

HEARUSA INC  
Form 10-Q  
November 10, 2009

**Table of Contents**

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

**(Mark One)**

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

For the quarterly period ended September 26, 2009

**OR**

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-11655

**HearUSA, Inc.**

(Exact Name of Registrant as Specified in Its Charter)

Delaware

22-2748248

(State of Other Jurisdiction of  
Incorporation or Organization)

(I.R.S. Employer  
Identification No.)

1250 Northpoint Parkway, West Palm Beach,  
Florida

33407

(Address of Principal Executive Offices)

(Zip Code)

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company

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

On November 6, 2009, 44,362,806 shares of the Registrant's Common Stock and 493,043 exchangeable shares of HEARx Canada, Inc. were outstanding.



**INDEX**

|   | <b>Page</b> |
|---|-------------|
| <b><u>PART I. FINANCIAL INFORMATION</u></b>   |             |
| <b><u>Item 1. Financial Statements:</u></b>   |             |
| <u>Consolidated Balance Sheets</u><br><u>September 26, 2009 and December 27, 2008</u>                               | 3           |
| <u>Consolidated Statements of Operations</u><br><u>Nine months ended September 26, 2009 and September 27, 2008</u>  | 4           |
| <u>Consolidated Statements of Operations</u><br><u>Three months ended September 26, 2009 and September 27, 2008</u> | 5           |
| <u>Consolidated Statements of Cash Flows</u><br><u>Nine months ended September 26, 2009 and September 27, 2008</u>  | 6           |
| <u>Notes to Consolidated Financial Statements</u>   | 7           |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                | 24          |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>   | 39          |
| <u>Item 4. Controls and Procedures</u>  | 40          |
| <b><u>PART II. OTHER INFORMATION</u></b>  |             |
| <u>Item 6. Exhibits</u>   | 41          |
| <u>Signatures</u>   | 43          |
| <u>Exhibit 10.1</u>   |             |
| <u>Exhibit 10.2</u>   |             |
| <u>Exhibit 31.1</u>   |             |
| <u>Exhibit 31.2</u>   |             |
| <u>Exhibit 32.1</u>   |             |

---

**Table of Contents****Part I Financial Information****Item 1. Financial Statements**

**HearUSA, Inc.**  
**Consolidated Balance Sheets**  
**(unaudited)**

|  | <b>September<br/>26,<br/>2009</b>                        | <b>December 27,<br/>2008</b> |
|--|--|------------------------------|
|  | <b>(Dollars in thousands, except for<br/>par values)</b> |                              |
| <b>ASSETS (Notes 2 and 4)</b>  |  |                              |
| <b>Current assets</b>  |  |                              |
| Cash and cash equivalents (Note 7)   | \$ 8,436   | \$ 3,553                     |
| Short-term marketable securities (Note 7)  | 6,406  |                              |
| Accounts and notes receivable, less allowance for doubtful accounts of \$644 and \$506 | 5,628  | 7,371                        |
| Inventories  | 1,882  | 1,682                        |
| Prepaid expenses and other   | 797  | 502                          |
| <b>Total current assets</b>  | <b>23,149</b>  | <b>13,108</b>                |
| <b>Property and equipment, net (Note 4)</b>  | <b>4,150</b>   | <b>4,876</b>                 |
| <b>Goodwill (Notes 2,3 and 4)</b>  | <b>51,309</b>  | <b>65,953</b>                |
| <b>Intangible assets, net (Notes 2 and 4)</b>  | <b>12,997</b>  | <b>15,630</b>                |
| <b>Deposits and other</b>  | <b>770</b>   | <b>810</b>                   |
| <b>Restricted cash and cash equivalents</b>  | <b>3,225</b>   | <b>224</b>                   |
| <b>Total Assets</b>  | <b>\$ 95,600</b>   | <b>\$ 100,601</b>            |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |  |                              |
| <b>Current liabilities</b>   |  |                              |
| Accounts payable   | \$ 9,885   | \$ 5,011                     |
| Accrued expenses   | 3,217  | 3,208                        |
| Accrued salaries and other compensation  | 3,103  | 3,713                        |
| Current maturities of long-term debt   | 6,372  | 6,915                        |
| Income taxes payable   | 1,870  |                              |
| Dividends payable  | 35   | 34                           |
| <b>Total current liabilities</b>   | <b>24,482</b>  | <b>18,881</b>                |
| <b>Long-term debt (Notes 2,4 and 7)</b>  | <b>37,308</b>  | <b>49,099</b>                |
| <b>Deferred income taxes</b>   | <b>7,085</b>   | <b>7,284</b>                 |
| <b>Total long-term liabilities</b>   | <b>44,393</b>  | <b>56,383</b>                |
| <b>Commitments and contingencies</b>   |  |                              |

**Stockholders equity (Note 8)**

Preferred stock (aggregate liquidation preference \$2,330, \$1 par, 7,500,000 shares authorized)

Series H Junior Participating (none outstanding)

Series J (233 shares outstanding)

Total preferred stock

Common stock: \$.10 par; 75,000,000 shares authorized 44,880,045 and 44,828,384 shares issued

Additional paid-in capital

Accumulated deficit

Accumulated other comprehensive income

Treasury stock, at cost: 523,662 common shares

Noncontrolling interest

**Total Stockholders equity**

**Total Liabilities and Stockholders Equity**

|           |            |
|-----------|------------|
| 4,488     | 4,483      |
| 137,577   | 136,924    |
| (114,810) | (116,360)  |
|           | 1,249      |
| (2,485)   | (2,485)    |
| 1,955     | 1,526      |
| 26,725    | 25,337     |
| \$ 95,600 | \$ 100,601 |

*See accompanying notes to consolidated financial statements*

**Table of Contents**

**HearUSA, Inc.**  
**Consolidated Statements of Operations**  
**Nine months ended September 26, 2009 and September 27, 2008**  
**(unaudited)**

|   | <b>September<br/>26,<br/>2009</b>                           | <b>September<br/>27,<br/>2008</b> |
|---|---|-----------------------------------|
|   | <b>(Dollars in thousands, except per<br/>share amounts)</b> |                                   |
| <b>Net revenues</b>   |   |                                   |
| Hearing aids and other products   | \$ 61,172   | \$ 69,241                         |
| Services  | 6,043   | 5,389                             |
| Total net revenues  | 67,215  | 74,630                            |
| <b>Operating costs and expenses</b>   |   |                                   |
| Hearing aids and other products (Note 4)  | 14,998  | 18,661                            |
| Services  | 1,325   | 1,627                             |
| Total cost of products sold and services excluding depreciation and amortization              | 16,323  | 20,288                            |
| Center operating expenses   | 33,510  | 38,237                            |
| General and administrative expenses (Note 9)  | 11,387  | 11,565                            |
| Depreciation and amortization   | 1,731   | 1,544                             |
| Total operating costs and expenses  | 62,951  | 71,634                            |
| <b>Income from operations</b>   | 4,264   | 2,996                             |
| <b>Non-operating income (expenses)</b>  |   |                                   |
| Gain on foreign exchange  | 499   |                                   |
| Interest income   | 6   | 29                                |
| Interest expense (Notes 3, 4 and 5)   | (3,728)   | (3,996)                           |
| <b>Income (loss) from continuing operations before income tax expense</b>                     | 1,041   | (971)                             |
| Income tax expense  | (630)   | (620)                             |
| <b>Income (loss) from continuing operations</b>   | 411   | (1,591)                           |
| <b>Discontinued operations (Note 2)</b>   |   |                                   |
| Income from discontinued operations, net of income tax expense (benefit) of \$(261) and \$196 | 1,144   | 2,356                             |
| Gain on sale of discontinued operations   | 2,158   |                                   |
| Income tax expense on sale of discontinued operations   | (1,632)   |                                   |
| Income from discontinued operations   | 1,670   | 2,356                             |

|  |    |        |    |         |
|--|----|--------|----|---------|
| <b>Net income</b>  |    | 2,081  |    | 765     |
| Net income attributable to noncontrolling interest   |    | (429)  |    | (1,174) |
| <b>Net income (loss) attributable to controlling interest</b>  |    | 1,652  |    | (409)   |
| Dividends on preferred stock   |    | (102)  |    | (104)   |
| <b>Net income (loss) attributable to common stockholders</b>   | \$ | 1,550  | \$ | (513)   |
| <b>Income (loss) from continuing operations attributable to common stockholders per common share basic</b>   | \$ | (0.00) | \$ | (0.07)  |
| <b>Income (loss) from continuing operations attributable to common stockholders per common share diluted</b> | \$ | (0.00) | \$ | (0.07)  |
| <b>Net income (loss) attributable to common stockholders per common share basic</b>                          | \$ | 0.03   | \$ | (0.01)  |
| <b>Net income (loss) attributable to common stockholders per common share diluted</b>                        | \$ | 0.03   | \$ | (0.01)  |
| <b>Weighted average number of shares of common stock outstanding basic</b>                                   |    | 44,831 |    | 38,501  |
| <b>Weighted average number of shares of common stock outstanding diluted</b>                                 |    | 45,416 |    | 38,501  |

*See accompanying notes to consolidated financial statements*



**Table of Contents**

**HearUSA, Inc.**  
**Consolidated Statements of Operations**  
**Three months ended September 26, 2009 and September 27, 2008**  
**(unaudited)**

|   | <b>September<br/>26,<br/>2009</b>                           | <b>September<br/>27,<br/>2008</b> |
|---|---|-----------------------------------|
|   | <b>(Dollars in thousands, except per<br/>share amounts)</b> |                                   |
| <b>Net revenues</b>   |   |                                   |
| Hearing aids and other products   | \$ 19,616   | \$ 22,716                         |
| Services  | 2,212   | 1,813                             |
| Total net revenues  | 21,828  | 24,529                            |
| <b>Operating costs and expenses</b>   |   |                                   |
| Hearing aids and other products (Note 4)  | 4,543   | 5,963                             |
| Services  | 441   | 571                               |
| Total cost of products sold and services excluding depreciation and amortization                      | 4,984   | 6,534                             |
| Center operating expenses   | 10,811  | 12,781                            |
| General and administrative expenses (Note 9)  | 3,694   | 3,217                             |
| Depreciation and amortization   | 593   | 520                               |
| Total operating costs and expenses  | 20,082  | 23,052                            |
| <b>Income from operations</b>   | 1,746   | 1,477                             |
| <b>Non-operating income (expenses)</b>  |   |                                   |
| Gain on foreign exchange  | 99  |                                   |
| Interest income   | 4   | 7                                 |
| Interest expense (Notes 3, 4 and 5)   | (1,137)   | (1,548)                           |
| <b>Income (loss) from continuing operations before income tax expense and discontinued operations</b> | 712   | (64)                              |
| Income tax expense  | (210)   | (214)                             |
| <b>Income (loss) from continuing operations</b>   | 502   | (278)                             |
| <b>Discontinued operations (Note 2)</b>   |   |                                   |
| Income (loss) from discontinued operations, net of income tax expense of \$82,000 in 2008             | (15)  | 720                               |
| Gain on sale of discontinued operations   | 529   |                                   |
| Income tax expense on gain on sale of discontinued operations   | (87)  |                                   |

|  |    |        |    |        |
|--|----|--------|----|--------|
| Income from discontinued operations  |    | 427    |    | 720    |
| <b>Net income</b>  |    | 929    |    | 442    |
| Net income attributable to noncontrolling interest   |    | (182)  |    | (482)  |
| <b>Net income (loss) attributable to controlling interest</b>  |    | 747    |    | (40)   |
| Dividends on preferred stock   |    | (34)   |    | (35)   |
| <b>Net income (loss) attributable to common stockholders</b>   | \$ | 713    | \$ | (75)   |
| <b>Income (loss) from continuing operations attributable to common stockholders per common share basic</b>   | \$ | 0.01   | \$ | (0.02) |
| <b>Income (loss) from continuing operations attributable to common stockholders per common share diluted</b> | \$ | 0.01   | \$ | (0.02) |
| <b>Net income (loss) attributable to common stockholders per common share basic</b>                          | \$ | 0.02   | \$ | (0.00) |
| <b>Net income (loss) attributable to common stockholders per common share diluted</b>                        | \$ | 0.02   | \$ | (0.00) |
| <b>Weighted average number of shares of common stock outstanding basic</b>                                   |    | 44,838 |    | 38,408 |
| <b>Weighted average number of shares of common stock outstanding diluted</b>                                 |    | 45,810 |    | 38,408 |

