
Series J (233 shares outstanding) (Note 10C)	233	233
Total preferred stock	233	233
Common stock: $0.10 par; 75,000,000 shares authorized: 31,893,200 and 30,060,690 shares issued (Notes 4,5,7,9,10 and 11)	3,189,320	3,006,069
Stock subscription (Note 10B)	(412,500)	(412,500)
Additional paid-in capital	121,934,658	120,197,937
Accumulated deficit	(103,252,279)	(101,968,452)
Accumulated other comprehensive income	2,262,895	1,639,838
Treasury stock, at cost: 523,662 common shares	(2,485,141)	(2,485,141)
Total stockholders equity	**21,237,186**	**19,977,984**
	$ 68,981,545	**$ 59,422,361**

See accompanying notes to consolidated financial statements

HearUSA, Inc.
Consolidated Statements of Operations

	Year Ended		
	Restated see Note 22 December 31, 2005	**December 25, 2004**	**December 27, 2003**
Net revenues			
Hearing aids and other products	$ 71,445,381	$ 63,227,775	$ 60,927,044
Services	5,226,622	5,521,767	6,153,064
Total net revenues	76,672,003	68,749,542	67,080,108
Operating costs and expenses			
Hearing aids and other products	20,972,635	17,511,405	18,836,929
Services	1,793,944	1,718,287	128,759
Total cost of products sold and services	22,766,579	19,229,692	18,965,688
Center operating expenses	36,555,590	34,890,950	32,591,897
General and administrative expenses	11,660,725	10,218,283	10,470,717
Depreciation and amortization	1,974,193	2,072,237	2,783,877
Total operating costs and expenses	72,957,087	66,411,162	64,812,179
Income from operations	3,714,916	2,338,380	2,267,929
Non-operating income (expense):			
Gain from insurance settlement	430,122		
Interest income	53,921	17,543	20,836
Interest expense (including approximately $2,540,000, $2,127,000 and $517,000, in 2005, 2004 and 2003, of non-cash debt discount amortization and a non-cash reduction of approximately $513,000 in interest expense for the decrease in the fair value of the warrant liability)	(4,640,558)	(4,563,729)	(2,828,327)
Loss from continuing operations before income taxes	(441,599)	(2,207,806)	(539,562)
Income taxes	(78,000)		
Net loss from continuing operations	(519,599)	(2,207,806)	(539,562)
Discontinued operations (Note 19) Gain on disposition of assets	332,470		

Loss from discontinued operations	(396,023)	(550,696)	(569,827)
Net loss from discontinued operations	(63,553)	(550,696)	(569,827)
Net loss	(583,152)	(2,758,502)	(1,109,389)
Dividends on preferred stock (Notes 9 and 10C)	(700,675)	(708,159)	(626,956)
Net loss applicable to common stockholders	$ (1,283,827)	$ (3,466,661)	$ (1,736,345)
Net loss from continuing operations, including dividends on preferred stock, applicable to common stockholders basic and diluted	$ (0.04)	$ (0.10)	$ (0.04)
Net loss applicable to common stockholders per common share basic and diluted (Note 1)	$ (0.04)	$ (0.11)	$ (0.06)
Weighted average number of shares of common stock outstanding (Notes 1, 10 and 11)	31,610,793	30,426,829	30,424,262

See accompanying notes to consolidated financial statements

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HearUSA, Inc.
Consolidated Statements of Changes in Stockholders Equity

	Year Ended December 31, 2005		Year Ended December 25, 2004		Year Ended December 27, 2003	
	Shares	Amount	Shares	Amount	Shares	Amount
Preferred stock						
Balance, beginning of year	233	$ 233	233	$ 233	4,796	$ 4,796
Exchange/redemption of preferred stock					(4,563)	(4,563)
Balance, end of year	233	$ 233	233	$ 233	233	$ 233
Common stock						
Balance, beginning of year	30,060,676	$ 3,006,068	29,528,450	$ 2,952,845	24,457,055	$ 2,445,705
Exercise of employee stock options	130,000	13,000	6,250	625	20	2
Issuance of common stock for exchangeable shares	102,524	10,252	525,976	52,598	5,071,375	507,138
Warrant exercise	1,600,000	160,000				
Balance, end of year	31,893,200	$ 3,189,320	30,060,676	$ 3,006,068	29,528,450	$ 2,952,845
Treasury stock						
Balance, beginning of year	523,662	$ (2,485,141)	523,662	$ (2,485,141)	518,660	$ (2,483,441)
Purchase of treasury stock					5,002	(1,700)
Balance, end of year	523,662	$ (2,485,141)	523,662	$ (2,485,141)	523,662	$ (2,485,141)
Stock subscription						
Balance, beginning of year		$ (412,500)		$ (412,500)		$ (412,500)
Balance, end of Year		$ (412,500)		$ (412,500)		$ (412,500)
Additional paid-in capital:						
		$ 120,197,937		$ 120,226,050		$ 117,314,681

Balance, beginning of year			
Exchange/redemption of preferred stock, including issuance costs			(4,759,324)
Value of warrants and beneficial conversion feature issued with convertible subordinated notes payable			7,708,229
Value of warrants issued with debt			429,339
Exercise of employee stock options	55,000	3,563	13
Issuance of common stock for exchangeable shares	(10,252)	(52,598)	(507,138)
Proceeds of Board of Directors stock			40,250
Exercise of warrants	1,665,000		
Consulting expense	26,973	12,672	
Compensation expense		8,250	
Balance, end of year	$ 121,934,658	$ 120,197,937	$ 120,226,050

See accompanying notes to consolidated financial statements

HearUSA, Inc.
Consolidated Statements of Changes in Stockholders Equity

	Year Ended		
	Restated see Note 22		
	December 31, 2005 Amount	**December 25, 2004 Amount**	**December 27, 2003 Amount**
Accumulated deficit:			
Balance, beginning of year	$ (101,968,452)	$ (98,501,791)	$ (96,765,446)
Net loss	(583,152)	(2,758,502)	(1,109,389)
Dividends on preferred stock	(700,675)	(708,159)	(626,956)
Balance, end of year	$ (103,252,279)	$ (101,968,452)	$ (98,501,791)
Accumulated other comprehensive income:			
Balance, beginning of year	$ 1,639,838	$ 1,033,616	$ 462,825
Foreign currency translation adjustment	623,057	606,222	570,791
Balance, end of year	$ 2,262,895	$ 1,639,838	$ 1,033,616
Comprehensive income (loss):			
Net loss	$ (583,152)	$ (2,758,502)	$ (1,109,389)
Foreign currency translation adjustment	623,057	606,222	570,791
Comprehensive income (loss)	$ 39,905	$ (2,152,280)	$ (538,598)

See accompanying notes to consolidated financial statements

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HearUSA, Inc.
Consolidated Statements of Cash Flows

	Year Ended		
	Restated see Note 22 December 31, 2005	December 25, 2004	December 27, 2003
Cash flows from operating activities			
Net loss	$ (583,152)	$ (2,758,502)	$ (1,109,389)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Debt discount amortization	2,540,120	2,127,054	516,992
Depreciation and amortization	1,974,193	2,072,237	2,783,877
Interest on Siemens Tranche D	964,361	655,568	710,027
Provision for doubtful accounts	354,107	430,454	801,303
Loss from discontinued operations	63,553	550,696	569,827
Consulting expense	26,969	12,672	
Principal payments on long-term debt made through preferred pricing reductions	(2,922,537)	(2,920,804)	(2,920,804)
(Gain) loss on disposition of equipment	(50,650)	53,836	648
Decrease in fair value of warrant liability	(513,293)		
Executive compensation expense		8,250	
(Increase) decrease in:			
Accounts and notes receivable	(982,851)	(467,068)	(842,031)
Inventories	(862,815)	99,475	(6,532)
Prepaid expenses and other	(606,766)	636,835	124,212
Increase (decrease) in:			
Accounts payable and accrued expenses	1,632,714	(361,241)	(4,671,611)
Accrued salaries and other compensation	595,860	261,810	(123,107)
Net cash provided by (used in) continuing activities	1,629,813	401,272	(4,166,588)
Net cash provided by (used in) discontinued operations	(113,457)	(356,598)	(666,013)
Net cash provided by (used in) operating activities	1,516,356	44,674	(4,832,601)
Cash flows from investing activities			
Purchase of property and equipment	(1,184,400)	(342,767)	(221,854)
Capital expenditures from discontinued operations	(13,332)	(39,906)	(46,025)
Proceeds from sale of discontinued operations	1,101,385	104,628	1,880,244
Business acquisitions	(1,589,411)		(251,533)
Net cash provided by (used in) investing activities	(1,685,758)	(278,045)	1,360,832

Cash flows from financing activities			
Proceeds from issuance of long-term debt	5,000,000		3,500,000
Proceeds from subordinated notes, net of issuing cost of $330,000	5,170,000		
Proceeds from convertible notes, net of issuing costs of $266,000		500,000	8,734,000
Payments on long-term debt from discontinued operations			(29,822)
Principal payments on long-term debt	(1,708,256)	(3,310,477)	(1,160,696)
Principal payments on subordinated notes	(440,000)		
Principal payments on convertible subordinated notes			(2,000,000)
Acquisition of treasury stock			(1,700)
Exchange and redemption of capital stock	(4,928,041)		(200,877)
Proceeds from exercise of employee stock options	68,000	4,189	15
Proceeds from Board of Director sale of stock			40,250
Proceeds from the exercise of warrants	1,825,000		
Dividends on preferred stock	(770,196)	(1,149,048)	(1,076,317)
Net cash provided by (used in) financing activities	4,216,507	(3,955,336)	7,804,853

