

NATUS MEDICAL INC  
Form 10-Q  
November 06, 2008  
Table of Contents

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

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2008

.. **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: 000-33001

**NATUS MEDICAL INCORPORATED**

(Exact name of registrant as specified in its charter)

<b>Delaware</b> (State or other jurisdiction)	<b>77-0154833</b> (I.R.S. Employer
of incorporation or organization)	Identification No.)
<b>1501 Industrial Road, San Carlos, CA 94070</b>	
(Address of principal executive offices) (Zip Code)	

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

(650) 802-0400

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for 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 is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, 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   
(Do not check if a smaller reporting company)

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

The number of issued and outstanding shares of the registrant's Common Stock, \$0.001 par value, as of November 3, 2008 was 27,979,003.

**Table of Contents**

**NATUS MEDICAL INCORPORATED**

**TABLE OF CONTENTS**

	<b>Page No.</b>
<b>PART I. <u>FINANCIAL INFORMATION</u></b>	<b>3</b>
Item 1. <u>Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets as of September 30, 2008 and December 31, 2007 (unaudited)</u>	3
<u>Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2008 and 2007 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2008 and 2007 (unaudited)</u>	5
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	24
Item 4. <u>Controls and Procedures</u>	24
<b>PART II. <u>OTHER INFORMATION</u></b>	<b>25</b>
Item 1. <u>Legal Proceedings</u>	25
Item 1A. <u>Risk Factors</u>	25
Item 6. <u>Exhibits</u>	35
<b><u>Signatures</u></b>	<b>36</b>

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****NATUS MEDICAL INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

(in thousands, except share amounts)

	September 30, 2008	December 31, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 68,006	\$ 11,916
Short-term investments	970	
Accounts receivable, net of allowance for doubtful accounts of \$1,026 and \$993	33,888	27,018
Inventories	23,233	19,264
Prepaid expenses and other current assets	3,412	3,402
Deferred income taxes	3,974	3,974
<b>Total current assets</b>	<b>133,483</b>	<b>65,574</b>
Property and equipment, net	15,257	14,504
Intangible assets	55,719	54,177
Goodwill	59,704	54,961
Other non-current assets	289	355
<b>Total assets</b>	<b>\$ 264,452</b>	<b>\$ 189,571</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Liabilities:		
Accounts payable	\$ 7,667	\$ 9,763
Current portion of long-term debt	206	18,554
Accrued liabilities	14,280	13,362
Deferred revenue	4,139	4,732
<b>Total current liabilities</b>	<b>26,292</b>	<b>46,411</b>
Long-term debt	1,333	18,262
Other liabilities	1,577	2,636
Deferred income taxes	6,179	6,544
<b>Total liabilities</b>	<b>35,381</b>	<b>73,853</b>
Stockholders' equity:		
Common Stock, \$0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 27,961,319 and 21,923,509	244,138	137,837
Accumulated deficit	(11,629)	(22,815)
Accumulated other comprehensive income (loss)	(3,438)	696
<b>Total stockholders' equity</b>	<b>229,071</b>	<b>115,718</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 264,452</b>	<b>\$ 189,571</b>

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

-3-

**Table of Contents**

**NATUS MEDICAL INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**

(in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Revenue	\$ 41,714	\$ 28,830	\$ 118,435	\$ 84,140
Cost of revenue	15,835	10,129	45,215	30,454
Gross profit	25,879	18,701	73,220	53,686
Operating expenses:				
Marketing and selling	9,965	6,752	29,020	20,147
Research and development	4,066	3,879	11,961	12,076
General and administrative	4,913	3,662	15,209	11,359
Total operating expenses	18,944	14,293	56,190	43,582
Income from operations	6,935	4,408	17,030	10,104
Other income, net	567	213	954	688
Income before provision for income tax	7,502	4,621	17,984	10,792
Provision for income tax	2,710	1,465	6,798	3,791
Net income	\$ 4,792	\$ 3,156	\$ 11,186	\$ 7,001
Earnings per share:				
Basic	\$ 0.17	\$ 0.15	\$ 0.46	\$ 0.32
Diluted	\$ 0.17	\$ 0.14	\$ 0.43	\$ 0.31
Weighted average shares used in the calculation of earnings per share:				
Basic	27,445	21,646	24,497	21,568
Diluted	28,756	22,965	25,775	22,798