*See accompanying notes to consolidated financial statements*

**Table of Contents**

**HearUSA, Inc.**  
**Consolidated Statements of Cash Flows**  
**Nine Months Ended September 26, 2009 and September 27, 2008**  
**(unaudited)**

|   | <b>September<br/>26,<br/>2009</b> | <b>September 27,<br/>2008</b> |
|---|-----------------------------------|-------------------------------|
|   | <b>(Dollars in thousands)</b>     |                               |
| <b>Cash flows from operating activities</b>                                       |                                   |                               |
| Net income  | \$ 2,081                          | \$ 765                        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |                               |
| Debt discount amortization  |                                   | 192                           |
| Depreciation and amortization   | 1,865                             | 1,922                         |
| Gain on foreign exchange  | (499)                             |                               |
| Gain on sale of assets  | (526)                             |                               |
| Employee and director stock-based compensation                                    | 623                               | 607                           |
| Provision for doubtful accounts   | 354                               | 396                           |
| Deferred income tax expense   | 630                               | 815                           |
| Interest on discounted notes payable  | 252                               | 355                           |
| Interest on discounted long-term contractual commitment to AARP                   |                                   | 260                           |
| Principal payments on long-term debt made through rebate credits                  | (2,485)                           | (2,996)                       |
| Other   | 21                                | (97)                          |
| (Increase) decrease in:   |                                   |                               |
| Accounts and notes receivable   | (354)                             | (453)                         |
| Inventories   | (352)                             | (342)                         |
| Prepaid expenses and other  | (130)                             | (44)                          |
| Increase (decrease) in:   |                                   |                               |
| Accounts payable and accrued expenses   | 3,805                             | 5,927                         |
| <b>Net cash provided by operating activities</b>                                  | <b>5,285</b>                      | <b>7,307</b>                  |
| <b>Cash flows from investing activities</b>                                       |                                   |                               |
| Purchase of property and equipment including software development                 | (681)                             | (1,192)                       |
| Purchase of intangible assets   | (208)                             |                               |
| Net proceeds from sale of Canada assets   | 22,747                            |                               |
| Net purchases of short-term marketable securities                                 | (6,402)                           |                               |
| Letter of credit restricted cash  | (3,000)                           |                               |
| Business acquisitions   | (1,313)                           | (3,551)                       |
| <b>Net cash provided by (used in) investing activities</b>                        | <b>11,143</b>                     | <b>(4,743)</b>                |
| <b>Cash flows from financing activities</b>                                       |                                   |                               |
| Proceeds from issuance of long-term debt  |                                   | 3,408                         |
| Principal payments on long-term debt  | (3,520)                           | (3,620)                       |

Edgar Filing: HEARUSA INC - Form 10-Q

|  |                 |                 |
|--|-----------------|-----------------|
| Principal payments on Siemens debt   | (8,097)         |                 |
| Principal payments on subordinated notes                                       |                 | (1,540)         |
| Proceeds from the exercise of employee options                                 | 13              | 146             |
| Dividends paid on preferred stock  | (102)           | (104)           |
| Dividends paid to noncontrolling interest                                      |                 | (759)           |
| <b>Net cash used in financing activities</b>                                   | <b>(11,706)</b> | <b>(2,469)</b>  |
| Effects of exchange rate changes on cash                                       | 161             | 82              |
| <b>Net increase in cash and cash equivalents</b>                               | <b>4,883</b>    | <b>177</b>      |
| <b>Cash and cash equivalents at the beginning of period</b>                    | <b>3,553</b>    | <b>3,369</b>    |
| <b>Cash and cash equivalents at the end of period</b>                          | <b>\$ 8,436</b> | <b>\$ 3,546</b> |
| <b>Supplemental disclosure of cash flows information:</b>                      |                 |                 |
| Cash paid for interest   | \$ 549          | \$ 647          |
| <b>Supplemental schedule of non-cash investing and financing activities:</b>   |                 |                 |
| Principal payments on long-term debt made through rebate credits               | \$ (2,485)      | \$ (2,996)      |
| Issuance of notes payable in exchange for business acquisitions                | \$ 1,217        | \$ 2,976        |
| Issuance of capital lease in exchange for property and equipment               | \$ 357          | \$ 223          |
| Conversion of accounts payable to notes payable                                | \$              | \$ 2,843        |
| Long-term contractual commitment to AARP in exchange for intellectual property | \$              | \$ 19,533       |
| Purchase of equipment with volume discount credit                              | \$              | \$ 200          |
| <i>See accompanying notes to consolidated financial statements</i>             |                 |                 |

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

The accompanying interim unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 26, 2009 are not necessarily indicative of the results that may be expected for the year ending December 26, 2009. We have evaluated subsequent events for recognition or disclosure through November 10, 2009, which was the date we filed this Form 10-Q with the SEC. For further information, refer to the audited consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 27, 2008.

**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. The Company has a network of 178 company-owned hearing care centers in ten states. The Company sold 31 company-owned hearing care centers in the Province of Ontario, Canada in April 2009. The Company also sponsors a network of approximately 1,900 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 the first nine months of 2009 and 2008, the Company's 50%-owned joint venture, HEARx West, generated net income of approximately \$858,000 and \$2.3 million, respectively. Since the Company is the general manager of HEARx West and its day to day operations, the Company has significant control over the joint venture. Therefore, the accounts of HEARx West, LLC and its wholly owned subsidiary, HEARx West, Inc., are consolidated in these financial statements.

The Company's HEARx West joint venture partners are the Permanente Federation LLC and Kaiser Foundation Health Plan, Inc. The Company recorded 50% of the joint venture's net income as minority interest in income of consolidated joint venture in the Company's consolidated statement of operations with a corresponding liability in its consolidated balance sheet through December 27, 2008. The Company records 50% of the joint venture's net income (loss) as income (loss) attributable to noncontrolling interests, in the Company's consolidated statements of operations with a corresponding noncontrolling interest in stockholders' equity on its consolidated balance sheets.

**Short term marketable securities**

The Company determines the appropriate classification of the securities at the time of purchase and reevaluates such designation as of each balance sheet date. Available for sale securities are reported at fair value with any unrealized gains and losses reported in other comprehensive income as a separate component in stockholders' equity, until realized.

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

**Net income (loss) attributable to controlling interest per common share**

Basic earnings per share ( EPS ), is computed by dividing net income or loss attributable to controlling interest per common share by the weighted average of common shares outstanding for the period. Basic EPS from continuing operations is computed by dividing income (loss) from continuing operations, less net income/loss attributable to non-controlling interest, less dividends on preferred stock by the weighted average of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock (convertible preferred stock, warrants to purchase common stock and common stock options using the treasury stock method) were exercised or converted into common stock. Potential common shares in the diluted EPS computation are excluded where their effect would be antidilutive.

Common stock equivalents for preferred stock, outstanding options and warrants to purchase common stock, of approximately 8.9 million were excluded from the computation of loss from continuing operations per common share diluted for the nine months ended September 27, 2008 and approximately 9.3 million were excluded from the computation of loss from continuing operations per common shares diluted for the quarter ended September 27, 2008, because they were anti-dilutive. For purposes of computing net income/loss attributable to controlling interest per common share basic and diluted, for the quarters ended September 26, 2009 and September 27, 2008, respectively, the weighted average number of shares of common stock outstanding includes the effect of the 493,043 and 506,661, respectively, exchangeable shares of HEARx Canada, Inc., as if they were outstanding common stock of the Company.

**Comprehensive income (loss)**

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

Components of comprehensive income (loss) are as follows:

|  | Nine Months Ended        |                          | Three Months Ended       |                          |
|--|--------------------------|--------------------------|--------------------------|--------------------------|
|  | September<br>26,<br>2009 | September<br>27,<br>2008 | September<br>26,<br>2009 | September<br>27,<br>2008 |
| Dollars in thousands                       |                          |                          |                          |                          |
| Net income for the period                  | \$ 2,081                 | \$ 765                   | \$ 929                   | \$ 442                   |
| Other comprehensive income (loss):         |                          |                          |                          |                          |
| Foreign currency translation adjustments   | 89                       | (183)                    |                          | (319)                    |
| Comprehensive income (loss) for the period | \$ 2,170                 | \$ 582                   | \$ 929                   | \$ 123                   |

**Commitments**

On August 11, 2009, the Company reached an agreement with the American Association of Retired Persons, Inc. ( AARP ) to amend the AARP Hearing Care Program Services Agreement and the AARP License Agreement originally entered into on August 8, 2008.

Under the terms of the agreements, the Company agreed to provide to the approximately 40 million members of AARP in the fifty states, the District of Columbia, and the five U.S. Territories, discounts on hearing aids and related services through the Company's company-owned centers and independent network of hearing care providers. Hearing aids sold under the AARP program ( the Program ) will come with a three year limited warranty and a three year supply of batteries included in the price of the hearing aid. The Company agreed to allocate \$4.4 million annually to promote the AARP program, including the contribution of 9.25% of that amount to AARP's marketing cooperative. The Company also agreed to contribute \$500,000 annually to fund an AARP sponsored education campaign to educate and promote hearing loss awareness and prevention to AARP members and to donate 1,000 hearing aids annually to be

distributed free of charge to economically disadvantaged individuals who have experienced hearing loss.

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

Under the terms of the amendments, the Company will pay AARP a royalty of \$50 per unit sold under the Program for calendar 2009 and 2010, \$55 per unit in calendar 2011 and \$60 per unit in calendar 2012. To the extent that a unit-based royalty arrangement for the Program not allowed under applicable law in any given state, the parties agreed to establish a fixed fee for the license of the intellectual property from AARP to HearUSA for Program activities conducted in that state. In the event the parties are unable to reach agreement on whether a unit-based royalty or a fixed fee payment is required in a particular state, AARP shall have the right, in its sole discretion, to elect payment in a fixed fee. The parties agreed to a fixed fee of \$29,948 per month in Florida beginning April 1, 2010 through June 10, 2010. The Parties shall mutually agree on a fixed fee amount for Florida for periods after June 10, 2010 at a later date. The amendments extended the existing agreements to August 31, 2012 and required that the Program be available to AARP members under the following timetable:

- (a) All Company owned centers and network providers in Florida and New Jersey by the end of calendar 2009.
- (b) Company network providers in Illinois, Michigan, Pennsylvania, Indiana, Massachusetts, Arizona, Wisconsin, Washington, California, Georgia, Maryland, North Carolina, Virginia, Missouri, New York, Texas and Ohio by the end of calendar 2010.
- (c) A combination of Company owned centers and network providers in all fifty states, the District of Columbia, and the five U.S. Territories by the end of 2011.

The Company agreed to use commercially reasonable efforts to expand the number of network providers to 5,000 over the term of the agreements and to sustain that number throughout the remaining term of the agreements.

The parties agreed that the Company will be relieved from its obligation to make the Program available to members in states where the Program may be prohibited by existing laws and regulations. The parties also agreed to relieve the Company of the requirement to make annual \$500,000 contributions to AARP for campaigns to educate and promote hearing loss awareness. The Company made a separate pledge to contribute \$125,000 a quarter through the end of the services agreement to AARP to support efforts to educate AARP members and the general public about hearing loss awareness and prevention. The Company's pledge is conditional upon the Company's reasonable satisfaction with the progress of AARP's educational programs.

AARP shall have the right to terminate the agreements in the event the Company breaches any of its material obligations under the agreements including, but not limited to, making the Program available to AARP members under the established time table, making the marketing budget expenditures of \$4.4 million per year including the allocation of 9.25% of those marketing expenses to the AARP General Program, and making the royalty payments as required. In the event of a breach, the Company will be given the opportunity to cure the breach within a minimum 60 days of written notice from AARP of the breach.

In the event AARP terminates the agreements by reason of an uncured breach, the Company has agreed to pay AARP an additional royalty fee of \$3 million if termination occurs before August 31, 2010; \$2 million if the termination occurs between September 1, 2010 and August 31, 2011; and \$1 million if the termination occurs between September 1, 2011 and August 31, 2012. The Company provided AARP with a \$3 million irrevocable standby letter of credit to ensure payment of the additional royalty, if required. The \$3 million of cash required to collateralize the letter of credit is recorded as restricted cash in the Company's consolidated balance sheet.



**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

**2. Discontinued Operations**

On April 27, 2009, the Company sold the assets of Helix Hearing Care of America Corp. (the Seller ) and the stock of 3371727 Canada Inc. ( Canada ), both indirect wholly owned subsidiaries of the Company. The Seller and Canada entered into and consummated an Asset Purchase Agreement (the Purchase Agreement ) with Helix Hearing Inc. (the Purchaser ), an unrelated company, for cash consideration of approximately \$27.9 million Canadian dollars (approximately \$23.1 million U.S. dollars at the opening exchange rate on April 27, 2009; all other amounts referenced herein are in U.S. dollars converted from Canadian dollars at the opening exchange rate on April 27, 2009), plus assumption of certain balance sheet liabilities, which resulted in a gain on sale of approximately \$86,000, net of applicable tax, during the quarter ended June 27, 2009 (the Asset Sale ). A portion of the purchase price was paid to trade creditors of the Seller and approximately \$828,000 was being held in escrow for up to 180 days after the closing pending any future claims under the Purchase Agreement, payable in two payments. The Company received approximately \$529,000 in escrow funds in July 2009 which resulted in a gain on sale of approximately \$442,000, net of applicable tax of \$87,000, during the third quarter of 2009. The remaining escrow of approximately \$299,000 was received in the fourth quarter of 2009. We incurred approximately \$561,000 of legal and financial advisory fees in connection with the sale, which are expensed in the net gain on sale.