See accompanying notes to consolidated financial statements

HearUSA, Inc.
Consolidated Statements of Cash Flows

	Year Ended		
	Restated see Note 22		
	December 31, 2005	**December 25, 2004**	**December 27, 2003**
Effects of exchange rate changes on cash	44,460	89,205	(28,226)
Net increase (decrease) in cash and cash equivalents	4,091,565	(4,099,502)	4,304,858
Cash and cash equivalents at beginning of year	2,615,379	6,714,881	2,410,023
Cash and cash equivalents at end of year	$ 6,706,944	$ 2,615,379	$ 6,714,881
Supplemental disclosure of cash flow information:			
Cash paid for interest	$ 1,244,049	$ 1,263,473	$ 424,337
Supplemental schedule of non-cash investing and financing activities:			
Principal payments on long-term debt through preferred pricing reductions	$ 2,922,537	$ 2,920,804	$ 2,920,804
Issuance of note payable and assumption of accounts payable in exchange business acquisitions	$ 2,250,000	$	$ 100,492
Issuance of capital lease in exchange for property and equipment	$ 141,913	$	$ 401,883
Purchase of equipment with volume discount credit	$	$ 158,800	$

See accompanying notes to consolidated financial statements

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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 December 31, 2005, the Company has a network of more than 133 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.

During 2005 and 2004, HEARx West generated net income of approximately $2,330,000 and $1,385,000. The HEARx West members deficit decreased from approximately $3,206,000 at the end of 2004 to approximately $876,000 at the end of 2005. According to the Company s agreement with the Permanente Federation, the Company included in its consolidated statement of operations 100% of the losses incurred by the venture since its inception and will receive 100% of the net income of the venture until the members deficit is eliminated. At such time as the members deficit is eliminated and the venture continues to be profitable, the Company will begin recording a minority interest, corresponding to 50% of the venture s net income, as an expense in the Company s consolidated statement of operations and with a corresponding liability on its consolidated balance sheet.

Revenue Recognition

Revenues from the sale of audiological products are recognized at the time of delivery to the patient. Revenues from hearing care services are recognized at the time those services are performed.

The Company has capitation contracts with certain health care organizations under which the Company is paid an amount for each enrollee of the health maintenance organization to provide to the enrollee a discount on certain hearing products and services. The amount paid to the Company by the healthcare organization is calculated on a per-capita basis and is referred to as capitation revenue. Capitation revenue is earned as a result of agreeing to provide services to members without regard to the actual amount of service provided. Revenue is recorded in the period that the beneficiaries are entitled to hearing care services.

Foreign Currency Translation

The consolidated financial statements for the Company s Canadian subsidiaries are translated into U.S. dollars at current exchange rates. For assets and liabilities, the year-end rate is used. For revenues, expenses, gains and losses the average rate for the period is used. Unrealized currency adjustments in the Consolidated Balance Sheet are accumulated in stockholders equity as a component of accumulated other comprehensive income.

Comprehensive Income (Loss)

Comprehensive income 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 represents foreign currency translation adjustment.

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. The current year includes 53 weeks with the additional week included in the first quarter of 2005. The next year with 53 weeks will be 2011.

Concentration of credit risk

The Company maintains its cash deposits at commercial banks. We place our cash and cash equivalents with high quality financial institutions. At times, our account balances may exceed federally insured limits. Management believes the Company is not exposed to any significant risk on its cash accounts.

Allowance for doubtful accounts

The Company provides an allowance for doubtful accounts equal to the estimated uncollectible amounts. That estimate is based on historical collection experience, current economic and market conditions and a review of the current status of each customer s trade accounts receivable.

Inventories

Inventories, which consist of hearing aids, batteries, special hearing devices and related items, are priced at the lower of cost (first-in, first-out) or market.

Property and equipment

Property and equipment is stated at cost. Depreciation is provided on the straight-line method over the estimated useful lives of the depreciable assets. Leasehold improvements are amortized over the shorter of the term of the lease or the useful life of the asset.

Goodwill and other intangible assets

Under Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets , effective in 2002, goodwill amortization ceased and goodwill is subject to impairment assessments. A fair-value-based test is applied at the reporting unit level. This test requires various judgments and estimates. A goodwill impairment loss would be recorded for any goodwill that is determined to be impaired. The Company utilized an independent appraisal firm to test goodwill for impairment as of the first day of the Company s fourth quarter during 2004 and 2005, and each of these tests indicated no impairment. Other intangible assets include finite lived intangible assets, such as patient files and customer lists, which are amortized over the estimated useful life of the assets of 15 years, generally based upon estimated undiscounted future cash flows resulting from use of the asset. Indefinite lived assets include trademarks and tradenames, which are not amortized.

Pre-opening costs

The costs associated with the opening of new centers are expensed as incurred.

Long-lived assets impairments and disposals

The Company reviews the carrying values of its long-lived and identifiable intangible assets for possible impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be recoverable through the estimated undiscounted future cash flows resulting from the use of these assets. At December 31, 2005 no long-lived assets were held for disposal. At December 25, 2004, long-lived assets of approximately $736,000 were held for disposal and sold in May 2005 (See Note 19 Discontinued Operations). No impairment losses were recorded in the consolidated statement of operations.

Convertible Instruments, Warrants, Amortization of Debt Discount and Fair Value Determination

In 2003 the Company issued debt instruments which are convertible into its common stock and included the issuance of warrants. These financing transactions are recorded in accordance with Emerging Issues Task Force Issue No. 98-5 Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios and 00-27 Application of Issue No. 98-5 to Certain Convertible Instruments . Accordingly, the beneficial conversion feature embedded in the convertible instrument and the value allocated to the related warrants based upon a relative fair value allocation of the proceeds of the instrument is recognized on the consolidated balance sheet as debt discount. The debt discount is amortized as interest expense over the life of the instrument.

Subordinated Notes, Warrants, Amortization of Debt Discount and Fair Value Determination

In August 2005 the Company issued subordinated notes that included the issuance of warrants. The Company has agreed to register the common shares underlying the warrant shares and to maintain such registration so that the Warrant holders may sell their shares if the Note Warrants are exercised. These financing transactions are recorded in accordance with Emerging Issues Task Force Issue No 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company s Own Stock. Accordingly, 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 using a Black-Scholes option pricing model. Any gains or losses resulting from the changes in fair value from period to period are included in income as interest expense

Advertising Costs

Costs for newspaper, television, and other media advertising are expensed as incurred and were $5,642,000, $5,493,000 and $4,514,000 in 2005, 2004, and 2003, respectively.

Sales return policy

The Company provides to all patients purchasing hearing aids a specific return period, which is a minimum of 30 days, if the patient is dissatisfied with the product. The Company provides an allowance in accrued expenses for returns. The return period can be extended to 60 days if the patient attends the Company s H.E.L.P. program.

Warranties

The Company provides its patients with warranties on hearing aids varying from one to three years. The first year of the warranty is always covered by the manufacturer s warranty. The warranties provided for the second and third year require a co-payment from the patients, usually covering the cost of the repair or replacement to the Company. When the cost of repair or replacement to the Company is estimated to exceed the patient co-pay, the Company provides an allowance in accrued expenses to cover the future excess cost. Historically such amounts have been minimal.

Income taxes

Deferred taxes are provided for temporary differences arising from the differences between financial statement and income tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates. Valuation allowances are established when necessary to reduce deferred tax assets and liabilities to amounts considered more likely than not to be realized.

Net loss per common share

Net 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 loss per common share basic is based on the weighted average number of common shares outstanding during the year. Net loss 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. Convertible preferred stock, stock options and stock warrants are excluded from the computations of net loss per common share because the effect of their inclusion would be anti-dilutive.

Due to the Company s losses, the following common stock equivalents for convertible debt, mandatorily redeemable convertible preferred stock, outstanding options and warrants to purchase common stock, of 7,699,153, 9,738,372, and 18,984,654, respectively, were excluded from the computation of net loss per common share diluted at December 31, 2005, December 25, 2004 and December 27, 2003 because they were anti-dilutive. For purposes of computing net loss per common share basic and diluted, for the years ended December 31, 2005 and December 25, 2004, the weighted average number of shares of common stock outstanding includes the effect of the 790,358 and 892,872, respectively, of exchangeable shares of HEARx Canada, Inc., as if they were outstanding common stock of the Company on June 30, 2002, the effective date of the Helix combination for financial reporting purposes.