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

**Table of Contents****NATUS MEDICAL INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**

(in thousands)

	<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating activities:</b>		
Net income	\$ 11,186	\$ 7,001
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,601	3,481
Accounts receivable reserves	209	138
Warranty reserves	399	203
Loss on disposal of property and equipment	61	
Share-based compensation	2,336	1,485
Excess tax benefits on the exercise of options	(2,066)	(922)
Changes in operating assets and liabilities:		
Accounts receivable	(6,080)	(1,574)
Inventories	(2,333)	(3,919)
Prepaid expenses, other assets, and deferred income taxes	374	402
Accounts payable	(2,152)	(1,189)
Accrued liabilities and deferred revenue	(2,337)	569
Net cash provided by operating activities	4,198	5,675
<b>Investing activities:</b>		
Acquisition of property and equipment	(2,174)	(1,612)
Capitalized software development costs	(1,161)	
Acquisition of business, net of cash acquired	(13,805)	(204)
Purchases of short-term investments	(12,120)	
Sales of short-term investments	11,150	
Net cash used in investing activities	(18,110)	(1,816)
<b>Financing activities:</b>		
Proceeds from stock option exercises and ESPP purchases	2,581	1,439
Proceeds from issuance of common stock, net of issuance costs	99,318	
Excess tax benefits upon the exercise of options	2,066	922
Borrowings on credit facility	6,000	
Payments on credit facility	(41,225)	
Net cash provided by financing activities	68,740	2,361
Exchange rate effect on cash and cash equivalents	1,262	835
Net increase in cash and cash equivalents	56,090	7,055
Cash and cash equivalents, beginning of period	11,916	15,392
Cash and cash equivalents, end of period	\$ 68,006	\$ 22,447

Supplemental disclosure of cash flow information:

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Cash paid for interest	\$	983	\$
Cash paid for income taxes	\$	4,243	\$ 1,248

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.



**Table of Contents****NATUS MEDICAL INCORPORATED AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)****1 - Basis of Presentation**

The accompanying interim condensed consolidated financial statements of Natus Medical Incorporated ( Natus, we, us, or the Company ) have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ). Except as updated below, the accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent in all material respects with those presented in Note 1 to the consolidated financial statements included in the Company 's Annual Report on Form 10-K for the year ended December 31, 2007.

Interim financial reports are prepared in accordance with the rules and regulations of the Securities and Exchange Commission, accordingly they do not include all of the information and notes required by GAAP for annual financial statements. The interim financial information is unaudited, but reflects all normal adjustments that are, in the opinion of management, necessary for the fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. Operating results for the three and nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries; intercompany transactions have been eliminated in consolidation.

**Short-Term Investments**

Short-term investments are classified as available for sale and recorded at fair value. Unrealized gains or losses, net of the deferred tax effect, are reported in other comprehensive income as a separate component of stockholders ' equity. Fair values are based on prices obtained from an independent pricing service which considers such observable data as dealer quotes, market spreads, cash flows, market consensus prepayment speeds, credit information, and the investment 's terms and conditions, among other factors.

**Internal Use Software Development Costs**

The Company accounts for Internal Use Software Development costs in accordance with American Institute of Certified Public Accountants Statement of Position No. ( SOP ) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. In accordance with SOP 98-1, costs to develop internal use computer software during the application development stage are capitalized and reported as a component of intangible assets and amortized on a straight-line basis over the estimated useful lives of the related software applications.