HearUSA expects to ultimately receive proceeds of approximately \$21.0 million in cash from the sale after the settlement of the outstanding escrows, remaining Canadian liabilities, taxes, transaction costs and closing adjustments. The Company is required to use approximately 50% of these proceeds to pay down debt to Siemens pursuant to the Credit Agreement. As of September 26, 2009 the Company has paid Siemens approximately \$8.1 million related to this transaction.

In connection with the sale, we agreed to provide certain transitional services to the Purchaser for eighteen months. We believe the majority of services will be completed in six to nine months, with minimal transitional services being provided in the last six months of the agreement. HearUSA will provide training, installation and support services for eighteen months in exchange for monthly payments totaling approximately \$1.2 million and transition support services for up to nine months for quarterly payments totaling approximately \$331,000. Pursuant to a separate agreement between HearUSA and a third party, HearUSA sold the right to this approximately \$1.2 million fee over eighteen months under the Support Agreement in exchange for a lump-sum payment of approximately \$1.1 million at the closing of the Asset Sale.

The fees earned from these services are accounted for as contract service revenues, as the services are provided. Approximately \$290,000 and \$182,000 was recorded as contract service revenue in the third and second quarter of 2009, respectively.

The Seller made customary representations and warranties in the Purchase Agreement regarding legal and business matters of the Seller and Canada. Additionally, HearUSA agreed to guarantee the obligations of the Seller under the Purchase Agreement, an escrow agreement and an accounts receivable trust agreement.

The Seller and HearUSA also entered into a Noncompetition Agreement with the Purchaser pursuant to which the Seller and HearUSA agreed not to directly or indirectly compete in the business of marketing, distributing and selling hearing aids to product end-users in Canada for a period of five years.

On April 24, 2009, in contemplation of the execution of the Purchase Agreement and the completion of the Asset Sale, HearUSA entered into a License Agreement with the Seller, which was assigned to the Purchaser as part of the Asset Sale on April 27, 2009. Pursuant to the License Agreement, HearUSA granted to the Seller a perpetual, non-transferable, non-exclusive license to use proprietary customer management software related to the operation of the business acquired by the Purchaser in the Asset Sale. The license is valid for use by the Purchaser in Canada.

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

As a result of the sale, the operations of the Canadian division are presented as discontinued operations and, accordingly, these operating results are segregated and reported as discontinued operations in the accompanying consolidated statements of operations for all periods presented.

The Canadian division's results of operations for the three and nine months ended September 26, 2009 and September 27, 2008, and the gain on sale of the division for the three and nine months ended September 26, 2009 were as follows:

|  | For the Nine Months Ended |                          | For the Three Months Ended |                          |
|--|---------------------------|--------------------------|----------------------------|--------------------------|
|  | September<br>26,<br>2009  | September<br>27,<br>2008 | September<br>26,<br>2009   | September<br>27,<br>2008 |
| Revenue  | \$ 4,533                  | \$ 12,900                | \$ (15)                    | \$ 4,187                 |
| Cost and expenses  | 3,650                     | 10,348                   |                            | 3,385                    |
| Income (loss) before provision of income taxes                 | \$ 883                    | \$ 2,552                 | \$ (15)                    | \$ 802                   |
| Income tax expense (benefit)                                   | (261)                     | 196                      |                            | 82                       |
| Income (loss) from discontinued operations                     | \$ 1,144                  | \$ 2,356                 | \$ (15)                    | \$ 720                   |
| Gain on sale of discontinued operations, net of applicable tax | \$ 526                    | \$                       | \$ 442                     | \$                       |
| <b>Income from discontinued operations basic</b>               | <b>\$ 0.03</b>            | <b>\$ 0.06</b>           | <b>\$ (0.00)</b>           | <b>\$ 0.02</b>           |
| <b>Income from discontinued operations diluted</b>             | <b>\$ 0.03</b>            | <b>\$ 0.06</b>           | <b>\$ (0.00)</b>           | <b>\$ 0.02</b>           |

The following is a summary of the net assets sold or allocated to the Asset Sale as of the April 27, 2009 closing date:

|   |           |
|---|-----------|
| Current Assets                                | \$ 1,918  |
| Property and equipment                        | 473       |
| Goodwill                                      | 16,810    |
| Intangible assets, net                        | 2,732     |
| Current liabilities                           | (105)     |
| Foreign currency translation adjustment       | (1,338)   |
| Net assets sold in or allocated to Asset Sale | \$ 20,490 |

**3. Business Acquisitions and Goodwill Impairment**

During the first quarter of 2009, the Company acquired the assets of nine hearing care centers in Michigan, and California in two separate transactions. Consideration paid was cash of approximately \$1.3 million and notes payable with an estimated fair value of approximately \$1.2 million. In connection with these acquisitions, the Company borrowed approximately \$863,000 from its acquisition line of credit with Siemens just before the end of the 2008 fiscal year (see Note 4 Long-term Debt). These funds were paid to the sellers in early 2009. The acquisitions resulted in additions to goodwill of approximately \$2.1 million, fixed assets of approximately \$67,000 and customer lists and non-compete agreements of approximately \$361,000.

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

The notes payable bear interest at rates varying from 5% to 6% and have been discounted to a market rate of 10%. The Notes are payable in quarterly installments varying from \$3,000 to \$71,000, plus accrued interest, through December 2012. The operating results of these acquired businesses are included in our consolidated statements of operations from the effective date of the acquisition, December 30, 2008. These acquisitions are not considered material to our results of operations, either individually, or in the aggregate, and therefore, no pro forma information is presented.

We account for business combinations using the acquisition method of accounting. We determine the purchase price of an acquisition based on the fair value of the consideration transferred. The total purchase price of an acquisition is allocated to the underlying net assets based on their respective estimated fair values. As part of this allocation process, management must identify and attribute values and estimated lives to intangible assets acquired. Such determinations involve considerable judgment, and often involve the use of significant estimates and assumptions, including those with respect to future cash inflows and outflows, discount rates and asset lives. These determinations will affect the amount of amortization expense recognized in future periods. Assets acquired in a business combination that will be re-sold are valued at fair value less cost to sell. Results of operating these assets are recognized currently in the period in which those operations occur.

The Company evaluates goodwill and certain intangible assets with indefinite lives not being amortized for impairment annually or more frequently if impairment indicators arise. Indicators at the Company include, but are not limited to: sustained operating losses or a trend of poor operating performance, a decrease in the Company's market capitalization below its book value and an expectation that a reporting unit will be sold or otherwise disposed of. If one or more indicators of impairment exist, the Company performs an evaluation to identify potential impairments. If impairment is identified, the Company measures and records the amount of impairment losses.

A two-step impairment test is performed on goodwill. In order to do this, management applies 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. In the first step, the Company compares the fair value of each reporting unit to its carrying value. Calculating the fair value of the reporting units requires significant estimates and long-term assumptions. The Company tests goodwill for impairment annually on the first day of the Company's fourth quarter, and the latest annual test in 2008 indicated no impairment. The Company estimates the fair value of its reporting units by applying a weighted average of two methods: quoted exchange market prices and discounted cash flows. The weighting is 40% exchange market price and 60% discounted cash flows.

If the carrying value of the reporting unit exceeds its fair value, additional steps are required to calculate an impairment charge. The second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying value of the goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. The implied fair value of goodwill is the fair value of the reporting unit allocated to all of the assets and liabilities of that unit as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit. 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.

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

The Company's market capitalization was approximately \$17.3 million in December 2008, which was substantially lower than the Company's estimated combined fair values of its three reporting units. The Company completed a reconciliation of the sum of the estimated fair values of its reporting units to its market value (based upon its stock price in December 2008). We believe one of the primary reconciling differences between fair value and our market capitalization was due to a control premium. We believe the value of a control premium is the value a market participant could extract as savings and/or synergies by obtaining control, and thereby eliminating duplicative overhead costs and obtaining discounts on volume purchasing from suppliers. The Company also considers the following qualitative items that cannot be accurately quantified and are based upon the beliefs of management, but provide additional support for the explanation of the remaining difference between the estimated fair value of the Company's reporting units and its market capitalization:

The Company's stock is thinly traded;

The decline in the Company's stock price during 2008 is not directly correlated to a change in the overall operating performance of the Company; and

Previously unseen pressures are in place given the global financial and economic crisis.

As a result of the Asset Sale in April 2009 described in Note 2 and the allocation of approximately \$16.8 million of goodwill to the disposed component of the centers reporting unit, we performed a step one goodwill impairment assessment, which indicated no impairment. At September 26, 2009, the Company's market capitalization of approximately \$55.0 million exceeded the book value of its three reporting units and there were no other indicators of impairment. Therefore, we did not perform a step one goodwill impairment assessment at that date. We will continue to monitor market trends in our business, the related expected cash flows and our calculation of market capitalization for purposes of identifying possible indicators of impairment. Should our book value per share exceed our market share price or we have other indicators of impairment, as previously discussed, we will be required to perform an interim step one impairment analysis, which may lead to a step two analysis resulting in goodwill impairment. Additionally, we would then be required to review our remaining long-lived assets for impairment.

Judgments regarding the existence of impairment indicators are based on legal factors, market conditions and operational performance of the acquired businesses. Future events could cause us to conclude that impairment indicators exist and that goodwill associated with the acquired businesses is impaired. Additionally, as the valuation of identifiable goodwill requires significant estimates and judgment about future performance, cash flows and fair value, our future results could be affected if these current estimates of future performance and fair value change. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

**4. Long-term Debt**

Long-term debt consists of the following:

|  | September<br>26,<br>2009 | December<br>27,<br>2008 |
|--|--------------------------|-------------------------|
| Dollars in thousands                               |                          |                         |
| Credit Facility payable to Siemens                 |                          |                         |
| Tranche B  | \$ 4,387                 | \$ 5,552                |
| Tranche C  | 31,697                   | 41,109                  |
| Total Credit Facility payable to Siemens           | 36,084                   | 46,661                  |
| Notes payable from business acquisitions and other | 7,596                    | 9,353                   |

|                         |           |           |
|-------------------------|-----------|-----------|
|                         | 43,680    | 56,014    |
| Less current maturities | 6,372     | 6,915     |
|                         | \$ 37,308 | \$ 49,099 |

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

The approximate aggregate maturities of principal on long-term debt obligations, net of discounts are as follows (dollars in thousands):

For the twelve months ended September:

|                     |          |
|---------------------|----------|
| 2010                | \$ 6,372 |
| 2011                | 4,969    |
| 2012                | 3,762    |
| 2013                | 2,686    |
| 2014 and thereafter | 25,891   |

The Company has entered into credit, supply, investor rights and security agreements with Siemens Hearing Instruments, Inc. ( Siemens ). The term of the current agreements extends to February 2015.

Pursuant to these agreements, Siemens has extended to the Company a \$50 million credit facility and the Company has agreed to purchase at least 90% of its hearing aid purchases in the United States from Siemens and its affiliates. If minimum purchase requirements are met, the Company earns rebates which are then used to liquidate principal and interest payments due under the credit agreement. When the agreements were amended on December 23, 2008, \$6.2 million of accounts payable under the supply agreement was converted into long term debt under the credit agreement and an additional \$3.8 million of trade payables under the supply agreement was converted into 6.4 million shares of the Company s common stock at a conversion price of \$0.60 a share. Equity conversion provisions previously in the credit agreement were eliminated.

Amended Credit Agreement

The credit agreement, as amended in December 2008, includes a revolving credit facility of \$50 million that bears interest at 9.5%, matures in February 2015 and is secured by substantially all of the Company s assets. Amounts available to be borrowed under the credit facility are to be used solely for acquisitions unless otherwise approved by Siemens. Borrowings under the credit facility are accessed through Tranche B and Tranche C. Approximately \$4.4 million has been borrowed under Tranche B for acquisitions and \$31.7 million has been borrowed under Tranche C. Borrowing for acquisitions under Tranche B is generally based upon a formula equal to 1/3 of 70% of the acquisition target s trailing 12 months revenues, and any amount greater than that may be borrowed under Tranche C with Siemens approval. Principal borrowed under Tranche B is repaid quarterly at a rate of \$65 per Siemens unit sold by the acquired businesses. Principal borrowed under Tranche C is repaid at \$500,000 per quarter. The required quarterly principal and interest payments on Tranches B and C are forgiven by Siemens through rebate credits of similar amounts as long as 90% of hearing aid units purchased by the Company in the United States are Siemens products. Amounts not forgiven through rebate credits are payable in cash each quarter. The Company has met the minimum purchase requirements of the arrangement since inception of the arrangement with Siemens. Approximately \$37.6 million has been rebated since the Company entered into this arrangement in December 2001. The Company has received rebates of approximately \$37.6 million since entering into this arrangement in December 2001.