Stock-based compensation-Restated

The Company has granted stock options to employees and directors under stock option plans that are more fully described in Note 10. The Company accounts for those plans using the intrinsic value method under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees . No stock-based employee compensation cost has been reflected in net loss, as all options granted under those plans had an exercise price greater than or equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation , to stock-based employee compensation (See Note 18 Recent Accounting Pronouncement):

	December 31, 2005	December 25, 2004	Restated December 27, 2003
Loss applicable to common stockholders			
As reported	$ (1,283,827)	$ (3,466,661)	$ (1,736,345)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax effects	(1,529,000)	(887,000)	(447,000)
Pro forma, net loss	$ (2,812,827)	$ (4,353,661)	$ (2,183,345)
Loss per share			
Net loss applicable to common stockholders per common share basic and diluted	$ (0.04)	$ (0.11)	$ (.06)
Net loss applicable to common stockholders per common share basic and diluted pro forma	$ (0.09)	$ (0.14)	$ (.07)

For purposes of the above disclosure, the determination of the fair value of stock options granted in 2005, 2004, and 2003, was based on the assumption of no expected dividends on the underlying common stock and the following weighted average assumptions:

	2005	2004	2003
Risk free interest rate	4.39%	4.16%	2.90%
Expected life, in years	5-10	5-10	5-10
Expected volatility	96%	92%	98%

Statements of Cash Flows

For the purposes of the Statements of Cash Flows, temporary cash investments which are not restricted as to their use and have an original maturity of ninety days or less are considered cash equivalents.

Estimates

The preparation of the financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain amounts in the 2004 and 2003 financial statements have been reclassified in order to conform to the 2005 presentation.

2. Restricted Cash and Cash Equivalents

Restricted cash and cash equivalents at December 31, 2005 and December 25, 2004 consist of certificates of deposit with contractual maturities of one year or less of $431,000 and $435,000.

Restricted cash and cash equivalents was pledged as collateral to a financial institution for automated clearing house exposure.

3. Property and Equipment and Leases

Property and equipment consists of the following:

	Range of Useful Lives	**December 31, 2005**	**December 25, 2004**
Equipment, furniture and fixtures	5 -10 years	$ 10,868,588	$ 10,305,606
Leasehold Improvements	5 -10 years	7,665,710	7,391,414
Computer systems	3 years	4,806,302	4,435,117
Construction in progress	N/A	34,583	23,498
		23,375,183	22,155,635
Less accumulated depreciation and amortization		19,900,802	18,808,847
		$ 3,474,381	$ 3,346,788

Total estimated future depreciation expense for the Company s current property and equipment are as follows:

	Amount
2006	$ 1,095,000
2007	779,000
2008	583,000
2009	334,000
2010	227,000
Thereafter	134,000

The Company leases facilities primarily for hearing centers. These are located in retail shopping areas having terms expiring at various dates through fiscal 2010. The Company recognizes rent expense on a straight line basis over the lease term. The leases have renewal clauses of 1 to 10 years at the option of the Company. The difference between the straight-line and cash payments, which is due to escalating rents in the lease contracts, is included in accrued expenses in the accompanying consolidated balance sheet. Equipment and building rent expense under operating leases in 2005, 2004 and 2003 was approximately $5,851,000, $5,793,000 and $5,836,000, respectively.

Approximate future minimum rental commitments under operating leases are as follows:

	Amount
2006	$ 5,368,000
2007	4,592,000
2008	3,709,000
2009	2,458,000
2010	1,722,000
Thereafter	1,086,000

4. Goodwill and Intangible Assets

A summary of changes in the Company s goodwill during the years ended December 31, 2005 and December 25, 2004, by business segment are as follows:

	December 25, 2004	**Additions & Adjustments**	**Currency Translation**	**December 31, 2005**
Centers	$ 32,330,000	$ 2,806,000	$ 379,000	$ 35,515,000
Network	880,000			880,000
	$ 33,210,000	$ 2,806,000	$ 379,000	$ 36,395,000

	December 27, 2003	**Additions & Adjustments**	**Currency Translation**	**December 25, 2004**
Centers	$ 31,901,000	$	$ 429,000	$ 32,330,000
Network	880,000			880,000

$ 32,781,000	$	$ 429,000	$ 33,210,000

As of December 31, 2005 and December 25, 2004, intangible assets consisted of the following:

	December 31, 2005	December 25, 2004
Amortizable intangible assets:		
Patient files and customer lists	$ 6,370,000	$ 5,505,000
Accumulated amortization	(2,340,000)	(1,766,000)
Amortizable intangible assets, net	4,030,000	3,739,000
Trademark and trade names	7,410,000	7,355,000
	$ 11,440,000	$ 11,094,000

The aggregate amortization expense was as follows in 2005, 2004 and 2003:

	2005	2004	2003
Amortization expense	$ 623,000	$ 478,000	$ 430,000

Total estimated future amortization expenses for the Company s current intangible assets are as follows:

	Amount
2006	$ 718,000
2007	484,000
2008	466,000
2009	436,000
2010	409,000
Thereafter	1,495,000

5. Business Acquisitions

During 2005, the Company acquired the assets of six hearing care centers in Michigan, New Jersey, New York and California in four separate transactions. Consideration paid was cash of $1 million and notes payable in the amount of $850,000. The acquisitions resulted in additions to goodwill of approximately $1.3 million, fixed assets of approximately $17,000 and intangible customer lists and non-compete of approximately $486,000. The notes bear interest at 5 percent and are payable in quarterly installments of $45,800 plus accrued interest, through September 2009.

In May 2005, the Company also acquired the assets of a hearing care network in Florida, including network. Consideration of $350,000 cash and a three-year convertible note payable $1.4 million was paid for network contracts of approximately $340,000 and goodwill of approximately $1.4 million. The note bears interest at 7 percent and is payable in 36 monthly installments of $38,889 plus interest, beginning on June 1, 2005. After September 30, 2005 the payee has the right to convert all or any portion of the unpaid principal, and accrued interest, on the note into the number of shares of the Company s common stock as determined by dividing such sum of unpaid principal and accrued interest to be converted by $1.74 (the market price of the Company s common stock on the date of the acquisition).

6. Long-term Debt (Also see Notes 7 and 8)

Long-term debt consists of the following, before and after reflecting the new amended and restated agreements signed on February 10, 2006 with Siemens See a) below:

	Before December 31, 2005	After December 31, 2005	December 25, 2004
Notes payable to a Siemens see (a) below:			
Tranche A	$ 1,299,984	$ 2,239,851	$ 3,599,988
Tranche B	39,867		62,400
Tranche C	900,000	20,875,256	1,500,000
Tranche D (including accrued interest of $1,298,865 and $1,813,971)	14,298,865		13,590,284
Tranche E	1,576,391		2,171,329
Tranche F	5,000,000		
Other			91,685
Total notes payable to Siemens	23,115,107	23,115,107	21,015,686
Notes payable to others	2,047,100	2,047,100	433,347
	25,162,207	**25,162,207**	**21,449,033**
Less current maturities	5,192,108	5,392,253	4,152,908
	$ 19,970,099	**$ 19,769,954**	**$ 17,296,125**

The approximate aggregate maturities on long-term debt obligations in years subsequent to 2005 are as follows:

	Amount
2006	$ 5,192,000
2007	4,820,000
2008	4,533,000
2009	4,320,000
2010	5,042,000
Thereafter	1,255,000

a) On December 7, 2001, the Company obtained a secured credit facility from Siemens comprised of (a) a $10,875,000 secured five-year term loan credit facility (the Tranche A Loan); (b) a $25,000,000 secured five-year revolving loan credit facility (the Tranche B Loan); (c) a $3,000,000 secured five-year term loan facility (the Tranche C Loan) and (d) a $13,000,000 secured five-year term loan credit facility (the Tranche D Loan). On March 14, 2003, the Company obtained an additional $3,500,000 secured five-year term loan from Siemens

bearing interest at a rate of 10% annually (the Tranche E Loan). The Tranche E Loan was obtained pursuant to an amendment to the Company s credit agreement with Siemens and is otherwise subject to the terms and conditions of the credit agreement and related security agreement. On December 28, 2005, the Company obtained an additional $5,000,000, bearing interest at prime plus 1% and having a five-year term (the Tranche F Loan). The Tranche F loan was obtained pursuant to a term sheet signed on December 28, 2005, which indicates the intention of both parties to extend their relationship and amend and restate the existing credit, supply and security agreements for an additional five years. At December 31, 2005 $1,299,984, $39,867, $900,000, $14,298,865, $1,576,391 and $5,000,000, representing principal on the Tranche A, Tranche B, Tranche C, Tranche D, Tranche E and Tranche F Loans, respectively, were outstanding.

On February 10, 2006, HearUSA, Inc. (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 have restructured the 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, including the currently outstanding $23.1 million, and is structured in three tranches.

The new Tranche A, with a principal balance of approximately $2.2 million and interest of 10% per annum, is payable in three quarterly installments commencing with the first quarter of 2006, which quarterly payments are subject to rebate credits as described below. This note is a consolidation of the old Tranches A, B and C.

The new 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.

The new 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, an interest rate of prime plus 1% per annum, and is payable in monthly installments of principal and interest of $130,000 commencing February 2006. In addition, the Company must make quarterly installment payments on Tranche C of $730,000 plus interest thereon commencing with the fourth quarter of 2006, which quarterly payments are also subject to rebate credits as described below. Additional loans may be made to the Company under Tranche C for certain acquisitions. The 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 on purchases of hearing aids from Siemens, provided that the Company purchases under the Amended Supply Agreement certain percentages of hearing aids it sold. 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 proceeds from equity offerings the Company may complete. During 2005, the Company made $267,000 in payments to Siemens pursuant to its 2004 excess cash flow. The estimated payment for 2006 based on 2005 excess cash flow is $237,000.