**Comprehensive Income**

Comprehensive income is comprised of net income and gains or losses resulting from currency translations of foreign investments. The details of comprehensive income are as follows (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Net income	\$ 4,792	\$ 3,156	\$ 11,186	\$ 7,001
Foreign currency translation adjustment	(2,529)	375	(4,134)	835
Comprehensive income	\$ 2,263	\$ 3,531	\$ 7,052	\$ 7,836

**Table of Contents****Stockholders Equity**

The details of changes in stockholders equity are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Balance, beginning of period	\$ 223,644	\$ 107,412	\$ 115,718	\$ 101,026
Net income	4,792	3,156	11,186	7,001
Proceeds from stock option exercises and ESPP	1,039	113	2,581	1,439
Proceeds from issuance of common stock	(153)		99,318	
Share-based compensation expense	913	696	2,336	1,485
Tax effect of option exercises	1,365	38	2,066	922
Adoption of FIN 48				(918)
Comprehensive income	(2,529)	375	(4,134)	835
Balance, end of period	\$ 229,071	\$ 111,790	\$ 229,071	\$ 111,790

**Recent Accounting Pronouncements**

In May 2008, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. ( SFAS ) 162, *The Hierarchy of Generally Accepted Accounting Principles*. SFAS 162 provides a framework for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. Generally Accepted Accounting Principles ( GAAP ) for nongovernmental entities. Prior to the issuance of SFAS 162, the GAAP hierarchy was defined in the American Institute of Certified Public Accountants Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. With the issuance of SFAS 162, the GAAP hierarchy for nongovernmental entities will move from auditing literature to accounting literature. SFAS 162 is effective 60 days following the Securities and Exchange Commission's approval of the Public Company Accounting Oversight Board amendments to remove the GAAP hierarchy from the auditing standards. The adoption of SFAS 162 is not expected to have a material impact on the Company's financial statements.

In May 2008, the FASB staff revisited Emerging Issues Task Force Issue No. ( EITF ) 03-6 and issued FASB Staff Position No. ( FSP ) EITF 03-6-1, *Determining Whether Instruments Granted in Shared-Based Payment Transactions are Participating Securities*. FSP EITF 03-6-01 requires unvested share-based payments that entitle employees to receive nonrefundable dividends to also be considered participating securities, as defined in EITF 03-6. This FSP is effective for fiscal years beginning after December 15, 2008 and interim periods within those years with early adoption prohibited. The adoption of FSP EITF 03-6-01 is not expected to have a material impact on the Company's financial statements.

In March 2008, FASB issued SFAS No. 161, *Disclosures About Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133*, which provides for additional disclosure and documentation surrounding derivative positions and hedging activity. The statement is applicable for all fiscal years beginning on or after November 15, 2008 and earlier adoption is encouraged. The Company does not have material hedging activity and accordingly it does not believe that the adoption of this statement will have a material impact on its financial statements.

In April 2008, the FASB issued FSP 142-3, *Determination of the Useful Life of Intangible Assets*. FSP 142-3 amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under SFAS 142, *Goodwill and Other Intangible Assets*. This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. FSP 142-3 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. The adoption of FSP 142-3 is not expected to have a material impact on the Company's financial statements.

In February 2008, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The fair value measurement election is irrevocable and subsequent changes in fair value must be recorded in earnings. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Unrealized gains and losses on items for which the fair value option is elected would be reported in

## Edgar Filing: NATUS MEDICAL INC - Form 10-Q

earnings. The Company adopted SFAS 159 effective January 1, 2008 and has elected not to measure any additional financial instruments and other items at fair value.

In December 2007 the FASB issued SFAS 141R (revised 2007), *Business Combinations*, which replaces SFAS 141. SFAS 141R requires the acquiring entity in a business combination to recognize most identifiable assets acquired, liabilities assumed, noncontrolling interests and goodwill acquired in a business combination at full fair value; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. SFAS 141R will apply to business combinations completed by the Company after December 31, 2008. The Company does not expect that the adoption of SFAS 141R will have a material impact on its historical financial statements.

**Table of Contents**

In September 2007 the FASB issued SFAS 157, *Fair Value Measurements*. The provisions of SFAS 157 define fair value, establish a framework for measuring fair value in generally accepted accounting principles, and expand disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. The provisions of SFAS 157 are effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FSP 157-2 which defers the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FSP 157-2 will apply to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company adopted SFAS 157 effective January 1, 2008. See Note 13 for a discussion of the Company's fair value accounting.