The credit agreement requires that the Company reduce the principal balance by making annual payments in an amount equal to 20% of Excess Cash Flow (as defined in the credit agreement), and by paying Siemens 50% of the proceeds of any net asset sales (as defined) and 25% of proceeds from any equity offerings the Company may complete. The Company did not have any Excess Cash Flow (as defined) in the first nine months of 2009 or fiscal 2008. As of September 26, 2009, the Company paid Siemens approximately \$8.1 million of the proceeds received from the sale of its Canadian operations.

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

The credit facility also 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 and making certain payments. If the Company cannot maintain compliance with the covenants, Siemens may terminate future funding under the credit agreement and declare all then outstanding amounts under the agreement immediately due and payable. At September 26, 2009 the Company was in compliance with the Siemens loan covenants.

**Amended Supply Agreement**

The supply agreement as amended in December 2008 extends to February 2015 and requires the Company to purchase at least 90% of its hearing aid purchases in the United States from Siemens and its affiliates. The 90% requirement is computed on a cumulative twelve month calculation. The Company has met the minimum purchase requirements of the supply agreement since inception of the arrangement with Siemens. The Company has received rebates of approximately \$37.6 million since entering into this arrangement in December 2001.

Additional quarterly volume rebates of \$156,250, \$312,500 or \$468,750 can be earned by meeting certain quarterly volume tests. These rebates reduce the principal due on the credit facility. Volume rebates of \$468,750 and \$937,500 were earned in the first nine months of 2009 and 2008, respectively.

All rebates earned are accounted for as a reduction of cost of products sold.

The following table summarizes the rebate structure:

Calculation of Pro forma Rebates to HearUSA when at least 90% of  
Units Purchased in the U.S. are from Siemens (1)  
Quarterly Siemens Unit Purchases Compared to Prior Years' Comparable  
Quarters

|                                 | 90% but <<br>95% | 95% to<br>100% | > 100% < 125% | 125% and >   |
|---------------------------------|------------------|----------------|---------------|--------------|
| Acquisition rebate (2)          | \$ 65/ unit      | \$ 65/ unit    | \$ 65/ unit   | \$ 65/ unit  |
|                                 | Plus             | Plus           | Plus          | Plus         |
| Notes payable rebate            | \$ 500,000       | \$ 500,000     | \$ 500,000    | \$ 500,000   |
| Additional volume rebate        |                  | 156,250        | 312,500       | 468,750      |
| Interest forgiveness rebate (3) | 1,187,500        | 1,187,500      | 1,187,500     | 1,187,500    |
|                                 | \$ 1,687,500     | \$ 1,843,750   | \$ 2,000,000  | \$ 2,156,250 |

(1) Calculated using trailing twelve month units purchased by the Company



- (2) Siemens units purchased by acquired businesses (\$65 per unit)
- (3) Assuming the first \$50 million portion of the line of credit is fully utilized

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

The following table shows the rebates received from Siemens pursuant to the supply agreement during each of the following periods:

|  | Nine Months Ended        |                          | Three Months Ended       |                          |
|--|--------------------------|--------------------------|--------------------------|--------------------------|
|  | September<br>26,<br>2009 | September<br>27,<br>2008 | September<br>26,<br>2009 | September<br>27,<br>2008 |
| Dollars in thousands                                 |                          |                          |                          |                          |
| Portion applied against quarterly principal payments | \$ 2,485                 | \$ 2,996                 | \$ 825                   | \$ 1,017                 |
| Portion applied against quarterly interest payments  | 2,954                    | 2,104                    | 861                      | 716                      |
|  | \$ 5,439                 | \$ 5,100                 | \$ 1,686                 | \$ 1,733                 |

A material breach of the supply agreement may be deemed 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.

**Amended Investor Rights Agreement**

Pursuant to the amended investor rights agreement, the Company granted Siemens:

Resale registration rights covering the 6.4 million shares of common stock acquired by Siemens on December 23, 2008 under the Siemens Purchase Agreement. The Company completed the registration of these shares for resale in the second quarter of 2009.

Certain rights of first refusal in the event the Company chooses to issue equity or if there is a change of control transaction involving a person in the hearing aid industry for a period of 18 months following the December 23, 2008 amendment. Thereafter Siemens will have a more limited right of first refusal and preemptive rights for the term of the agreement.

The rights to have a representative of Siemens attend meetings of the Board of Directors of the Company as a nonvoting observer.

A willful breach of the Company's resale registration obligations under the investor rights agreement may be deemed 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.

**Notes payable from business acquisitions and other**

Notes payable from business acquisitions and other are primarily notes payable related to acquisitions of hearing care centers and total approximately \$6.6 million at September 26, 2009. They are payable in monthly or quarterly installments of principal and interest varying from \$3,000 to \$83,000 over periods varying from two to five years and bearing interest at rates varying from 5% to 7%. The notes have been discounted to market rates ranging from 9.5% to 10%. Other notes payable relate mostly to capital leases totaling approximately \$971,000 at September 26, 2009, payable in monthly or quarterly installments varying from \$400 to \$10,000 over periods varying from 1 to 5 years and bear interest at rates varying from 4.6% to 16.7%.

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

**5. Subordinated Notes and Warrants**

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 approximately 1.5 million shares of the Company's common stock at \$2.00 per share expiring in August 2010. The Note Warrants are all currently exercisable. The quoted closing market price of the Company's common stock on the commitment date for this transaction was \$1.63 per share. The Subordinated Notes bore interest at 7% per annum and were subordinate to the Siemens debt. Proceeds from this financing were used to redeem all of the Company's 1998-E Series Convertible Preferred Stock. The Subordinated Notes were paid in full in August of 2008.

During the first nine months of 2008 approximately \$189,000 in interest expense was recorded related to this financing, including non-cash prepaid finder fees and debt discount amortization charges of approximately \$109,000.

**6. Noncontrolling Interest**

Beginning December 28, 2008, the Company began using a single method of accounting for changes in its ownership interest in a subsidiary that do not result in deconsolidation.

A reconciliation of noncontrolling interest of our subsidiary HEARx West, LLC for the nine months ended September 26, 2009 is as follows:

|  | Amount<br>(thousands) |
|--|-----------------------|
| Balance at December 28, 2008                               | \$ 1,526              |
| Joint venture earnings allocable to joint venture partners | 429                   |
| Dividends to joint venture partners                        |                       |
| Balance at September 26, 2009                              | \$ 1,955              |

**7. Fair Value**

As of September 26, 2009 and December 27, 2008, the fair value of the Company's long-term debt is estimated at approximately \$43.7 million and \$56.0 million, respectively, based on discounted cash flows and the application of the fair value interest rates applied to the expected cash flows, which is consistent with its carrying value. The Company has determined that the long-term debt is defined as Level 2 in the fair value hierarchy. Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument.

The book values of cash equivalents approximate their respective fair values due to the short-term nature of these instruments. These are Level 1 in the fair value hierarchy.

The inputs used in measuring fair value into the fair value hierarchy are as follows:

Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 Inputs other than quoted prices included in Level 1 that are either directly or indirectly observable;

Level 3 Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing.

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

Assets or liabilities that have recurring fair value measurements are shown below as of September 26, 2009:

| Description                      | Total as of<br>September<br>26,<br>2009 | Fair Value<br>Measurements<br>at Reporting<br>Date Using<br>Quoted Price<br>in<br>Active<br>Markets<br>for Identical<br>Assets<br>(Level 1) |
|----------------------------------|---|---|
| Short-term marketable securities | \$ 6,406                                | \$ 6,406  |

The Company's short-term marketable securities primarily consist of money market mutual funds invested in U.S. treasury securities generally maturing in three months or less. These debt securities are classified as available for sale. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. The fair value option (i) may be applied instrument by instrument, with a few exceptions, such as investments accounted for by the equity method; (ii) is irrevocable (unless a new election date occurs); and (iii) is applied only to entire instruments and not to portions of instruments. We did not elect to report any additional assets or liabilities at fair value.

The fair value of financial instruments represents the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. The assumptions used have a significant effect on the estimated amounts reported.

**8. Stockholders' Equity****Common Stock**

During the nine months ended September 26, 2009, employee stock options for 18,750 shares of common stock were exercised for net cash proceeds of approximately \$13,000.

**9. Stock-based Compensation**

Under the terms of the Company's stock option plans, officers, certain other employees and non-employee directors may be granted options to purchase the Company's common stock at a price equal to the closing price of the Company's common stock on the date the option is granted. For financial reporting purposes, stock-based compensation expense is included in general and administrative expenses. Stock-based compensation expense totals approximately \$623,000 and \$607,000 in the first nine months of 2009 and 2008, respectively.

During the nine months ended September 26, 2009, we granted options to purchase 900,000 shares of our common stock to certain employees. These options have an exercise price of \$0.53 per share and vest 25% on each anniversary of the date of grant over four years. The weighted-average grant-date fair value of the option grants was approximately \$403,000.

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

During September 2009, we granted options to purchase 160,000 shares of our common stock to certain non-employee directors. These options have an exercise price of \$1.17 per share and vest 33.3% on each anniversary of the date of grant over three years. The weighted-average grant date fair value of the option grants was approximately \$158,000.

The fair value of options granted is estimated using the Black-Scholes option pricing model using the following assumptions:

|                                 |   |
|---------------------------------|---|
|                                 | Nine Months<br>Ended<br>September 26,<br>2009 |
| Risk free interest rate         | 2.78% to 3.47%                                |
| Expected life in years          | 10  |
| Expected volatility             | 84% to 85%                                    |
| Weighted average exercise price | \$0.53 to \$1.17                              |

The expected term of the options represents the estimated period of time from grant until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. Expected stock price volatility is based on historical volatility of our stock for a period of at least equal to the expected term. The risk-free interest rate is based on the implied yield available on United States Treasury zero-coupon issues with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the foreseeable future.

As of September 26, 2009, there was approximately \$1.8 million of total unrecognized compensation cost related to share-based compensation under our stock award plans. That cost is expected to be recognized over a vesting period of usually three or four years on a straight-line basis.

**Stock-based payment award activity**

The following table provides additional information regarding options outstanding and options that were exercisable as of September 26, 2009 (options and in-the-money values in thousands):

|                                   | Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>(in years) | Aggregate<br>Intrinsic<br>Value |
|-----------------------------------|--------|--|---|---------------------------------|
| Outstanding at December 27, 2008  | 5,356  | \$ 1.30                                  |   |                                 |
| Granted                           | 1,060  | 0.63                                     |   |                                 |
| Exercised                         | (19)   | 0.67                                     |   | \$ 11                           |
| Forfeited/expired/cancelled       | (209)  | 1.70                                     |   |                                 |
| Outstanding at September 26, 2009 | 6,188  | \$ 1.17                                  | 6.09  | \$ 1,622                        |
| Exercisable at September 26, 2009 | 4,145  | \$ 1.22                                  | 4.63  | \$ 963                          |



**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for the options that were in-the-money at September 26, 2009. As of September 26 2009, the aggregate intrinsic value of the non-employee director options outstanding and exercisable was approximately \$109,000.

A summary of the status and changes in our non-vested shares related to our equity incentive plans as of and during the nine months ended September 26, 2009 is presented below:

|                                  | Shares<br>(in thousands) | Weighted<br>Average<br>Grant-<br>Date<br>Fair<br>Value |
|----------------------------------|--------------------------|--|
| Non-vested at December 27, 2008  | 1,552                    | \$ 1.59  |
| Granted                          | 1,060                    | \$ 0.53  |
| Vested                           | (509)                    | \$ 1.59  |
| Forfeited unvested               | (60)                     | \$ 1.70  |
| Non-vested at September 26, 2009 | 2,043                    | \$ 1.09  |

**Restricted stock units**

The Company began granting restricted stock units pursuant to its 2002 Flexible Stock Plan and 2007 Incentive Compensation Plan in 2008. Restricted stock units are awards that, upon vesting, will result in the delivery to the holder shares of the Company's common stock. Some restricted stock units are service based and vest ratably over a period of time, and some are performance-based and subject to forfeiture if certain performance criteria are not met. The performance based units granted in 2008 were forfeited because the performance targets were not met.

During September 2009, we granted 255,000 performance-based restricted stock units to certain employees. These restricted stock units are subject to forfeiture if certain performance criteria are not met.

A summary of the Company's restricted stock unit activity and related information for the nine months ended September 26, 2009 is as follows:

|                                   | Service-based<br>Restricted Stock<br>Units (1) | Performance-based<br>Restricted Stock<br>Units (1) |
|-----------------------------------|--|--|
| Outstanding at December 27, 2008  | 136,500  | 230,333  |
| Awarded                           |  | 255,000  |
| Vested                            | (45,500)                                       |  |
| Forfeited                         |  | (230,333)  |
| Outstanding at September 26, 2009 | 91,000   | 255,000  |

(1) Each stock unit represents the fair market value of one

share of  
common stock.

Based on the closing price of the Company's common stock of \$1.24 on September 26, 2009, the total pretax intrinsic value of all outstanding restricted stock units on that date was approximately \$429,000.