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

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 years:

	2005	2004	2003
Preferred pricing reductions recorded as a reduction of cost of products sold	$ 3,311,000	$ 3,641,000	$ 3,947,000
Portion applied against quarterly principal payments	$ (2,922,000)	$ (2,921,000)	$ (2,921,000)
Portion applied against quarterly interest payments	(389,000)	(720,000)	(1,026,000)
	$ (3,311,000)	$ (3,641,000)	$ (3,947,000)

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.

7. 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 notes could not be converted and warrants to purchase 2,142,750 shares could not be exercised for a two-year period. The remaining warrants to purchase 500,000 shares were exercisable after May 31, 2005 at $1.75 per share. Beginning December 2005 the notes could have been converted at $1.75 per share and the lender warrants would have been 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 is making quarterly payments of interest only. Beginning March 25, 2006, the Company will make 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 $2,500,000 in each of 2006, 2007 and 2008.

During 2005 and 2004, approximately $2,948,000 and $2,170,000, respectively, of prepaid financing fees and debt discount was amortized as interest expense, including a non-cash portion of approximately $2,151,000 and $1,595,000, respectively. The future non-cash debt discount and prepaid finder fees to be amortized as interest expense over the next five years are approximately $1,763,000 in 2006, $1,145,000 in 2007 and $434,000 in 2008. In the event the investors convert or exercise the debt or warrants, the Company will be required to expense the remaining debt discount and prepaid financing fees in the period in which the conversion payment or exercise occurs.

8. Subordinated Notes and Warrant Liability-Restated

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 to purchase 1,124,970 shares) are exercisable subsequent to August 22, 2005 at $2.00 per share and the remaining Warrants to purchase 374,990 shares, are exercisable after January 1, 2006 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 (See Note 9 Mandatorily Redeemable Convertible Preferred Stock). The Company has 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 was originally 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 included in income 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.

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 originally 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 $1,760,000 in 2006, $1,760,000 in 2007 and $1,540,000 in 2008.

During 2005 approximately $595,000 of prepaid financing fees and debt discount was amortized as interest expense, including a non-cash portion of approximately $389,000. The future non-cash debt discount and prepaid finder fees to be amortized as interest expense over the following three years are approximately $850,000 in 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 payment occurs.

At December 31, 2005, the fair value of the Note Warrants, using a Black-Scholes option pricing model resulted in a decrease in the fair value of the warrant liability of approximately $513,000 which was recorded as a reduction in interest expense.

9. Mandatorily Redeemable Convertible Preferred Stock

On August 27, 2003, the Company exchanged all 4,563 outstanding shares of its 1998 Convertible Preferred Stock for 4,563 shares of Series E Convertible Preferred Stock (E Series Convertible Preferred Stock). If the E Series Convertible Preferred Stock had not converted or redeemed by December 18, 2006 it would have been redeemed by the Company on December 18, 2006 for a price equal to 108% of its stated value plus accrued and unpaid premiums. The E Series Convertible Preferred Stock was presented as Mandatorily Redeemable Convertible Preferred Stock in the accompanying consolidated balance sheet. The Company had the right to redeem the newly designated preferred stock at its stated value plus accrued but unpaid premiums for sixteen months and thereafter until the redemption date at 108% of its stated value plus accrued but unpaid premiums.

In September 2005 the Company used the proceeds from an August 2005 private placement (See Note 8 Subordinated Notes and Warrant Liability) to redeem all of the Series E Convertible Preferred Stock for approximately $4.9 million, which included approximately $135,000 of unpaid premium.

10. Stockholders Equity

A. Private Placement

On March 29, 2002, the Company closed a private placement of 1.5 million shares of common stock and 1.5 million common stock purchase stock warrants for an aggregate sales price of $1.5 million. The offers and sales were made only to accredited investors as defined in Rule 501(a) of Regulation D and the Company relied on Regulation D and Section 4(2) of the Securities Act of 1933 to issue the securities without registration. The warrants may be exercised at any time until March 29, 2005 to purchase shares of common stock for an exercise price of $1.15 per share. The Company registered the common stock for resale in 2004.

B. Stock Subscription

On April 1, 2001, the Company sold 200,000 shares of the Company s common stock to an investment banker for $2.0625 per share, and received a secured, nonrecourse promissory note receivable for the principal amount of $412,500. The note receivable is collateralized by the common stock purchased which is held in escrow. The principal amount of the note and accrued interest is payable on April 1, 2006. The note bears interest at the prime rate published by the Wall Street Journal adjusted annually. At December 25, 2004, the interest rate of the note was 5.25%. The note receivable under the caption Stock Subscription is part of stockholders equity in the accompanying consolidated balance sheets.

C. Series J Preferred Stock

On December 13, 2001, the Company completed an exchange and redemption of all of the 418 shares of outstanding Series I Convertible Preferred Stock and 203,390 associated common stock purchase warrants for $1,951,000 in cash, 233 shares of newly created Series J Preferred Stock, and 470,530 shares of Common Stock. The cost of the transaction included legal and broker fees of approximately $47,500 in cash and 136,180 shares of Common Stock issued to the broker. The fair value of the cash, shares of Series J Preferred Stock, and common stock transferred to the holders of the Series I Convertible Preferred Stock approximated the carrying value of the Series I Convertible Preferred Stock and the related dividends payable of approximately $4.7 million.

The Series J Preferred Stock has a stated value of $10,000 per share and is non-convertible and non-voting. The holders of the Series J Preferred Stock are entitled to receive cumulative dividends, in cash, at a rate of 6% per year. Dividends earned but not paid on the applicable dividend payment date will bear interest at a rate of 18% per year payable in cash unless the holders and the Company agree that such amounts may be paid in shares of common stock. At any time the Company has the right to redeem all or a portion of the Series J Preferred Stock for a redemption price equal to the stated value plus accrued and unpaid dividends. If there is a change in control of the Company, only upon or after the approval thereof by the Company s Board of Directors, the holders of the Series J Preferred Stock have the right to require the Company to redeem the Series J Preferred Stock at a price of 120% of the stated value plus any accrued and unpaid dividends. The parties agreed that the transaction with Helix would not be deemed to be a change in control for this purpose.

In the event of liquidation, dissolution or winding up of the Company prior to the redemption of the Series J Preferred Stock, holders of the Series J Preferred Stock will be entitled to receive the stated value per share plus any accrued and unpaid dividends before any distribution or payment is made to the holders of any junior securities but after payment is made to the holders of the 1998 Convertible Preferred Stock, if any. In the event that the assets of the Company are insufficient to pay the full amount due the holders of the Series J Preferred Stock and any holders of securities equal in ranking, such holders will be entitled to share ratably in all assets available for distribution.

In connection with this transaction, the Company also entered into a Registration Rights Agreement with the holder under which the Company was required to file a registration statement on Form S-3 covering the resale of the 470,530 shares of common stock issued in this transaction no later than 180 days from December 13, 2001. During November 2003 the Company agreed to pay $25,000 to the holder during 2004 as settlement for not filing timely such registration statement. The 470,530 shares of common stock

issued in the transaction, together with 129,470 shares of common stock then held by the same holder, were placed in escrow and subject to resale restrictions based on the trading price of the common stock. Those shares have all been released from escrow and most have been sold into the public market. During 2005, 2004 and 2003, approximately $141,000, $143,000 and $140,000 of the 6% dividend on the Series J Preferred Stock is included in the caption Dividends on Preferred Stock in the accompanying Consolidated Statements of Operations.

D. Shareholder Rights Plan

On December 14, 1999, the Board of Directors approved the adoption of a Shareholder Rights Plan, in which a dividend of one preferred share purchase right (a Right) for each outstanding share of common stock was declared, and payable to the stockholders of record on December 31, 1999.

The Shareholder Rights Plan as amended and restated on July 11, 2002, in connection with the combination with Helix to, among other things, give effect to the issuance of the exchangeable shares as voting stock of the Company, and to otherwise take into account the effects of the combination. The Rights will be exercisable only if a person or group acquires 15% or more of the Company s common stock or announces a tender offer which would result in ownership of 15% or more of the common stock. The Rights entitle the holder to purchase one one-hundredth of a share of Series H Junior Participating Preferred Stock at an exercise price of $28.00 and will expire on December 31, 2009 (See Note 10E).

Following the acquisition of 15% or more of the Company s common stock by a person or group without the prior approval of the Board of Directors, the holders of the Rights (other than the acquiring person) would be entitled to purchase shares of common stock (or common stock equivalents) at one-half the then current market price of the common stock, or at the election of the Board of Directors, to exchange each Right for one share of the Company s common stock (or common stock equivalent). In the event of a merger or other acquisition of the Company without the prior approval of the Board of Directors, each Right will entitle the holder (other than the acquiring person), to buy shares of common stock of the acquiring entity at one-half of the market price of those shares. The Company would be able to redeem the Rights at $0.01 per Right at any time until a person or group acquires 15% or more of the Company s common stock. The Board of Directors exempted the Helix transaction from the operation of the Plan.

E. Series H Junior Participating Preferred Stock

See Shareholder Rights Plan, above, and Exchangeable Right Plan, below. The Series H Junior Participating Preferred Stock is subject to the rights of the holders of any shares of any series of preferred stock of the Company ranking prior and superior to the Series H Junior participating Preferred Stock with respect to dividends. The holders of shares of Series H Junior Participating Preferred, in preference to the holders of shares of common stock, and any other junior stock, shall be entitled to receive dividends, when, as and if declared by the Board of Directors out of funds legally available therefore.