**2 - Business Combinations, Goodwill, and Intangible Assets****Schwarzer Neurology**

The Company acquired Schwarzer Neurology, a division of Schwarzer GmbH, on July 2, 2008 for EUR 4.5 million, or approximately \$7.0 million including direct costs of the acquisition. Schwarzer Neurology develops and markets computer-based electrodiagnostic systems and disposable supplies used by medical practitioners to aid in the detection, diagnosis, and monitoring of neurologic disorders. The acquisition broadens the Company's product offerings in the EEG market, allowing it to further leverage its international distribution organization. In addition to the purchase price paid at closing, an earnout provision of the purchase agreement could result in additional cash consideration to Schwarzer GmbH based on the future performance of Schwarzer Neurology, as further described below.

In accordance with SFAS 141, *Business Combinations*, the acquisition has been accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed from Schwarzer Neurology as of the date of acquisition are recorded in the consolidated financial statements at their respective fair values as of the acquisition date. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill in the approximate amount of \$1.7 million. The results of operations of Schwarzer Neurology are included in the consolidated financial statements from the date of the acquisition.

The Company is obligated to make future payments pursuant to an earnout provision in the purchase agreement of up to EUR 2.25 million, or approximately \$3.2 million, over a 15-month period based on the achievement of certain revenue targets. To date the Company has not recorded additional purchase consideration as a result of this provision.

The determination of estimated fair value requires management to make significant estimates and assumptions. The Company determined the fair value by applying established valuation techniques, based on information that management believed to be relevant to this determination. The following table summarizes the preliminary purchase price allocation of the fair value of the assets acquired and liabilities assumed as of the date of acquisition (in thousands):

Cash	\$ 14
Accounts receivable	703
Inventories	1,604
Prepaid expenses and other current assets	58
Other receivables	133
Property and equipment	256
Deposits	130
Identifiable intangible assets:	
Developed technology	900
Customer-related	1,200
Trademarks and trade names	900
Goodwill	1,669
Accrued expenses and other current liabilities	(541)
 Total purchase price	 \$ 7,026

**Table of Contents**

Valuing certain components of the acquisition, including primarily inventory, accrued expenses, and warranty obligations, required the Company to make estimates that may be adjusted in the future; consequently, the purchase price allocation is considered preliminary. The Company recorded approximately \$160,000 of direct costs associated with the acquisition. Final determination of these estimates could result in an adjustment to the preliminary purchase price allocation, with an offsetting adjustment to goodwill.

*Identifiable intangible assets.* Intangible assets included in the purchase price allocation consist of: (a) developed technology of \$900,000 assigned an economic life of 20 years being amortized on the straight line method, (b) customer-related intangible assets of \$1.2 million assigned an economic life of eight years being amortized on the straight line method, and (c) trademarks and trade names of \$900,000 that have an indefinite life and are not being amortized.

*Goodwill.* Approximately \$1.7 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the underlying net tangible and intangible assets. In accordance with SFAS 142, *Goodwill and Other Intangible Assets*, goodwill will not be amortized but instead will be tested for impairment at least annually (more frequently if certain indicators are present). In the event that management determines that the value of goodwill has become impaired, the Company will incur an accounting charge for the amount of impairment during the fiscal quarter in which the determination is made.

**Sonamed** The Company acquired Sonamed Corporation ( Sonamed ) on May 27, 2008, for \$9.0 million including direct costs of the acquisition. In June 2008 the Company transitioned substantially all of the operations of Sonamed to its Bio-logic facility in Mundelein, Illinois; Sonamed had previously been based in Massachusetts. The Company continues to manufacture and market the Sonamed Clarity Screener and associated disposable supplies that aid medical practitioners in screening for hearing loss in newborns. The acquisition expands the Company's product offerings in newborn hearing screening.

**Xltek** The Company acquired Excel-Tech Ltd. ( Xltek ) in November 2007 for \$64 million including direct costs of the acquisition. Xltek, based in Oakville, Ontario, Canada develops and markets computer-based electrodiagnostic systems and disposable supplies used by medical practitioners to aid in the detection, diagnosis, and monitoring of neurologic and sleep disorders. The acquisition adds to the Company's growth opportunities by broadening its product offerings in neurology, including Xltek's products for the diagnosis of peripheral nervous system dysfunction.