**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

**10. 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 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. Revenues associated with units sold by our Company-owned centers as part of the AARP program are included in the centers segment. 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. Revenues associated with units sold by our provider network under the AARP program will be included in the network segment. Cost associated with the AARP program are included in the network segment, including start up costs of approximately \$421,000 in the first nine months of 2009 and \$168,000 in the first nine months of 2008. 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.

The following is the Company's segment information:

| Dollars in thousands                            | <b>Centers</b> | <b>E-commerce</b> | <b>Network</b> | <b>Corporate</b> | <b>Total</b> |
|---|----------------|-------------------|----------------|------------------|--------------|
| <b>Hearing aids and other products revenues</b> |                |                   |                |                  |              |
| 9 months ended September 26, 2009               | \$ 61,112      | \$ 60             |                |                  | \$ 61,172    |
| 9 months ended September 27, 2008               | \$ 69,161      | \$ 80             |                |                  | \$ 69,241    |
| <b>Service revenues</b>                         |                |                   |                |                  |              |
| 9 months ended September 26, 2009               | \$ 3,730       | \$                | \$ 1,841       | \$ 472           | \$ 6,043     |
| 9 months ended September 27, 2008               | \$ 3,895       | \$                | \$ 1,494       |                  | \$ 5,389     |
| <b>Income (loss) from operations</b>            |                |                   |                |                  |              |
| 9 months ended September 26, 2009               | \$ 14,875      | \$ (51)           | \$ 829         | \$ (11,389)      | \$ 4,264     |
| 9 months ended September 27, 2008               | \$ 14,155      | \$ (115)          | \$ 850         | \$ (11,894)      | \$ 2,996     |
| <b>9 months ended September 26, 2009</b>        |                |                   |                |                  |              |
| Depreciation and amortization                   | \$ 1,257       |                   | \$             | \$ 474           | \$ 1,731     |
| Total assets                                    | \$ 66,398      |                   | \$ 919         | \$ 28,283        | \$ 95,600    |
| Capital expenditures                            | \$ 509         |                   |                | \$ 172           | \$ 681       |
| <b>9 months ended September 27, 2008</b>        |                |                   |                |                  |              |
| Depreciation and amortization                   | \$ 1,591       |                   | \$             | \$ 331           | \$ 1,922     |
| Total assets                                    | \$ 67,963      |                   | \$ 20,193      | \$ 38,066        | \$ 126,222   |
| Capital expenditures                            | \$ 1,080       |                   |                | \$ 112           | \$ 1,192     |

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

Hearing aids and other products revenues consisted of the following:

|                         | Nine months ended        |                          |
|-------------------------|--------------------------|--------------------------|
|                         | September<br>26,<br>2009 | September<br>27,<br>2008 |
| Hearing aid revenues    | 97.1%                    | 97.5%                    |
| Other products revenues | 2.9%                     | 2.5%                     |

Services revenues consisted of the following:

|                          | Nine months ended        |                          |
|--------------------------|--------------------------|--------------------------|
|                          | September<br>26,<br>2009 | September<br>27,<br>2008 |
| Hearing aid repairs      | 42.8%                    | 46.8%                    |
| Testing and other income | 57.2%                    | 53.2%                    |

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:

|  | Nine months ended        |                       |
|--|--------------------------|-----------------------|
|  | September<br>26,<br>2009 | September 27,<br>2008 |
| Dollars in thousands                                   |                          |                       |
| Contract service revenue on Canadian support agreement | \$ (472)                 | \$                    |
| General and administrative expense                     | 11,387                   | 11,565                |
| Corporate depreciation and amortization                | 474                      | 331                   |
| Corporate loss from operations                         | \$ 11,389                | \$ 11,894             |

**RECENT ACCOUNTING PRONOUNCEMENTS**

**Table of Contents**

HearUSA, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

In June 2009, the Financial Accounting Standards Board ( FASB ) issued FASB Accounting Standards Codification ( ASC ) Topic 105, *Generally Accepted Accounting Principles* ( ASC 105 ) (the Codification ) was adopted. ASC 105 supersedes all existing non-SEC accounting and reporting standards. All other non-grandfathered, non-SEC accounting literature not included in the Codification will become non-authoritative. Going forward, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates ( ASU ), which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification. The Codification was effective for financial statements issued for fiscal years and interim periods beginning after September 15, 2009. As a result of the adoption, the Company has included references to the Codification, as appropriate, in these financial statements, referred to previously under the former FASB references.

In August 2009, the FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value* ( ASU 2009-05 ), which clarified how to measure the fair value of liabilities in circumstances when a quoted price in an active market for the identical liability is not available. ASU 2009-05 is effective for the first reporting period beginning after the issuance of this standard. The Company is currently evaluating the impact that the adoption of ASU 2009-05 will have on its consolidated financial statements.

In October 2009, the FASB issued ASU No. 2009-13, *Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force* ( ASU 2009-13 ), which addresses the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. ASU 2009-13 is effective prospectively for revenue arrangements entered into or materially modified beginning in fiscal years on or after June 15, 2010, however early adoption is permitted. The Company is currently evaluating the impact that the adoption of ASU 2009-13 will have on its consolidated financial statements.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Forward Looking Statements**

*This Form 10-Q and, in particular, this management's discussion and analysis contain or incorporate a number of forward-looking statements. These statements include those relating to the Company's belief that its 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. The forward-looking statements in this Form 10-Q are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate and management's beliefs and assumptions. Any statements that are not statements of historical fact should be considered forward-looking statements and should be read in conjunction with our consolidated financial statements and notes to the consolidated financial statements included in this report. The statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict, including those risks described in this report and in the Company's annual report on Form 10-K for fiscal 2008 filed with the Securities and Exchange Commission.*

**RESULTS OF OPERATIONS**

For the three months ended September 26, 2009 compared to the three months ended September 27, 2008

**Revenues**

Dollars in thousands

|                                 | <b>2009</b>      | <b>2008</b>      | <b>Change</b>     | <b>%<br/>Change</b> |
|---------------------------------|------------------|------------------|-------------------|---------------------|
| Hearing aids and other products | \$ 19,616        | \$ 22,716        | \$ (3,100)        | (13.6)%             |
| Services                        | 2,212            | 1,813            | 399               | 22.0%               |
| <b>Total net revenues</b>       | <b>\$ 21,828</b> | <b>\$ 24,529</b> | <b>\$ (2,701)</b> | <b>(11.0)%</b>      |

|   | <b>2009</b>      | <b>2008</b>      | <b>Change</b>     | <b>%<br/>Change</b> |
|---|------------------|------------------|-------------------|---------------------|
| Revenues from centers acquired in 2008 (1)  | \$ 180           | \$               | \$ 180            | 0.7%                |
| Revenues from centers acquired in 2009      | 283              |                  | 283               | 1.2%                |
| <b>Revenues from acquired centers</b>       | <b>463</b>       |                  | <b>463</b>        | <b>1.9%</b>         |
| <b>Revenues from comparable centers (2)</b> | <b>21,075</b>    | <b>24,529</b>    | <b>(3,454)</b>    | <b>(14.1)%</b>      |
| <b>Revenues from contract services (3)</b>  | <b>290</b>       |                  | <b>290</b>        | <b>1.2%</b>         |
| <b>Total net revenues</b>                   | <b>\$ 21,828</b> | <b>\$ 24,529</b> | <b>\$ (2,701)</b> | <b>(11.0)%</b>      |

(1) Represents that portion of revenues from the 2008 acquired centers recognized for those acquisitions that had less than one full year of revenues

recorded in 2008 due to the timing of their acquisition.

- (2) Also includes revenues from the network business segment.
- (3) Represents fees earned pursuant to the support agreement entered into upon the sale of our Canadian operations.

The \$3.1 million or 13.6% decrease in hearing aid and other products revenue from the third quarter 2008 is principally the result of a decline in organic revenue as a result of current economic slow-down and steps taken by the Company to increase profitability. The Company has reduced the number of discounts offered, increased some prices and reduced marketing expenditures and center staffing. These actions have significantly increased profitability but had a slight detrimental impact on revenues. The 22.0% increase in service revenues is primarily due to \$290,000 of contract service revenue earned pursuant to the support agreement entered into upon the sale of our Canadian operations.

**Table of Contents****Cost of Products Sold and Services****Dollars in thousands**

|   | <b>2009</b>     | <b>2008</b>     | <b>Change</b>     | <b>%</b>       |
|---|-----------------|-----------------|-------------------|----------------|
| Hearing aids and other products                 | \$ 4,543        | \$ 5,963        | \$ (1,420)        | (23.8)%        |
| Services  | 441             | 571             | (130)             | (22.8)%        |
| <b>Total cost of products sold and services</b> | <b>\$ 4,984</b> | <b>\$ 6,534</b> | <b>\$ (1,550)</b> | <b>(23.7)%</b> |
| <b>Percent of total net revenues</b>            | <b>22.8%</b>    | <b>26.6%</b>    | <b>(3.8)%</b>     | <b>(14.3)%</b> |

The cost of products sold includes the effect of rebate credits earned under our agreement with Siemens.

The following table reflects the components of the Siemens rebate credits which are included in cost of products sold for hearing aids (see Note 4 Long-term Debt, Notes to Consolidated Financial Statements included herein):

|   | <b>2009</b>     | <b>2008</b>     | <b>Change</b>  | <b>%</b>      |
|---|-----------------|-----------------|----------------|---------------|
| Rebates offsetting base required payments on Tranche C                                  | \$ 500          | \$ 500          | \$             |               |
| Volume rebates used to reduce Tranche C principal                                       | 152             | 313             | (161)          | (51.4)%       |
| Required principal payments of \$65 per Siemens unit from acquired centers on Tranche B | 173             | 204             | (31)           | (15.2)%       |
| Rebates offsetting interest on Tranches B and C   | 861             | 716             | 145            | 20.3%         |
| <b>Total rebate credits</b>   | <b>\$ 1,686</b> | <b>\$ 1,733</b> | <b>\$ (47)</b> | <b>(2.7)%</b> |
| <b>Percent of total net revenues</b>  | <b>7.7%</b>     | <b>7.1%</b>     | <b>0.6%</b>    | <b>8.5%</b>   |

The \$161,000 reduction in volume rebates earned was due to a decline in Siemens units sold from the prior period. The \$145,000 increase in interest forgiven is due to the fact that all Siemens debt is now subject to rebates as a result of the December 23, 2008 amendments. Cost of products sold as a percent of total net revenues before the impact of the Siemens rebate credits was 30.6% in the third quarter of 2009 compared to 33.7% in the third quarter of 2008. The decline is the result of product mix, a reduction in discounting and increases in prices charged on select product lines.

**Expenses****Dollars in thousands**

|  | <b>2009</b>      | <b>2008</b>      | <b>Change</b>     | <b>%</b>       |
|--|------------------|------------------|-------------------|----------------|
| <b>Center operating expenses</b>           | <b>\$ 10,811</b> | <b>\$ 12,781</b> | <b>\$ (1,970)</b> | <b>(15.4)%</b> |
| Percent of total net revenues              | 49.5%            | 52.1%            | (2.6)%            | (5.0)%         |
| <b>General and administrative expenses</b> | <b>\$ 3,694</b>  | <b>\$ 3,217</b>  | <b>\$ 477</b>     | <b>14.8%</b>   |
| Percent of total net revenues              | 16.9%            | 13.1%            | 3.8%              | 29.0%          |
| <b>Depreciation and amortization</b>       | <b>\$ 593</b>    | <b>\$ 520</b>    | <b>\$ 73</b>      | <b>14.0%</b>   |
| Percent of total net revenues              | 2.7%             | 2.1%             | 0.6%              | 28.6%          |

The decrease in center operating expenses of approximately \$2.0 million in the third quarter of 2009 is attributable to staff reductions, temporary salary decreases put into effect in May of 2009 and other cost saving measures. These actions resulted in reductions of approximately \$825,000 in staffing costs, \$468,000 in other center operating expenses, \$496,000 in decreases in gross marketing costs and approximately \$248,000 in decreased regional management expense. The balance of the decrease in operating expenses in the quarter over quarter comparison is related to decreases in incentive compensation of approximately \$579,000 as a result of the decline in revenues and changes to compensation arrangements. These decreases were partially offset by additional expenses of approximately \$327,000 related to acquired centers owned less than twelve months. Costs related to AARP were approximately \$189,000 in the third quarter of 2009 and \$168,000 in the third quarter of 2008. The operating expenses of the acquired centers were 71.0% of the related net revenues for those centers during the third quarter of 2009.

**Table of Contents**

General and administrative expenses increased by approximately \$477,000 in the third quarter of 2009 as compared to the third quarter of 2008. This was primarily the result of \$200,000 of vendor rebates recorded in the third quarter of 2008 which did not occur in 2009 and increases in consulting expenses and franchise taxes.

Depreciation was \$387,000 in the third quarter of 2009 and \$343,000 in the third quarter of 2008. Amortization expense was \$206,000 in the third quarter of 2009 and \$177,000 in the third quarter of 2008.