F. Exchangeable Rights Plan

On July 11, 2002, in connection with the combination with Helix, HEARx Canada, Inc., an indirect subsidiary of the Company, adopted a Rights Agreement (the Exchangeable Rights Plan) substantially equivalent to the Company s Shareholder Rights Plan (See Note 10D). Under the Exchangeable Rights Plan, each exchangeable share (See Note 10I) issued has an associated right (an Exchangeable Share Right) entitling the holder of such Exchangeable Share Right to acquire additional exchangeable shares on terms and conditions substantially the same as the terms and conditions upon which a holder of shares of common stock is entitled to acquire either one one-hundredth of a share of the Company s Series H Junior Participating Preferred Stock or, in certain circumstances, shares of common stock under the Company s Shareholder Rights Plan. The definitions of beneficial ownership, the calculation of percentage ownership and the number of shares outstanding and related provisions of the Company s Shareholder Rights Plan and the Exchangeable Rights Plan apply, as appropriate, to shares of common stock and exchangeable shares as though they were the same security. The Exchangeable Share Rights are intended to have characteristics essentially equivalent in economic effect to the Rights granted under the Company s Shareholder Rights Plan.

G. Warrants

In 2005 1,600,000 warrants were exercised and 131,695 warrants expired. No warrants were exercised in 2004. The aggregate number of common shares reserved for issuance upon the exercise of warrants is 5,114,853 as of December 31, 2005. The expiration date and exercise prices of the outstanding warrants are as follows:

Outstanding Warrants	Expiration Date	Exercise Price
2,759,893	2008	1.75
240,000	2010	1.25
560,000	2010	1.31
1,554,960	2010	2.00
5,114,853		

H. Aggregate and Per Share Cumulative Preferred Dividends

As of December 31, 2005, there were no arrearages in cumulative preferred dividends/premiums. As of December 25, 2004, the aggregate and per share amount of arrearages in cumulative preferred dividends/premiums was approximately $178,000 and $.01/share.

I. Exchangeable Shares

Immediately following the effective combination of the Company and Helix, each outstanding Helix common share, other than shares held by dissenting Helix Stockholders who were paid the fair value of their shares and shares held by the Company, were automatically exchanged for, at the election of the holder, 0.3537 fully-paid and non-assessable exchangeable shares (Exchangeable Shares) of HEARx Canada, Inc., or 0.3537 shares of HearUSA, Inc. common stock. The Exchangeable Shares are the economic equivalent of HearUSA, Inc. common stock. Each Exchangeable Share will be exchanged at any time at the option of the holder, for one share of HearUSA, Inc. common stock, subject to any anti-dilution adjustments. Until exchanged for HearUSA, Inc. common stock; (i) each Exchangeable Share outstanding will entitle the holder to one vote per share at all meetings of HearUSA, Inc. common stockholders; (ii) if any dividends are declared on HearUSA, Inc. common stock, an equivalent dividend must be declared on such exchangeable shares and (iii) in the event of the liquidation, dissolution or winding-up of HEARx Canada, Inc., such exchangeable shares will be exchanged for an equivalent number of shares of HearUSA, Inc. common stock. The exchangeable shares will be subject to mandatory exchange on July 27, 2006, the fifth anniversary of the transaction.

11. Stock Plans

The Company has the following stock plans:

A. Employee Stock Option Plans

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 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.

In 2002, the Board of Directors adopted and the Company s stockholders approved, the 2002 Flexible Stock Plan. This plan is administered by the Company s Board of Directors. A maximum of 3,000,000 shares of the Company s common stock were originally authorized for issuance under this plan. The plan authorizes an annual increase in authorized shares equal to 10% of the number of shares subject to the plan as of the prior year beginning in fiscal year 2003 not to exceed 5,000,000 shares in the aggregate. 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.

As of December 31, 2005, employees of the Company held options permitting them to purchase an aggregate 5,258,770 shares of common stock at prices ranging from $0.35 to $18.75 per share. Options are exercisable for periods ranging from four to ten years commencing one year following the date of grant and are generally exercisable in cumulative annual installments of 25 percent per year.

The following table summarizes the transactions of the Company s employee stock option plans:

	Year Ended					
	December 31, 2005		December 25, 2004		December 27, 2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	5,296,987	$ 1.49	3,387,755	$ 1.78	2,168,290	$ 3.04
Granted	360,000	$ 1.63	2,495,000	$ 1.36	1,785,000	$ 0.46
Exercised	130,000	$ .52	6,250	$ .67	20	$ 0.77
Forfeited	268,217	$ 4.66	592,018	$ 2.69	565,515	$ 2.47
Outstanding at end of year	5,258,770	$ 1.36	5,296,987	$ 1.49	3,387,755	$ 1.78
Exercisable at end of year	2,265,944		1,538,540		1,418,012	
Weighted average fair value of options granted during year	$ 1.35		$ 1.20		$ 0.37	

The following table summarizes information about fixed employee stock options outstanding at December 31, 2005:

Range of Exercise Price	Options Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Options Exercisable At December 31, 2005	Weighted Average Exercise Price
$.35 - $.77	1,762,900	6.2	$ 0.50	996,023	$ .55
$.78 - $2.00	3,046,730	8.5	$ 1.36	877,031	$ 1.30
$2.01 - $5.40	294,511	5.2	$ 3.14	238,261	$ 3.34
$5.41 - $8.75	141,269	1.3	$ 7.20	141,269	$ 7.21
$8.76 - $18.75	13,360	1.3	$ 15.90	13,360	$ 15.91
	5,258,770			2,265,944	

The stock options are exercisable in the following years:

2006	3,366,770
2007	1,093,750
2008	708,250
2009	90,000
	5,258,770

B. Non-Employee Director Plan

In April 1993, the stockholders of the Company approved the adoption of the HearUSA Inc. Non-qualified Stock Option Plan for Non-Employee Directors (Directors Plan). The Directors Plan terminated in accordance with its terms in 2003.

As of December 31, 2005, three directors hold options as follows: 4,500 at $4.00, 4,500 shares at $5.00, 10,500 at $7.50, and 3,000 shares at prices ranging from $12.50 to $58.75 per share.

C. Non-Employee Director Non-Plan Grant

On April 1, 2003 options to purchase 125,000 shares of common stock were granted to members of the Board of Directors, at an exercise price of $0.35, which was equal to the quoted closing price of the common stock on the grant date. The options vested after one year and have a ten-year life.

12. Major Customers and Suppliers

During 2005, 2004 and 2003 no customer accounted for more than 10% or more of net revenues.

During 2005, 2004 and 2003, the Company purchased approximately 93.1%, 88.7% and 88.7%, respectively, of all hearing aids sold by the Company from Siemens. As described in Note 6, the Company is a party to a supply agreement with Siemens whereby the Company has agreed to purchase minimum levels from Siemens. Although there are a limited number of manufacturers of hearing aids, management believes that other suppliers could provide similar hearing aids on comparable terms. In the

event of a disruption of supply from Siemens, the Company could obtain comparable products from other manufacturers. The Company has not experienced any significant disruptions in supply in the past.

13. Related Party Transactions

The Company is a party to a capitation contract with an affiliate of its minority owner, the Permanente Federation LLC (the Kaiser Plan a member of its subsidiary, HEARx West, LLC. Under the terms of the contract, HEARx West is paid an amount per enrollee of the Kaiser Plan, to provide a once every three years benefit on certain hearing products and services. During 2005, 2004 and 2003 approximately $6,886,000 $6,451,000 and $6,095,000, respectively, of capitation revenue from this contract is included in net revenue in the accompanying consolidated statements of operations.

As mentioned in Note 19 Discontinued Operations, on July 15, 2003, the Company sold its three Quebec subsidiaries to private entities owned and controlled by Steve Forget, a former Helix officer and director. Mr. Forget served as an officer of HearUSA until October 2002 and as a director until May 2003. Prior to the disposition, the Quebec subsidiaries provided management services to a single client, Forget & Sauvé, audioprothesistes, s.e.n.c. operating under the name Le Groupe Forget (Le Groupe Forget). Le Groupe Forget is controlled by Steve Forget. Le Groupe Forget operates a network of 16 hearing healthcare centers in the Province of Quebec. The services provided to Le Groupe Forget by the Quebec subsidiaries included inventory purchasing and management, office service support, general administration and patient management software and related training. The aforementioned services were rendered to Le Groupe Forget by the Quebec subsidiaries pursuant to management agreements entered into by each of the subsidiaries and Le Groupe Forget. During the year ended, December 27, 2003 revenues of approximately $2,559,000 were earned from services to Le Groupe Forget. These revenues are presented, net of related expenses, under Discontinued Operations in the Consolidated Statements of Operations.

14. Income Taxes-Restated

The components of loss before discontinued operations are as follows:

	Restated 2005	2004	2003
Domestic	$ (1,425,000)	$ (3,142,000)	$ (727,000)
Foreign	905,000	934,000	187,000
Total loss before loss of discontinued operations	$ (520,000)	$ (2,208,000)	$ (540,000)

The Company has accounted for certain items (principally depreciation and the allowance for doubtful accounts) for financial reporting purposes in periods different from those for tax reporting purposes. The beneficial conversion feature has been reclassed for all periods presented in accordance with EITF Issue No. 05-8, Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature.