The Company recognized \$1.1 million of pre-acquisition deferred tax assets during the nine months ended September 30, 2008, for which the Company had previously provided a full valuation allowance, resulting in a decrease in goodwill. The Company recorded additional purchase consideration and accruals for estimated severance benefits of \$27,300 and \$229,700 during the three and nine months ended September 30, 2008, respectively, that were recorded as an increase in goodwill. In addition, a change in the exchange rate between the U.S. dollar and the Canadian dollar resulted in a net decrease in goodwill for the nine months ended September 30, 2008.

Valuing certain components of the Xltek acquisition, consisting primarily of employee severance costs, required the Company to make estimates that may be adjusted in the future; consequently, the purchase price allocation is considered preliminary. Final determination of these estimates as of the purchase date could result in adjustments to the preliminary purchase price allocation, with offsetting adjustments to goodwill.

**Olympic** The Company acquired privately held Olympic Medical Corp. ( Olympic ) in October 2006 for \$16.9 million including direct costs of the acquisition. Olympic, based in Seattle, Washington develops and markets medical products used in the neonatal intensive care unit and pediatric department of the hospital, including devices for the detection of neurologic function of newborns. The acquisition enhances the Company's growth opportunities by broadening its newborn care product offerings, which the Company is leveraging through its direct sales force in the U.S. and international distribution organization.

The Company is obligated to make future payments pursuant to an earnout provision in the purchase agreement of up to \$2.6 million over a three-year period based on the achievement of certain revenue targets for the Olympic Cool-Cap system. The Company recorded additional purchase consideration of \$419,000 and \$822,000 during the three and nine months ended September 30, 2008, respectively, pursuant to this earnout provision that were recorded as an increase in goodwill.

**Nascor** The Company acquired certain product rights, manufacturing and distribution contracts, inventory, and intangible assets from Nascor Pty. Ltd. ( Nascor ) in September 2006 for \$953,000 including direct costs of the acquisition. The Company had previously distributed the associated products in certain markets. This acquisition provides the Company with worldwide distribution rights and improved margins on these products.

The Company is obligated to make future payments pursuant to an earnout provision of the purchase agreement of up to \$675,000 over a three-year period based on the achievement of certain revenue targets. The Company recorded additional purchase consideration of \$279,000

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

during the nine months ended September 30, 2008 pursuant to this earnout provision that was recorded as an increase in goodwill.

**Table of Contents****Goodwill**

The carrying amount of goodwill and the changes in those balances are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Balance, beginning of period	\$ 58,798	\$ 26,987	\$ 54,961	\$ 25,790
Purchase of business	1,664		6,617	
Purchase accounting adjustments	27	339	188	532
Adjustments associated with earnout provisions	329	979	1,102	1,480
Adjustment of pre-acquisition deferred tax assets			(1,065)	503
Change in foreign currency exchange rates	(1,114)		(2,099)	
Balance, end of period	\$ 59,704	\$ 28,305	\$ 59,704	\$ 28,305

**Amortization of Intangible Assets Acquired Through Business Combinations**

Amortization of intangible assets associated with the Company's business combinations was \$782,000 and \$2.6 million for the three and nine months ended September 30, 2008, respectively, and was \$671,000 and \$2.0 million for the three and nine months ended September 30, 2007, respectively.

**Capitalized Software Development Costs**

Pursuant to SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*, the Company capitalized \$0 and \$134,000 of software development costs during the three and nine months ended September 30, 2008, respectively.

Pursuant to SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, the Company capitalized \$372,000 and \$1,158,000 of software development costs during the three and nine months ended September 30, 2008, respectively.

The Company reports capitalized software development costs as a component of intangible assets.

**3 - Basic and Diluted Earnings Per Common Share**

Earnings per share is computed in accordance with SFAS 128, *Earnings Per Share*. Basic earnings per share is based upon the weighted average number of common shares outstanding during the period. Diluted earnings per share is based upon the weighted average number of common shares outstanding and dilutive common stock equivalents outstanding during the period. Common stock equivalents are options granted and shares of restricted stock issued under the Company's stock awards plans and are calculated under the treasury stock method. Common equivalent shares from unexercised stock options are excluded from the computation if the exercise price of such options is greater than the average market price of the stock for the period.