**Gain on Foreign Exchange**

As a result of the Canadian asset sale in April 2009, the Company plans to repatriate its remaining investment in its Canadian operations. Therefore, gains and losses on foreign currency exchange related to the Company's net investment remaining in its Canadian operations after the asset sale will be recognized in continuing operations. The Company recognized a \$99,000 foreign currency gain in the third quarter of 2009.

**Interest Expense****Dollars in thousands**

|   | 2009            | 2008            | Change          | %              |
|---|-----------------|-----------------|-----------------|----------------|
| Notes payable from business acquisitions and others (1) | \$ 276          | \$ 244          | \$ 32           | 13.1%          |
| Long-term contractual commitment-AARP (2)               |                 | 260             | (260)           | (100.0)%       |
| Siemens Tranches B and C interest forgiven (3)          | 861             | 716             | 145             | 20.3%          |
| Siemens Tranche D                                       |                 | 289             | (289)           | (100.0)%       |
| 2005 Subordinated Notes (4)                             |                 | 39              | (39)            | (100.0)%       |
| <b>Total interest expense</b>                           | <b>\$ 1,137</b> | <b>\$ 1,548</b> | <b>\$ (411)</b> | <b>(26.6)%</b> |

|                                     | 2009            | 2008            | Change          | %              |
|-------------------------------------|-----------------|-----------------|-----------------|----------------|
| Total cash interest expense (5)     | \$ 86           | \$ 612          | \$ (526)        | (85.9)%        |
| Total non-cash interest expense (6) | 1,051           | 936             | 115             | 12.3%          |
| <b>Total interest expense</b>       | <b>\$ 1,137</b> | <b>\$ 1,548</b> | <b>\$ (411)</b> | <b>(26.6)%</b> |

(1) Includes \$74,000 and \$74,000 in the third quarter of 2009 and 2008, respectively, of non-cash interest expense related to the recording of notes at their present value by discounting future payments to market rate of interest (see Note 4 Long-term



Debt, Notes to Consolidated Financial Statements included herein) and \$74,000 of non-cash interest expense in the third quarter of 2009 related to recording of warrants at their fair market value.

(2) Represents non-cash interest expense related to the recording of long-term contractual commitment to AARP at its present value by discounting future payments to market rate of interest.

(3) The interest expense on Tranches B and C is forgiven by Siemens as long as the minimum purchase requirements are met a corresponding rebate credit is recorded as a reduction of the cost of products sold (see Note 4

Long-term Debt, Notes to Consolidated Financial Statements

included herein  
and Liquidity  
and Capital  
Resources,  
below).

- (4) Third quarter 2008 includes \$12,000 of non-cash debt discount amortization (see Note 5 Subordinated Notes and Warrants, Notes to Consolidated Financial Statements included herein).
- (5) Represents the sum of the cash interest portion paid on the notes payable for business acquisitions and others and the cash interest paid to Siemens on the Siemens Tranche D loans.
- (6) Represents the non-cash interest expense related to recording the notes payable for business acquisitions at their present value by discounting future payments to market rate of interest, long-term

contractual  
commitment to  
AARP at its  
present value by  
discounting  
future payments  
to market rate of  
interest, debt  
discount  
amortization on  
the 2005  
Subordinated  
Notes and  
interest on  
Siemens  
Tranches B and  
C offset by  
rebates.

The decrease in interest expense in the third quarter of 2009 is mostly attributable to the amendment of the AARP contractual commitment and redemption of the Subordinated Notes in August of 2008.

**Table of Contents****Income Taxes**

The Company has net operating loss carryforwards of approximately \$59.1 million for U.S. income tax purposes. In addition, the Company has temporary differences between the financial statement and tax reporting arising primarily from differences in the amortization of intangible assets and goodwill and depreciation of fixed assets. The deferred tax assets for U.S. income tax purposes have been offset by a valuation allowance because it was determined that these assets were not likely to be realized. The deferred tax assets for Canadian tax purposes are recorded as a reduction of the deferred income tax liability on the Company's balance sheet.

During the third quarter of 2009, the Company recorded a deferred tax expense of approximately \$210,000 compared to approximately \$214,000 in the third quarter of 2008 related to the estimated deduction of tax deductible goodwill from its U.S. operations. The deferred income tax expense was recorded because it cannot be offset by other temporary differences as it relates to infinite-lived assets and the timing of reversing the liability is unknown. Deferred income tax expense will continue to be recorded until the tax deductible goodwill is fully amortized. Tax deductible goodwill with a balance of approximately \$28.9 million at September 26, 2009 and \$33.2 million at December 27, 2008, will continue to increase as we continue to purchase the assets of businesses.

**Net Income attributable to noncontrolling interest**

During the third quarters of 2009 and 2008, the Company's 50% owned joint venture, HEARx West, generated net income of approximately \$364,000 and \$964,000, respectively. The Company records 50% of the venture's net income as net income attributable to noncontrolling interest in the income of a joint venture in the Company's consolidated statements of operations. The net income attributable to noncontrolling interest for the third quarters of 2009 and 2008 was approximately \$182,000 and \$482,000, respectively.

**Discontinued Operations**

On April 27, 2009, the Company sold the assets of Helix Hearing Care of America Corp. (the Seller) and the stock of 3371727 Canada Inc. both indirect wholly owned subsidiaries of the Company for cash consideration of approximately \$23.1 million U.S. dollars, plus assumption of certain balance sheet liabilities, which resulted in a gain on sale of approximately \$86,000, net of applicable tax, during the quarter ended June 27, 2009.

A portion of the purchase price was paid to trade creditors of the Seller and approximately \$828,000 was initially held in escrow for up to 180 days after the closing pending any future claims under the Purchase Agreement. The Company received approximately \$529,000 in escrow funds in July 2009 which resulted in a gain on sale of approximately \$442,000, net of applicable tax of approximately \$87,000, during the third quarter of 2009. The balance of the escrow funds of approximately \$299,000 was received by the Company in the fourth quarter of 2009. We incurred approximately \$561,000 of legal and financial advisory fees in connection with the sale, which are included in the net gain on sale.

During third quarter of 2009 income tax expense included in discontinued operations of approximately \$87,000 related to the gain on the sale of discontinued operations compared to approximately \$82,000 in the third quarter of 2008 which related to estimated taxable income generated by the Canadian operations.

**Table of Contents***For the nine months ended September 26, 2009 compared to the nine months ended September 27, 2008***Revenues**

Dollars in thousands

|                                 | <b>2009</b>      | <b>2008</b>      | <b>Change</b>     | <b>%<br/>Change</b> |
|---------------------------------|------------------|------------------|-------------------|---------------------|
| Hearing aids and other products | \$ 61,172        | \$ 69,241        | \$ (8,069)        | (11.7)%             |
| Services                        | 6,043            | 5,389            | 654               | 12.1%               |
| <b>Total net revenues</b>       | <b>\$ 67,215</b> | <b>\$ 74,630</b> | <b>\$ (7,415)</b> | <b>(9.9)%</b>       |

|   | <b>2009</b>      | <b>2008</b>      | <b>Change</b>     | <b>%<br/>Change</b> |
|---|------------------|------------------|-------------------|---------------------|
| Revenues from centers acquired in 2008 (1)  | \$ 1,866         | \$               | \$ 1,866          | 2.5%                |
| Revenues from centers acquired in 2009      | 911              |                  | 911               | 1.2%                |
| <b>Revenues from acquired centers</b>       | <b>2,777</b>     |                  | <b>2,777</b>      | <b>3.7%</b>         |
| <b>Revenues from comparable centers (2)</b> | <b>63,966</b>    | <b>74,630</b>    | <b>(10,664)</b>   | <b>(14.3)%</b>      |
| <b>Revenues from contract services (3)</b>  | <b>472</b>       |                  | <b>472</b>        | <b>0.6%</b>         |
| <b>Total net revenues</b>                   | <b>\$ 67,215</b> | <b>\$ 74,630</b> | <b>\$ (7,415)</b> | <b>(9.9)%</b>       |

(1) Represents that portion of revenues from the 2008 acquired centers recognized for those acquisitions that had less than one full year of revenues recorded in 2008 due to the timing of their acquisition.

(2) Also includes revenues from the network business segment.

(3) Represents fees earned pursuant to the support

agreement  
entered into  
upon the sale of  
our Canadian  
operations.

The \$8.1 million or 11.7% decrease in hearing aids and other products revenue from the first nine months of 2008 is principally a result of a decline in organic revenue as a result of the current economic slow-down and steps taken by the Company to increase profitability. The Company has reduced the number of discounts offered, increased some prices and reduced marketing expenditures and center staffing. The actions taken have significantly increased profitability but have had a slightly detrimental impact on revenues. The 12.1% increase in service revenues is primarily due to \$472,000 of contract service revenue earned pursuant to the support agreement entered into upon the sale of our Canadian operations.

### Cost of Products Sold and Services

Dollars in thousands

|   | <b>2009</b>      | <b>2008</b>      | <b>Change</b>     | <b>%</b>       |
|---|------------------|------------------|-------------------|----------------|
| Hearing aids and other products                 | \$ 14,998        | \$ 18,661        | \$ (3,663)        | (19.6)%        |
| Services  | 1,325            | 1,627            | (302)             | (18.6)%        |
| <b>Total cost of products sold and services</b> | <b>\$ 16,323</b> | <b>\$ 20,288</b> | <b>\$ (3,965)</b> | <b>(19.5)%</b> |
| <b>Percent of total net revenues</b>            | <b>24.3%</b>     | <b>27.2%</b>     | <b>(2.9)%</b>     | <b>(10.7)%</b> |

The cost of products sold includes the effect of rebate credits earned under our agreement with Siemens.

**Table of Contents**

The following table reflects the components of the Siemens rebate credits which are included in cost of products sold for hearing aids (see Note 4 Long-term Debt, Notes to Consolidated Financial Statements included herein):

|  | 2009            | 2008            | Change        | %            |
|--|-----------------|-----------------|---------------|--------------|
| Rebates offsetting base required payments on Tranche C   | \$ 1,500        | \$ 1,500        | \$            |              |
| Volume rebates used to reduce Tranche C principal  | 472             | 943             | (471)         | (49.9)%      |
| Rebates offsetting required payments of \$65 per Siemens unit from acquired centers on Tranche B | 513             | 553             | (40)          | (7.2)%       |
| Rebates offsetting interest on Tranches B and C  | 2,954           | 2,104           | 850           | 40.4%        |
| <b>Total rebate credits</b>  | <b>\$ 5,439</b> | <b>\$ 5,100</b> | <b>\$ 339</b> | <b>6.6%</b>  |
| <b>Percent of total net revenues</b>   | <b>8.1%</b>     | <b>6.8%</b>     | <b>1.3%</b>   | <b>19.1%</b> |

The \$471,000 reduction in volume rebates earned was due to a decline in Siemens units sold. The \$850,000 increase in interest forgiven is due to an increase in Siemens indebtedness and the fact that all Siemens debt is now subject to rebate as a result of the December 23, 2008 amendments. Cost of products sold as a percent of total net revenues before the impact of the Siemens rebate credits was 32.4% in the first nine months of 2009 compared to 34.0% in the first nine months of 2008. The decline is the result of product mix, a reduction in discounting and increases in prices charged on select product lines.

**Expenses****Dollars in thousands**

|  | 2009             | 2008             | Change            | %              |
|--|------------------|------------------|-------------------|----------------|
| <b>Center operating expenses</b>           | <b>\$ 33,510</b> | <b>\$ 38,237</b> | <b>\$ (4,727)</b> | <b>(12.4)%</b> |
| Percent of total net revenues              | 49.9%            | 51.2%            | (1.3)%            | (2.5)%         |
| <b>General and administrative expenses</b> | <b>\$ 11,387</b> | <b>\$ 11,565</b> | <b>\$ (178)</b>   | <b>(1.5)%</b>  |
| Percent of total net revenues              | 16.9%            | 15.5%            | 1.4%              | 9.0%           |
| <b>Depreciation and amortization</b>       | <b>\$ 1,731</b>  | <b>\$ 1,544</b>  | <b>\$ 187</b>     | <b>12.1%</b>   |
| Percent of total net revenues              | 2.6%             | 2.1%             | 0.5%              | 23.8%          |

The approximate \$4.7 million decrease in center operating expenses in the first nine months of 2009 as compared with the first nine months of 2008 is primarily attributable to staff reductions, temporary salary decreases put into effect in May of 2009 and other cost saving measures. These actions resulted in reductions of approximately \$2.2 million in staffing costs, \$1.1 million in other center operating expenses, \$1.6 million in decreases in gross marketing costs and approximately \$686,000 in decreased regional management expense. The balance of the decrease in operating expenses in the quarter over quarter comparison is related to decreases in incentive compensation of approximately \$1.6 million as a result of the decline in revenues and changes to compensation arrangements. These decreases were partially offset by additional expenses of approximately \$1.9 million related to acquired centers owned less than twelve months and approximately \$254,000 of costs related to AARP. The operating expenses of the acquired centers were 56.0% of the related net revenues for those centers during the first nine months of 2009.