Deferred tax assets (liabilities) are comprised of the following:

	Restated 2005	2004
Depreciation	$ 1,367,000	$ 1,285,000
Allowance for doubtful accounts	142,000	129,000
Joint Venture	(881,000)	(985,000)
Beneficial conversion feature	(775,000)	(1,236,000)
Decrease in fair value of warrant liability	(193,000)	
Amortization	(1,321,000)	(184,000)
Other	364,000	279,000
Net operating loss carryforwards	28,452,000	28,441,000
	27,155,000	27,729,000
Less valuation allowance	(27,155,000)	(27,729,000)
Net deferred tax asset	$	$

At December 31, 2005 the Company had net operating loss carryforwards of approximately $76,000,000 for U.S. Federal tax purposes, and approximately $2,500,000 of operating loss carryforwards in Canada. Included in the U.S. Federal tax net operating loss carryforwards are approximately $8,300,000 related to U.S. subsidiaries of Helix pre-combination whose annual utilization would be limited due to the ownership change of Helix in connection with the combination with the Company. Should tax benefits ever be realized from such Helix pre-combination net operating loss carryforwards, the valuation allowance would be reduced and the benefit would be recorded as a reduction of the goodwill resulting from the Helix combination.

The losses are available for carryforward for twenty year periods and expire in years through 2026. Any future significant changes in ownership of the Company may limit the annual utilization of the tax net operating loss carryforwards.

The provision for income taxes on loss from continuing operations differ from the amount computed using the Federal statutory income tax rate as follows:

	Restated 2005	2004	2003
Provision at Federal statutory rate	$ (177,000)	$ (751,000)	$ (183,000)
State income taxes, net of Federal income tax effect	(16,000)	(80,000)	(20,000)
Nondeductible expenses	32,000	29,000	23,000
Changes in valuation allowance	574,000	802,000	256,000
Other	(335,000)		(76,000)
Income tax provision	$ 78,000	$	$

No income tax provision is applicable to the loss from discontinued operations. Provision has not been made for U.S. or additional foreign taxes on undistributed earnings of the Company s Canadian subsidiaries. Such earnings have been and will continue to be reinvested but could become subject to additional tax if they were remitted as dividends, or

were loaned to the Company, or if the Company should sell its stock in the foreign subsidiaries. Such undistributed earnings are not significant at December 31, 2005.

15. Commitments and Contingencies

The Company established the HearUSA Inc. 401(k) plan in October 1998. All employees who have attained age 21 with at least three months of service are eligible to participate in the plan. The Company s contribution to the plan is determined from year to year by the Board of Directors. The Company s

contributions to the plan were approximately $56,900, $67,800 and $44,800 for the years 2005, 2004 and 2003, respectively.

In August 2005, the Company entered into employment agreements with four of its executive officers that provide for annual salaries, severance payments, and accelerated vesting of stock options upon termination of employment under certain circumstances or a change in control, as defined.

The Company also entered into change of control agreements with several of its other officers which provide for severance payments and acceleration of stock option vesting upon termination of employment after a change in control, as defined.

16. Quarterly Financial Data (Unaudited)

Year Ended December 31, 2005	**First Quarter**	**Second Quarter**	**Restated Third Quarter**	**Restated Fourth Quarter**
Net revenues	$ 19,030,585	$ 19,058,460	$ 19,615,555	$ 18,967,403
Operating costs and expenses	18,015,611	17,863,348	18,353,874	18,724,254
Income (loss) from operations	1,014,974	1,195,112	1,261,681	243,149
Net income (loss) applicable to common stockholders	$ (445,068)	$ 154,076	$ (164,453)	$ (828,382)
Net loss from continuing operations, including dividends on preferred stock, applicable to common stockholders- basic and diluted	$ (0.01)	$ 0.00	$ 0.00	$ (0.03)
Net loss applicable to common stockholders per common share - basic and diluted (Note 1)	$ (0.01)	$ 0.00	$ 0.00	$ (0.03)

Year Ended December 25, 2004	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Net revenues	$ 16,048,307	$ 17,190,923	$ 17,535,395	$ 17,974,917
Operating costs and expenses	16,228,093	16,713,585	16,316,981	17,152,503
Income (loss) from operations	(179,786)	477,338	1,218,414	822,414
Net income (loss) applicable to common stockholders	$ (1,615,869)	$ (948,008)	$ (233,413)	$ (669,371)
Net loss from continuing operations, including dividends on preferred stock, applicable to common stockholders- basic and diluted	$ (0.05)	$ (0.03)	$ (0.01)	$ (0.02)
	$ (0.05)	$ (0.03)	$ (0.01)	$ (0.02)

Net loss applicable to common stockholders per common share - basic and diluted (Note 1)

a) In the third quarter of 2005 an adjustment was made to record an increase in the amount of the warrant liability of approximately $76,000 which was recorded as an increase in interest expense.
b) The fourth quarter of 2005 has been restated for the decrease in the amount of the warrant liability of approximately $598,000 which was recorded as a decrease in interest expense.

17. Fair Value of Financial Instruments

SFAS 107 requires the disclosure of fair value of financial instruments. The estimated fair value amounts have been determined by the Company s management using available market information and other valuation methods. However, considerable judgment is required to interpret market data in developing the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methods may have a material effect on the estimated fair value amounts. Furthermore, the Company does not intend to dispose of a significant portion of its financial instruments and thus, any aggregate unrealized gains or losses should not be interpreted as a forecast of future earnings and cash flows. SFAS 107 excludes certain financial instruments from its disclosure requirements, such as leases. In addition, disclosure of fair value estimates are not required for nonfinancial assets and liabilities, such as fixed assets, intangibles and anticipated future business. As a result, the following fair values are not comprehensive and therefore do not reflect the underlying value of the Company.

At December 31, 2005 and December 25, 2004, the fair value of cash and cash equivalents, restricted cash, investment securities, accounts and notes receivable, accounts payable and accrued expenses approximated their carrying value based on the short-term nature of these instruments. The fair value of the Company s long-term debt and debt-related derivative instruments is estimated based on discounted cash flows and the application of the fair value interest rates applied to the expected cash flows. The carrying amounts and related estimated fair values for the Company s debt and debt-related derivative instruments are as follows:

	December 31, 2005		December 25, 2004	
	Book Value	Fair Value	Book Value	Fair Value
Long-term debt	$ 25,162,000	$ 24,974,000	$ 21,449,000	$ 21,449,000
Convertible subordinated notes	$ 7,500,000	$ 7,273,000	$ 7,500,000	$ 7,500,000
Subordinated notes	$ 5,060,000	$ 4,943,000	$	$
Mandatorily subordinated redeemable convertible preferred stock	$	$	$ 4,710,000	$ 4,710,000

18. Recent Accounting Pronouncements

In December 2004, SFAS No. 123(R), *Share-Based Payment,* which addresses the accounting for employee stock options, was issued. SFAS No. 123(R) revises the disclosure provisions of SFAS 123, *Accounting for Stock Based Compensation* and supersedes APB Opinion 25, *Accounting for Stock Issued to Employees.* SFAS 123(R) requires that the cost of all employee stock options, as well as other equity-based compensation arrangements, be reflected in the financial statements based on the estimated fair value of the awards. This statement is effective for all public entities the beginning of the first interim period that begins after December 15, 2005. The Company plans to implement SFAS 123 (R) on its effective date. Based on the outstanding number of employee stock options and excluding the impact of any future grants at December 15, 2005, the total stock-based employee compensation expense determined under the fair value method that would be reflected in the consolidated financial statements is approximately $1,529,000 in 2005 (See Note 1 Description of the Company and Summary of Significant Accounting Policies- stock-based compensation) and $930,000 in 2006. This additional expense will not affect the Company s operation cash flows.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections- A Replacement of APB Opinion No. 20 and FASB Statement No. 3* (SFAS 154). This statement requires that a voluntary change in accounting principle be applied retroactively with all prior period financial

statements presented on the basis of the new accounting principal, unless it is impractical to do so. SFAS 154 also requires that a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for prospectively as a change in estimate, and correction of errors in previously issued financial statements should be termed a restatement . The new standard is effective for accounting changes and a correction of errors made in fiscal years beginning after December 15, 2005. We will adopt this pronouncement in fiscal year 2006.

19. Discontinued Operations

On July 15, 2003, the Company sold 100% of the shares of the Company s three subsidiaries and selected assets associated with the management of the centers located in the Canadian Province of Quebec (Quebec) to private entities owned and controlled by Steve Forget, a former Helix officer and director. Mr. Forget served as an officer of HearUSA until October 2002 and as a director until May 2003. The sale agreement provided for payments to the Company of approximately $1.7 million, representing, in part, payment of pre-existing debt owed the Company by Forget & Sauve of approximately $1.6 million. The Company received an initial cash payment of $700,000 at closing and $1 million over the five following months.

The operating results of Quebec are presented as discontinued operations. The sale resulted in a loss on disposal of approximately $105,000. Net revenues of the discontinued operations for the years ended December 27, 2003 were approximately $2.6 million. Net losses from discontinued operations applicable to common stockholders per common shares-basic and diluted were $ (0.01) for 2003. Pre-tax net losses of the discontinued operation were approximately $96,000 and $158,000, for the 2003 period through disposal.

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 Company received proceeds totaling approximately $786,000 in June 2005 and had an outstanding receivable of approximately $314,000 which was received in the third quarter of 2005.

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, including $145,850 of property and equipment, $442,000 of goodwill and $148,275 of net intangibles as of December 25, 2004. The assets and operating expenses of these hearing care centers sold were reported under the center segment.

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 years ended December 31, 2005, December 25, 2004 and December 27, 2003 were approximately as follows:

	2005	2004	2003
Net revenues of discontinued operations:			
Quebec discontinued operations	$	$	$ 2,600,000
Minnesota, Washington and Wisconsin discontinued operations	1,825,000	3,551,000	3,465,000
Combined net revenues	$ 1,825,000	$ 3,551,000	$ 6,065,000
Pre-tax net losses of discontinued operations:			
Quebec discontinued operations	$	$	$ 202,000
Minnesota, Washington and Wisconsin discontinued operations	396,000	551,000	368,000
Combined pre-tax net losses	$ 396,000	$ 551,000	$ 570,000
Net loss from discontinued operations applicable to common stockholders-basis and diluted:			
Quebec discontinued operations	$	$	$ (0.01)
Minnesota, Washington and Wisconsin discontinued operations	0.00	(0.01)	(0.01)
Combined net loss from discontinued operations applicable to common stockholders-basic and diluted	$ 0.00	$ (0.01)	$ (0.02)

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20. Segments

The following operating segments represent identifiable components of the company for which separate financial information is available. The following table represents key financial information for each of the Company s business segments, which include the operation and management of centers, the establishment, maintenance and support of an affiliated network and the operation of an e-commerce business. The centers offer people afflicted with hearing loss a complete range of services and products, including diagnostic audiological testing, the latest technology in hearing aids and listening devices to improve their quality of life. The network, unlike the Company-owned centers, is comprised of hearing care practices owned by independent audiologists. The network revenues are mainly derived from administrative fees paid by employer groups, health insurers and benefit sponsors to administer their benefit programs as well as maintaining an affiliated provider network. E-commerce offers on-line product sales of hearing aid related products, such as batteries, hearing aid accessories and assistive listening devices. The Company s business units are located in the United States and Canada. The following is the Company s segment information by year:

	Centers	E-commerce	Network	Corporate	Total
Hearing aids and other products revenues					
2005	$ 71,365,000	$ 80,000			$ 71,445,000
2004	$ 63,149,000	$ 79,000			$ 63,228,000
2003	$ 60,858,000	$ 69,000			$ 60,927,000
Service revenues					
2005	$ 3,805,000		$ 1,422,000		$ 5,227,000
2004	$ 4,413,000		$ 1,109,000		$ 5,522,000
2003	$ 5,100,000		$ 1,053,000		$ 6,153,000
Income (loss) from operations					
2005	15,137,000	(105,000)	549,000	(11,866,000)	3,715,000
2004	12,310,000	(27,000)	447,000	(10,392,000)	2,338,000
2003	13,063,000	(49,000)	504,000	(11,250,000)	2,268,000
2005					
Depreciation and amortization	1,764,000		5,000	205,000	1,974,000
Total assets	50,119,000		1,131,000	17,732,000	68,982,000
Capital expenditures	970,000			228,000	1,198,000
2004					
Depreciation and amortization	1,893,000		5,000	174,000	2,072,000
Total assets	47,241,000		1,722,000	10,459,000	59,422,000
Capital expenditures	318,000		3,000	62,000	383,000
2003					
Depreciation and amortization	2,002,000		3,000	779,000	2,784,000
Total assets	44,100,000		1,149,000	20,934,000	66,183,000
Capital expenditures	174,000			94,000	268,000

Hearing aids and other products revenues consisted of the following:

	2005	2004	2003
Hearing aid revenues	95.5%	94.6%	96.8%
Other products revenues	4.5%	5.4%	3.2%

Services revenues consisted of the following:

	2005	2004	2003
Hearing aid repairs	53.4%	50.1%	60.5%
Testing and other income	46.6%	49.9%	39.5%

Income (loss) from operations at the segment level is computed before the following, the sum of which is included in the column Corporate as loss from operations:

	2005	2004	2003
General and administrative expense	$ 11,661,000	$ 10,218,000	$ 10,471,000
Deprecation and amortization	$ 205,000	$ 174,000	$ 779,000
Corporate loss from operations	$ 11,866,000	$ 10,392,000	$ 11,250,000

Information concerning geographic areas:

As of and for the Years Ended December 31, 2005 and December 25, 2004

	United States 2005 $	**Canada 2005 $**	**United States 2004 $**	**Canada 2004 $**
Hearing aid and other product revenues	63,500,000	7,945,000	56,743,000	6,485,000
Service revenues	4,835,000	392,000	5,212,000	310,000
Long-lived assets	41,587,000	10,308,000	39,235,000	9,704,000
Total assets	55,771,000	13,211,000	47,658,000	11,764,000

Net revenues by geographic area are allocated based on the location of the subsidiary operations.

21. Liquidity

During 2005, the working capital deficit decreased $1.8 million to $3.1 million as of December 31, 2005 from $4.9 million as of December 27, 2004. The decrease in the deficit is attributable to an excess of approximately $4.0 million in cash from operations and financing activities over cash used for investing activities offset by an increase in current maturities of long-term debt, convertible subordinated debt and subordinated notes of approximately $2.8 million. The working capital deficit of $3.1 million includes approximately $3.0 million representing the current maturities of the long-term debt to Siemens which may be repaid through preferred pricing reductions and approximately $652,000 ($2.5 million in current maturities, net of $1.5 million of debt discount) related to the $7.5 million convertible subordinated notes that can be repaid by either cash or stock, at the option of the Company. In 2005, the Company generated income from operations of approximately $3.7 million compared to $2.3 million in 2004. Cash and cash equivalents as of December 31, 2005 were approximately $6.7 million.

The Company believes that current cash and cash equivalents and cash flow from operations, at current net revenue levels, will be sufficient to support the Company s operational needs through the next twelve months, although there can be no assurance that the Company can maintain compliance with the Siemens loan covenants, that net revenue levels will remain at or higher than current levels or that unexpected cash needs will not arise for which the cash, cash equivalents and cash flow from operations will not be sufficient. In the event of a shortfall in cash, the Company might consider short-term debt, or additional equity or debt offerings. There can be no assurance however, that such financing will be available to the Company on favorable terms or at all. The Company also is continuing its aggressive cost controls and sales and gross margin improvements.

22. Restatement

The Company is filing this Amendment No. 1 on Form 10-K/A to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2005, to correct an error relating to the valuation of the warrant liability appearing on the consolidated balance sheets. This liability arose as a result of the Company s agreement to register the common shares underlying certain warrants and keep them registered during the three year term of the warrants. The Company is required to value this liability based on the fair value of the warrants using a Black-Scholes option pricing model. Changes in fair value of the warrant liability from period to period must be recorded as reductions or additions to interest expense. As the warrant holders exercise the warrants, the applicable portion of the remaining liability is reclassified to additional paid in capital. For the 2005 fiscal year, the Company originally recorded $1.9 million related to the warrant liability. Due to the fluctuation in the Company s common stock price at the end of 2005 the warrant liability should have been reduced to approximately $1.3 million and the Company should have reduced interest expense by approximately $513,000 in its consolidated statements of operations. Instead the Company recorded an increase of approximately $9,000. The correction of this error resulted in an increase to the previously reported warrant liability balance at October 1, 2005 and an increase of the previously reported interest expense for the quarter ended October 1, 2005 of approximately $76,000. The correction of this error also resulted in a decrease to the previously reported warrant liability balance at December 31, 2005 and decrease of the previously reported interest expense for the quarter ended December 31, 2005 of approximately $598,000. These corrections resulted in a reduction of the net loss applicable to common stockholders previously reported of approximately $1.8 million to approximately $1.3 million for the year ended December 31, 2005.

HearUSA Inc.
Schedule II Valuation and Qualifying Accounts

	Balance at Beginning Of Period	Additions	Restated Deductions	Restated Balance at End Of Period
December 31, 2005				
Allowance for doubtful accounts	$ 373,583	$ 354,107	$ (314,304)	$ 413,386
Allowance for sales returns (1)	$ 425,116	$ 17,287	$ (1,818)	$ 440,585
Valuation allowance	$ 27,729,000	$	$ (574,000)	$ 27,155,000
December 25, 2004				
Allowance for doubtful accounts	$ 490,881	$ 430,454	$ (547,752)	$ 373,583
Allowance for sales returns	$ 445,147	$ 71,061	$ (91,092)	$ 425,116
Valuation allowance	$ 28,531,000	$	$ (802,000)	$ 27,729,000
December 27, 2003				
Allowance for doubtful accounts	$ 578,323	$ 801,303	$ (888,745)	$ 490,881
Allowance for sales returns	$ 789,539	$ 32,830	$ (377,222)	$ 445,147
Valuation allowance	$ 28,787,000	$	$ (256,000)	$ 28,531,000

(1) Allowance for sales returns is included in accounts payable on the Consolidated Balance Sheets.