General and administrative expenses decreased by approximately \$178,000 in the first nine months of 2009 as compared to the first nine months of 2008. This is the result of \$811,000 of severance costs incurred in the first nine

months of 2008, partially offset by a \$200,000 rebate recorded in the same period and increases in salaries, professional fees and other costs during the first nine months of 2009.

Depreciation was \$1.1 million in the first nine months of 2009 and \$997,000 in the first nine months of 2008.

Amortization expense was \$620,000 in the first nine months of 2009 and \$547,000 in the first nine months of 2008.



**Table of Contents****Gain on Foreign Exchange**

As a result of the Canadian asset sale in April 2009, the Company plans to repatriate its remaining investment in its Canadian operations. Therefore, gains and losses on foreign currency exchange related to the Company's net investment remaining in its Canadian operations after the asset sale will be recognized in continuing operations. The Company recognized a \$499,000 foreign currency gain in the first nine months of 2009.

**Interest Expense****Dollars in thousands**

|   | <b>2009</b>     | <b>2008</b>     | <b>Change</b>   | <b>%</b>      |
|---|-----------------|-----------------|-----------------|---------------|
| Notes payable from business acquisitions and others (1) | \$ 774          | \$ 673          | \$ 101          | 15.0%         |
| Long-term contractual commitment to AARP (2)            |                 | 260             | (260)           | (100.0)%      |
| Siemens Tranches B and C interest forgiven (3)          | 2,954           | 2,104           | 850             | 40.4%         |
| Siemens Tranche D                                       |                 | 712             | (712)           | (100.0)%      |
| 2005 Subordinated Notes (4)                             |                 | 247             | (247)           | (100.0)%      |
| <b>Total interest expense</b>                           | <b>\$ 3,728</b> | <b>\$ 3,996</b> | <b>\$ (268)</b> | <b>(6.7)%</b> |
|   | <b>2009</b>     | <b>2008</b>     | <b>Change</b>   | <b>%</b>      |
| Total cash interest expense (5)                         | \$ 412          | \$ 1,276        | \$ (864)        | (67.7)%       |
| Total non-cash interest expense (6)                     | 3,316           | 2,720           | 596             | 21.9%         |
| <b>Total interest expense</b>                           | <b>\$ 3,728</b> | <b>\$ 3,996</b> | <b>\$ (268)</b> | <b>(6.7)%</b> |

(1) Includes \$252,000 and \$290,000 in the first nine months of 2009 and 2008, respectively, of non-cash interest expense related to recording of notes at their present value by discounting future payments to market rate of interest (see Note 4 Long-term Debt, Notes to Consolidated Financial Statements

included herein) and \$110,000 of non-cash interest expense in the first nine months of 2009 related to recording warrants at their fair market value.

(2) Represents non-cash interest expense related to the recording of long-term contractual commitment to AARP at its present value by discounting future payments to market rate of interest.

(3) The interest expense on Tranches B and C is forgiven by Siemens as long as the minimum purchase requirements are met. A corresponding rebate credit is recorded as a reduction of the cost of products sold (see Note 4

Long-term Debt, Notes to Consolidated Financial Statements included herein and Liquidity and Capital Resources,

below).

- (4) The first nine months of 2008 includes \$121,000 of non-cash debt discount amortization (see Note 5 Subordinated Notes and Warrants, Notes to Consolidated Financial Statements included herein).
- (5) Represents the sum of the cash interest portion paid on the notes payable for business acquisitions and others and the cash interest paid to Siemens on the Siemens Trance D loans.
- (6) Represents the non-cash interest expense related to recording the notes payable for business acquisitions at their present value by discounting future payments to market rate of interest, long-term contractual commitment to AARP at its present value by

discounting  
future payments  
to market rate of  
interest, 2005  
Subordinated  
Notes related to  
the debt  
discount  
amortization  
and interest on  
Siemens  
Tranches B and  
C offset by  
rebates.

The decrease in interest expense in the first nine months of 2009 is mostly attributable to the amendment of the AARP contractual commitment and redemption of the subordinated notes in August 2008.

#### **Income Taxes**

The Company has net operating loss carryforwards of approximately \$59.1 million for U.S. income tax purposes. In addition, the Company has temporary differences between the financial statement and tax reporting arising primarily from differences in the amortization of intangible assets and goodwill and depreciation of fixed assets. The deferred tax assets for US tax purposes have been offset by a valuation allowance because it was determined that these assets were not likely to be realized.

During the first nine months of 2009, the Company recorded a deferred tax expense of approximately \$630,000 compared to approximately \$620,000 in the first nine months of 2008 related to the estimated deduction of tax deductible goodwill from its US operations. The deferred income tax expense was recorded because it cannot be offset by other temporary differences as it relates to infinite-lived assets and the timing of reversing the liability is unknown. Deferred income tax expense will continue to be recorded until the tax deductible goodwill is fully amortized.

**Table of Contents****Net Income attributable to noncontrolling interest**

During the first nine months of 2009 and 2008, the Company's 50% owned joint venture, HEARx West, generated net income of approximately \$859,000 and \$2.3 million, respectively. The Company records 50% of the venture's net income as net income attributable to noncontrolling interest in the income of a joint venture in the Company's consolidated statements of operations. The net income attributable to noncontrolling interest for the first nine months of 2009 and 2008 was approximately \$429,000 and \$1.2 million, respectively.

**Discontinued Operations**

On April 27, 2009, the Company sold the assets of Helix Hearing Care of America Corp. (the Seller) and the stock of 3371727 Canada Inc. both indirect wholly owned subsidiaries of the Company for cash consideration of approximately \$23.1 million U.S. dollars, plus assumption of certain balance sheet liabilities, which resulted in a gain on sale of approximately \$86,000, net of applicable tax, during the quarter ended June 27, 2009.

A portion of the purchase price was paid to trade creditors of the Seller and approximately \$828,000 was initially held in escrow for up to 180 days after the closing pending any future claims under the Purchase Agreement. The Company received approximately \$529,000 in escrow funds in July 2009 which resulted in a gain on sale of approximately \$442,000, net of applicable tax of approximately \$87,000, during the third quarter of 2009. The remaining escrow funds of approximately \$299,000 were received by the Company in the fourth quarter of 2009. We incurred approximately \$561,000 of legal and financial advisory fees in connection with the sale, which are included in the net gain on sale.

During first nine months of 2009 income tax expense included in discontinued operations of approximately \$1.4 million included approximately \$1.6 million of income tax expense related to the gain on the sale of discontinued operations net of a tax benefit of approximately \$261,000 related to the estimated taxable loss generated by the Canadian operations compared to approximately \$196,000 of income tax expense in the first nine months of 2008 which related to estimated taxable income generated by the Canadian operations.

**LIQUIDITY AND CAPITAL RESOURCES****Working Capital**

The Company's working capital position improved by \$4.5 million from a deficit of \$5.8 million at December 27, 2008 to a deficit of \$1.3 at September 26, 2009. The increase in working capital is primarily attributable to the approximate \$20.1 million of net proceeds received for the sale of assets related to our Canadian operations offset by accounts payable of \$6.2 million converted into indebtedness as part of the December 23, 2008 amendments to the Siemens Credit Agreement.

In the first nine months of 2009, the Company generated income from operations of approximately \$4.3 million (including approximately \$421,000 of expenses related to the AARP program, \$623,000 of non-cash other employee stock-based compensation expense and approximately \$620,000 of amortization of intangible assets) compared to \$3.0 million (including approximately \$720,000 in accrued compensation expense and \$91,000 in non-cash stock based compensation related to the former Chairman's retirement, \$607,000 of non-cash other employee stock-based compensation and approximately \$547,000 of amortization of intangible assets) in the first nine months of 2008. Cash, cash equivalents and short-term marketable securities as of September 26, 2009 were approximately \$14.8 million. The working capital deficit of \$1.3 million includes approximately \$2.6 million representing the current maturities of the long-term debt owed to Siemens which is anticipated to be repaid through rebate credits.

**Table of Contents****Cash Flows**

Net cash provided by operating activities in the first nine months of 2009 was approximately \$5.3 million compared to approximately \$7.3 million in the first nine months of 2008.

During the first nine months of 2009, cash of approximately \$1.3 million was used to complete the acquisition of centers, a decrease of approximately \$2.3 million over the \$3.6 million spent on acquisitions in the first nine months of 2008.

In the first nine months of 2009, net cash proceeds of approximately \$22.7 million were received related to the sale of assets of our Canadian operations and approximately \$11.6 million were used to repay long-term debt.

In the first nine months of 2009, cash of approximately \$6.4 million was used to purchase short-term marketable securities and approximately \$3.0 was used to collateralize an irrevocable standby letter of provided to AARP and approximately \$8.1 million was paid to Siemens.

The Company believes that current cash and cash equivalents, including the proceeds received from the sale of the Company's Canadian operations and cash flow from continuing operations, at current net revenue levels, will be sufficient to support the Company's operational needs through the next twelve months. However, 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 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.

**Contractual Obligations**

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 September 26, 2009.

|   | Total  | Payments due by period (000's) |             |             |                   |
|---|--------|--------------------------------|-------------|-------------|-------------------|
|   |        | Less than 1 year               | 1 - 3 years | 4 - 5 Years | More Than 5 years |
| Contractual obligations                           | \$     | \$                             | \$          | \$          | \$                |
| Long-term debt (1 and 3)                          | 44,126 | 6,613                          | 8,904       | 5,069       | 23,540            |
| Subtotal of obligations recorded on balance sheet | 44,126 | 6,613                          | 8,904       | 5,069       | 23,540            |
| Interest to be paid on long-term debt (2 and 3)   | 16,408 | 3,535                          | 6,345       | 5,120       | 1,408             |
| Operating leases                                  | 17,139 | 6,363                          | 7,252       | 2,684       | 840               |
| Employment agreements                             | 2,896  | 1,961                          | 863         | 72          |                   |
| Purchase obligations (4)                          | 3,542  | 1,357                          | 2,185       |             |                   |
| Total contractual cash obligations                | 84,111 | 19,829                         | 25,549      | 12,945      | 25,788            |

(1) Approximately \$36.1 million can be repaid through rebate credits from Siemens, including \$2.6 million in

less than 1 year and \$5.2 million in years 1-3, \$4.9 million in years 4-5 and \$23.5 million in more than 5 years.

(2) Interest on long-term debt includes the interest on the new Tranches B and C that can be repaid through rebate credits from Siemens pursuant to the Amended and Restated Credit Agreement, including \$3.2 million in less than 1 year and \$6.1 million in years 1-3, \$5.1 million in years 4-5 and \$1.4 million in more than 5 years. Interest repaid through preferred pricing reductions was \$3.0 million in the first nine months of 2009. (See Note 4 Long-Term Debt, Notes to Consolidated Financial Statements included herein).

(3) Principal and interest

payments on long-term debt is based on cash payments and not the fair value of the discounted notes (See Note 4 Long-Term Debt, Notes to Consolidated Financial Statements included herein).

- (4) Purchase obligations includes the contractual commitment to AARP for campaigns to educate and promote hearing loss awareness and prevention and the contractual commitment to AARP for public marketing funds for the AARP Health Care Options General Program, including \$805,000 in less than 1 year.



**Table of Contents**

**CRITICAL ACCOUNTING POLICIES**

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

**Business acquisitions and goodwill**

We account for business combinations using the acquisition method of accounting. We determine the purchase price of an acquisition based on the fair value of the consideration transferred. The total purchase price of an acquisition is allocated to the underlying net assets based on their respective estimated fair values. As part of this allocation process, management must identify and attribute values and estimated lives to intangible assets acquired. Such determinations involve considerable judgment, and often involve the use of significant estimates and assumptions, including those with respect to future cash inflows and outflows, discount rates and asset lives. These determinations will affect the amount of amortization expense recognized in future periods. Assets acquired in a business combination that will be re-sold are valued at fair value less cost to sell. Results of operating these assets are recognized currently in the period in which those operations occur.

The Company evaluates goodwill and certain intangible assets with indefinite lives not being amortized for impairment annually or more frequently if impairment indicators arise. Indicators at the Company include, but are not limited to: sustained operating losses or a trend of poor operating performance, a decrease in the Company's market capitalization below its book value and an expectation that a reporting unit will be sold or otherwise disposed of. If one or more indicators of impairment exist, the Company performs an evaluation to identify potential impairments. If impairment is identified, the Company measures and records the amount of impairment losses. The Company performs its annual analysis on the first day of its fourth quarter.

A two-step impairment test is performed on goodwill. In order to do this, management applies 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. In the first step, the Company compares the fair value of each reporting unit to its carrying value. Calculating the fair value of the reporting units requires significant estimates and long-term assumptions. The Company tests goodwill for impairment annually on the first day of the Company's fourth quarter and the latest annual test in 2008 indicated no impairment. The Company estimates the fair value of its reporting units by applying a weighted average of two methods: quoted market prices and discounted cash flows. The weighting is 40% exchange market price and 60% discounted cash flows.

If the carrying value of the reporting unit exceeds its fair value, additional steps are required to calculate an impairment charge. The second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying value of the goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. The implied fair value of goodwill is the fair value of the reporting unit allocated to all of the assets and liabilities of that unit as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit. 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.

**Table of Contents**

The market capitalization of the Company's stock temporarily declined to approximately \$17.3 million in December 2008, which was substantially lower than the Company's estimated combined fair values of its three reporting units. The Company completed a reconciliation of the sum of the estimated fair values of its reporting units to its market value (based upon its stock price in December 2008). We believe one of the primary reconciling differences between fair value and our market capitalization is due to a control premium. We believe the value of a control premium is the value a market participant could extract as savings and/or synergies by obtaining control, and thereby eliminating duplicative overhead costs and obtaining discounts on volume purchasing from suppliers. The Company also considers the following qualitative items that cannot be accurately quantified and are based upon the beliefs of management, but provide additional support for the explanation of the remaining difference between the estimated fair value of the Company's reporting units and its market capitalization:

The Company's stock is thinly traded;

The decline in the Company's stock price during 2008 is not directly correlated to a change in the overall operating performance of the Company; and

Previously unseen pressures are in place given the global financial and economic crisis.

As a result of the Canadian asset sale in April 2009 described in Note 2 and the allocation of approximately \$16.8 million of goodwill to the disposed component of the centers reporting unit, we performed a step 1 goodwill impairment assessment, which indicated no impairment. At September 26, 2009 the Company's market capitalization of approximately \$55.0 million was in excess of the book value of its three reporting units and there were no other indicators of impairment. We will continue to monitor market trends in our business, the related expected cash flows and our calculation of market capitalization for purposes of identifying possible indicators of impairment. Should our book value per share exceed our market share price or we have other indicators of impairment, as previously discussed, we will be required to perform an interim step one impairment analysis, which may lead to a step two analysis resulting in goodwill impairment. Additionally, we would then be required to review our remaining long-lived assets for impairment. Judgments regarding the existence of impairment indicators are based on legal factors, market conditions and operational performance of the acquired businesses. Future events could cause us to conclude that impairment indicators exist and that goodwill associated with the acquired businesses is impaired. Additionally, as the valuation of identifiable goodwill requires significant estimates and judgment about future performance, cash flows and fair value, our future results could be affected if these current estimates of future performance and fair value change. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

**Revenue recognition**

HearUSA has company-owned centers in its core markets and a network of affiliated providers who provide products and services to customers that are located outside its core markets. HearUSA enters into provider agreements with benefit providers (third party payors such as insurance companies, managed care companies, employer groups, etc.) under (a) a discount arrangement on products and service; (b) a fee for service arrangement; or (c) a per capita basis or capitation arrangements, which is a fixed per member per month fee received from the benefit providers.

All contracts are for one calendar year and are cancelable with ninety days notice by either party.

Under the discount arrangements, the Company provides the products and services to the eligible members of a benefit provider at a pre-determined discount or customary price and the member pays the Company directly for the products and services.

**Table of Contents**

Under the fee for service arrangements, the Company provides the products and services to the eligible members at its customary price less the benefit they are allowed (a specific dollar amount), which the member pays directly to the Company. The Company then bills the benefit provider the agreed upon benefit for the service.

Under the capitation agreements, the Company agrees with the benefit provider to provide their eligible members with a pre-determined discount. Revenue under capitation agreements is derived from the sales of products and services to members of the plan and from a capitation fee paid to the Company by the benefit provider at the beginning of each month. The members that are purchasing products and services pay the customary price less the pre-determined discount. The revenue from the sales of products to these members is recorded at the customary price less applicable discount in the period that the product is delivered. The direct expenses consisting primarily of the cost of goods sold and commissions on sales are recorded in the same period. Other indirect operating expenses are recorded in the period which they are incurred. The capitation fee revenue is calculated based on the total members in the benefit provider's plan at the beginning of each month and is non-refundable. Only a small percentage of these members may ever purchase product or services from the Company. The capitation fee revenue is earned as a result of agreeing to provide services to members without regard to the actual amount of service provided. That revenue is recorded monthly in the period that the Company has agreed to see any eligible members.

The Company records each transaction at its customary price for the three types of arrangements, less any applicable discounts from the arrangements in the center business segment. The products sold are recorded under the hearing aids and other products line item and the services are recorded under the service line item on the consolidated statement of operations. Revenue and expense are recorded when the product has been delivered to its customers, net of an estimate for return allowances when the Company is entitled to the benefits of the revenues. Revenue and expense from services and repairs are recorded when the services or repairs have been performed. Capitation revenue is recorded as revenue from hearing aids since it relates to the discount given to the members.

When the arrangements are related to members of benefit providers that are located outside the Company-owned centers' territories, the revenues generated under these arrangements are provided by our network of affiliated providers and are included under the network business segment. The Company records a receivable for the amounts due from the benefit providers and a payable for the amounts owed to the affiliated providers. The Company only pays the affiliated provider when the funds are received from the benefit provider. The Company records revenue equal to the minimal fee for processing and administrative fees. The costs associated with these services are operating costs, mostly for the labor of the network support staff and are recorded when incurred.

No contract costs are capitalized by the Company.

**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 allowance for doubtful accounts. Then a specific percent per plan and per aging categories is applied against the remaining receivables to estimate the necessary allowance. Any changes in the percent assumptions per plan and aging categories result in a change in the allowance for doubtful accounts. For example, an increase of 10% in the percentage applied against the remaining receivables would increase the allowance for doubtful accounts by approximately \$36,000.

**Table of Contents**

**Marketable securities as held to maturity, trading and available for sale**

The Company determines the appropriate classification of its investments in debt and equity securities at the time of purchases and reevaluates such determinations at each balance-sheet date. Debt securities are classified as held to maturity when the Company has the positive intent and ability to hold the securities to maturity. Debt securities for which the Company does not have the intent or ability to hold to maturity are classified as available for sale. Held-to-maturity securities are recorded as either short term or long term on the Balance Sheet, based on contractual maturity date and are stated at amortized cost. Marketable securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and are reported at fair value, with unrealized gains and losses recognized in earnings. Debt and marketable equity securities not classified as held to maturity or as trading, are classified as available for sale, and are carried at fair market value, with the unrealized gains and losses, net of tax, included in the determination of comprehensive income and reported in shareholders equity.

The fair value of substantially all securities is determined by quoted market prices. The estimated fair value of securities for which there are no quoted market prices is based on similar types of securities that are traded in the market.

**Sales returns**

The Company provides to all patients purchasing hearing aids a specific return period of at least 30 days, or as mandated by state guidelines 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. classes. 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.

**Vendor rebates**

The Company receives various pricing rebates from Siemens recorded based on the earning of such rebates by meeting the minimum purchase requirements of the supply agreement as discussed in the Liquidity and Capital Resource section above. These rebates are recorded monthly on a systematic basis based on supporting historical information that the Company has met these compliance levels.

**Marketing allowances**

The Company receives a monthly marketing allowance from Siemens to reimburse the Company for marketing and advertising expenses for promoting its business and Siemens products. The Company's advertising rebates, which represent a reimbursement of specific incremental, identifiable advertising costs, are recorded as an offset to advertising expense. If the cash consideration exceeds the allocated cost of advertising, the excess would be recorded as a reduction of cost of products sold.

**Impairment of long-lived assets**

Long-lived assets are subject to a review for impairment if events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. If the future undiscounted cash flows generated by an asset or asset group is less than its carrying amount, it is considered to be impaired and would be written down to its fair value. Currently we have not experienced any events that would indicate a potential impairment of these assets, but if circumstances change we could be required to record a loss for the impairment of long-lived assets.

**Table of Contents**

**Stock-based compensation**

To determine the fair value of our stock option awards, we use the Black-Scholes option pricing model, which requires management to apply judgment and make assumptions to determine the fair value of our awards. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them (the expected term), the estimated volatility of the price of our common stock over the expected term and an estimate of the number of options that will ultimately be forfeited.

The expected term is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. Expected stock price volatility is based on a historical volatility of our common stock for a period at least equal to the expected term. Estimated forfeitures are calculated based on historical experience. Changes in these assumptions can materially affect the estimate of the fair value of our share-based payments and the related amount recognized in our Consolidated Financial Statements.

**Income taxes**

Income taxes are calculated using of the asset and liability method. Under this method, deferred tax assets and liabilities are recognized based on the difference between the carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using the enacted tax rates. A valuation allowance is established against the deferred tax assets when it is more likely than not that some portion or all of the deferred taxes may not be realized.

Both the calculation of the deferred tax assets and liabilities, as well as the decision to establish a valuation allowance requires management to make estimates and assumptions. Although we do not believe there is a reasonable likelihood that there will be a material change in the estimates and assumptions used, if actual results are not consistent with the estimates and assumptions, the balances of the deferred tax assets, liabilities and valuation allowance could be adversely affected.

We recognize interest relating to unrecognized tax benefits within our provision for income taxes.

**RECENT ACCOUNTING PRONOUNCEMENTS**

**Table of Contents**

In June 2009, the Financial Accounting Standards Board ( FASB ) issued FASB Accounting Standards Codification ( ASC ) Topic 105, *Generally Accepted Accounting Principles* ( ASC 105 ) (the Codification ) was adopted. ASC 105 supersedes all existing non-SEC accounting and reporting standards. All other non-grandfathered, non-SEC accounting literature not included in the Codification will become non-authoritative. Going forward, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates ( ASU ), which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification. The Codification was effective for financial statements issued for fiscal years and interim periods beginning after September 15, 2009. As a result of the adoption, the Company has included references to the Codification, as appropriate, in these financial statements, referred to previously under the former FASB references.

In August 2009, the FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value* ( ASU 2009-05 ), which clarified how to measure the fair value of liabilities in circumstances when a quoted price in an active market for the identical liability is not available. ASU 2009-05 is effective for the first reporting period beginning after the issuance of this standard. The Company is currently evaluating the impact that the adoption of ASU 2009-05 will have on its consolidated financial statements.

In October 2009, the FASB issued ASU No. 2009-13, *Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force* ( ASU 2009-13 ), which addresses the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. ASU 2009-13 is effective prospectively for revenue arrangements entered into or materially modified beginning in fiscal years on or after June 15, 2010, however early adoption is permitted. The Company is currently evaluating the impact that the adoption of ASU 2009-13 will have on its consolidated financial statements.

**Table of Contents****Item 3. Quantitative and Qualitative Disclosure About Market Risk**

The Company does not engage in derivative transactions. The Company's exposure to market risk for changes in interest rates relates primarily to the Company's long-term debt. The following table presents the Company's financial instruments for which fair value and cash flows are subject to changing market interest rates:

|                      | Fixed Rate<br>9.5%<br>Due February<br>2015<br>\$<br>(000 s) | Variable<br>Rate<br>5% to 16%<br>Other<br>\$<br>(000 s) | Total<br>\$<br>(000 s) |
|----------------------|---|---|------------------------|
| 2009                 | (2,156)   | (1,250)   | (3,406)                |
| 2010                 | (2,617)   | (3,185)   | (5,802)                |
| 2011                 | (2,589)   | (2,428)   | (5,017)                |
| 2012                 | (2,538)   | (570)   | (3,108)                |
| 2013                 | (2,454)   | (163)   | (2,617)                |
| Thereafter           | (23,730)  |   | (23,730)               |
| Total                | (36,084)  | (7,596)   | (43,680)               |
| Estimated fair value | (36,084)  | (7,596)   | (43,680)               |

**Table of Contents**

**Item 4. Controls and Procedures**

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 September 26, 2009. The Company's chief executive officer and chief financial officer concluded that, as of September 26, 2009 the Company's disclosure controls and procedures were effective.

No change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) occurred during the fiscal quarter ended September 26, 2009 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.



**Table of Contents**

**Part II Other Information**

**Item 6. 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 as of October 26, 2009 (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, filed October 27, 2009).
- 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).



**Table of Contents**

|        |  |
|--------|--|
| 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   | Amendment No. 1 to the AARP Hearing Care Program Services Agreement with AARP Inc. ( AARP ) and AARP Services Inc. ( ASI ) (the Services Agreement Amendment ), dated August 11, 2009.   |
| 10.2   | Amendment No. 2 to the AARP License Agreement with AARP (the License Agreement Amendment ), dated August 11, 2009.   |
| 10.3** | Form of Nonqualified Option Grant Agreement (pursuant to Amended and Restated 2007 Incentive Compensation Plan) (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed September 11, 2009.   |
| 31.1   | CEO Certification, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2   | CFO Certification, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1   | CEO and CFO Certification, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |

\*\* Designates a management compensatory plan or arrangement

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HearUSA Inc.  
(Registrant)

November 10, 2009

/s/ Stephen J. Hansbrough  
Stephen J. Hansbrough  
Chairman and Chief Executive Officer  
HearUSA, Inc.

/s/ Francisco Puñal  
Francisco Puñal  
Senior Vice President and  
Chief Financial Officer  
HearUSA, Inc.