Item 9A. Controls and Procedures

In connection with the preparation and filing of this Amendment No. 1 to the Company s annual report on Form 10-K/A, the Company s management, with the participation of the Company s chief executive officer and chief financial officer, evaluated the effectiveness of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of December 31, 2005. Management reviewed in particular the Company s procedures relating to the calculation of the warrant liability described, and the related restatement reflected in, this Form 10-K/A (see, especially, Note 8 to Notes to Consolidated Financial Statements). In light of the restatement necessitated by the error in the calculation of the warrant liability, the Company s chief executive officer and chief financial officer concluded that, as of December 31, 2005, the Company s disclosure controls and procedures were not effective. The Company is currently evaluating steps that it can take to remediate any deficiencies in its disclosure controls and procedures, especially as they may relate to the calculation and documentation of warrant liability and other related matters.

No change in the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended December 31, 2005 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Report on Form 8-K

(a) The following documents are filed as part of this report:

(1) Financial Statements

(i) Consolidated Balance Sheets as of December 31, 2005 and December 25, 2004. Consolidated Statements of Operations for the years ended December 31, 2005, December 25, 2004 and December 27, 2003.

(ii) Consolidated Statements of Changes in Stockholders Equity for the years ended December 31, 2005, December 25, 2004 and December 27, 2003.

(iii) Consolidated Statements of Cash Flows for the years ended December 31, 2005, December 25, 2004 and December 27, 2003.

(iv) Notes to Consolidated Financial Statements

(2) Financial statement schedule:

Schedule II Valuation and Qualifying Accounts

(3) Exhibits:

2.1 Plan of Arrangement, including exchangeable share provisions (incorporated herein by reference to Exhibit 2.3 to the Company s Joint Proxy Statement/Prospectus on Form S-4 (Reg. No. 333-73022)).

3.1 Restated Certificate of Incorporation of HEARx Ltd., including certain certificates of designations, preferences and rights of certain preferred stock of the Company (incorporated herein by reference to Exhibit 3 to the Company s Current Report on Form 8-K, filed May 17, 1996 (File No. 001-11655)).

3.2 Amendment to the Restated Certificate of Incorporation (incorporated herein by reference to Exhibit 3.1A to the Company s Quarterly Report on Form 10-Q for the period ended June 28, 1996 (File No. 001-11655)).

3.3 Amendment to Restated Certificate of Incorporation including one for ten reverse stock split and reduction of authorized shares (incorporated herein to Exhibit 3.5 to the Company s Quarterly Report on Form 10-Q for the period ending July 2, 1999 (File No. 001-11655)).

3.4 Amendment to Restated Certificate of Incorporation including an increase in authorized shares and change of name (incorporated herein by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K, filed July 17, 2002 (File No. 001-11655)).

3.5 Certificate of Designations, Preferences and Rights of the Company s 1999 Series H Junior Participating Preferred Stock (incorporated herein by reference to Exhibit 4 to the Company s Current Report on Form 8-K, filed December 17, 1999 (File No. 001-11655)).

3.6 Certificate of Designations, Preferences and Rights of the Company s Special Voting Preferred Stock (incorporated herein by reference to Exhibit 3.2 to the Company s Current Report on Form 8-K, filed July 19, 2002 (File No. 001-11655)).

3.7 Amendment to Certificate of Designations, Preferences and Rights of the Company s 1999 Series H Junior Participating Preferred Stock (incorporated herein by reference to Exhibit 4 to the Company s Current Report on Form 8-K, filed July 17, 2002 (File No. 001-11655)).

3.8

Certificate of Designations, Preferences and Rights of the Company s 1998-E Convertible Preferred Stock (incorporated herein by reference to Exhibit 4.1 to the Company s Current Report on Form 8-K, filed August 28, 2003 (File No. 001-11655)).

3.9 Amendment of Restated Certificate of Incorporation (increasing authorized capital) (incorporated herein by reference to Exhibit 3.9 to the Company s Quarterly Report on Form 10-Q for the quarter ended June 26, 2004).

3.10 Amended and Restated By-Laws of HearUSA, Inc. (effective May 9, 2005) (incorporated herein by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K, filed May 13, 2005).

4.1 Amended and Restated Rights Agreement, dated July 11, 2002 between HEARx and the Rights Agent, which includes an amendment to the Certificate of Designations, Preferences and Rights of the Company s 1999 Series H Junior Participating Preferred Stock (incorporated herein by reference to Exhibit 4.9.1 to the Company s Joint Proxy/Prospectus on Form S-4 (Reg. No. 333-73022)).

4.2 Form of Support Agreement among HEARx Ltd., HEARx Canada, Inc. and HEARx Acquisition ULC (incorporated herein by reference to Exhibit 99.3 to the Company s Joint Proxy Statement/Prospectus on Form S-4 (Reg No. 333-73022)).

4.3 Form of 2003 Convertible Subordinated Note due November 30, 2008 (incorporated herein by reference to Exhibit 4.1 to the Company s Current Report on Form 8-K, filed December 31, 2003).

9.1 Form of Voting and Exchange Trust Agreement among HearUSA, Inc., HEARx Canada, Inc and HEARx Acquisition ULC and ComputerShare Trust Company of Canada (incorporated herein by reference to Exhibit 9.1 to the Company s Joint Proxy Statement/Prospectus on Form S-4 (Reg. No. 333-73022)).

10.1 HEARx Ltd. 1987 Stock Option Plan (incorporated herein by reference to Exhibit 10.11 to the Company s Registration Statement of Form S-18 (Reg. No. 33-17041-NY))#

10.2 HEARx Ltd. Stock Option Plan for Non-Employee Directors and Form of Option Agreement (incorporated herein by reference to Exhibits 10.35 and 10.48 to Post-Effective Amendment No. 1 to the Company s Registration Statement of Form S-18 (Reg. No. 33-17041-NY))#

10.3 1995 Flexible Employee Stock Plan (incorporated herein by reference to Exhibit 4 to the Company s 1995 Proxy Statement)#

10.4 Employment Agreement, dated August 31, 2005 with Dr. Paul A. Brown (incorporated herein by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q, for the quarter ended October 1, 2005.)#

10.5 Employment Agreement, dated August 31, 2005 with Stephen J. Hansbrough (incorporated herein by reference to Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q, for the quarter ended October 1, 2005.)#

10.6 Employment Agreement, dated August 31, 2005 with Gino Chouinard (incorporated herein by reference to Exhibit 10.3 to the Company s Quarterly Report on Form 10-Q, for the quarter ended October 1, 2005.)#

10.7 Employment Agreement, dated August 31, 2005 with Ken Schofield (incorporated herein by reference to Exhibit 10.4 to the Company s Quarterly Report on Form 10-Q, for the quarter ended October 1, 2005.)#

10.8 Form of Change in Control Agreement (incorporated herein by reference to Exhibit 10.5 to the Company s Quarterly Report on Form 10-Q for the quarter ended October 1, 2005.)#

10.9 Credit Agreement, dated December 7, 2001 between HEARx Ltd and Siemens Hearing Instruments, Inc (incorporated herein by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K, filed December 26, 2001)

10.10 Security Agreement, dated December 7, 2001 between HEARx Ltd and Siemens Hearing Instruments, Inc (incorporated herein by reference to Exhibit 10.2 to the Company s Current Report on Form 8-K, December 26, 2001)

10.11 Supply Agreement, dated December 7, 2001 between HEARx Ltd and Siemens Hearing Instruments, Inc (incorporated herein by reference to Exhibit 10.3 to the Company s Current Report on Form 8-K, December 26, 2001)

10.12 HearUSA 2002 Flexible Stock Plan (incorporated herein by reference to Exhibit 10.9 to the Company s Joint Proxy Statement/Prospectus on Form S-4 (Reg. No. 333-73022)#

10.13 Amendment to Security Agreement, dated March 12, 2003 between HearUSA, Inc. and Siemens Hearing Instruments, Inc. (incorporated herein by reference to Exhibit 10.2 to the Company s Form 10Q for the period ended March 29, 2003).

10.14 Amendment to Credit Agreement, dated March 12, 2003 between HearUSA, Inc. and Siemens Hearing Instruments, Inc. (incorporated herein by reference to Exhibit 10.1 to the Company s Form 10-Q for the period ended March 29, 2003).

10.15 Purchase Agreement dated August 19, 2005 by and among HearUSA, Inc. and the purchasers named therein (incorporated by reference to Exhibit 10.1 to the Company s Registration Statement on Form S-3/A filed October 7, 2005).

10.16 Form of Registration Rights Agreement by and among HearUSA, Inc. and the purchasers named in the Purchase Agreement dated August 19, 2005 (incorporated by reference to Exhibit 10.2 to the Company s Registration Statement on Form S-3/A filed October 7, 2005).

10.17 Asset Purchase Agreement dated June 15, 2005, between HearUSA, Inc. and Sonus-USA, Inc. (incorporated herein by reference to Exhibit 10.5 to the Company s Quarterly Report on Form 10-Q for the quarter ended July 2, 2005).

21 List of Subsidiaries*

23 Consent of the Independent Public Accountants

31.1 CEO Certification, pursuant to Section 30 2 of the Sarbanes-Oxley Act of 2002

31.2 CFO Certification, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 CEO and CFO Certification, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

# Denotes compensatory plan or arrangement for Company officer or director.

* Previously filed.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Amendment No. 1 to Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

HearUSA, Inc.
(Registrant)

Date: May 11, 2006

By: /s/ Stephen J. Hansbrough
Stephen J. Hansbrough
President and Chief Executive Officer