For the three and nine months ended September 30, 2008, common stock equivalents of 1,311,262 and 1,277,836 shares, respectively, were included in the weighted average shares outstanding used to calculate diluted earnings per share. For the three and nine months ended September 30, 2008, common stock equivalents of 366,551 and 220,254 shares, respectively, were excluded from the calculation of diluted earnings per share because the exercise price of such options was greater than the average market price of the stock for the periods. For the three and nine months ended September 30, 2007, common stock equivalents of 1,319,344 and 1,229,984 shares, respectively, were included in the weighted average shares outstanding used to calculate diluted earnings per share. For the three and nine months ended September 30, 2007, common stock equivalents of approximately 506,000 and 38,000 shares, respectively were excluded from the calculation of diluted earnings per share because the exercise price of such options was greater than the average market price of the stock for the periods.

**Table of Contents****4 - Inventories**

Inventories consist of the following (in thousands):

	September 30, 2008	December 31, 2007
Raw materials and subassemblies	\$ 13,328	\$ 12,186
Finished goods	9,905	7,078
<b>Total</b>	<b>\$ 23,233</b>	<b>\$ 19,264</b>

Work in process represents an immaterial amount in all periods presented.

**5 - Property and Equipment**

Property and equipment consist of the following (in thousands):

	September 30, 2008	December 31, 2007
Land	\$ 3,956	\$ 3,956
Building	5,504	5,504
Leasehold improvements	1,243	917
Office furniture and equipment	4,721	4,971
Computer hardware and software	4,725	3,218
Demonstration and loaned equipment	4,794	3,605
	24,943	22,171
Accumulated depreciation	(9,686)	(7,667)
<b>Total</b>	<b>\$ 15,257</b>	<b>\$ 14,504</b>

Depreciation and amortization expense of property and equipment was \$819,000 and \$2.0 million for the three and nine months ended September 30, 2008, respectively, and was \$655,000 and \$1.5 million for the three and nine months ended September 30, 2007, respectively.

**6 - Reserve for Product Warranties**

The Company provides a warranty on all of its medical device products that is generally one year in length. The Company also sells extended service agreements on its medical device products. Service for domestic customers is provided by Company-owned service centers that perform all service, repair and calibration services. Service for international customers is provided by a combination of Company-owned facilities and third-party vendors on a contract basis.

The Company has accrued a warranty reserve, included in accrued liabilities on the accompanying condensed consolidated balance sheets, for the expected future costs of servicing products during the initial warranty period. Amounts are added to the reserve on a per-unit basis by reference to historical experience in honoring warranty obligations. On new products, where the Company does not have historical experience of the cost to honor warranties, additions to the reserve are based on a combination of factors including the standard cost of the product and other judgments, such as the degree to which the product incorporates new technology. As warranty costs are incurred, the reserve is reduced.

The details of activity in the warranty reserve are as follows (in thousands):



Edgar Filing: NATUS MEDICAL INC - Form 10-Q

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Balance, beginning of period	\$ 938	\$ 848	\$ 1,000	\$ 877
Warranty accrued for the period	149	77	399	203
Repairs for the period	(74)	(47)	(386)	(202)
Balance, end of period	\$ 1,013	\$ 878	\$ 1,013	\$ 878

-11-

**Table of Contents****7 - Share-Based Compensation**

At September 30, 2008, the Company has the following plans that give rise to share-based compensation: (i) two active stock option plans, the Amended and Restated 2000 Stock Awards Plan and the 2000 Director Option Plan, and (ii) the 2000 Employee Stock Purchase Plan. The terms of awards granted during the nine months ended September 30, 2008 and the Company's methods for determining grant-date fair value of the awards were consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2007.

Detail of share-based compensation expense is as follows, (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Cost of revenue	\$ 86	\$ 45	\$ 253	\$ 109
Marketing and sales	229	129	558	314
Research and development	102	20	273	82
General and administrative	496	501	1,252	980
<b>Total</b>	<b>\$ 913</b>	<b>\$ 695</b>	<b>\$ 2,336</b>	<b>\$ 1,485</b>

**Stock Options**

Activity in our stock option plans during the nine months ended September 30, 2008 is as follows:

	Shares	Weighted Average Exercise Price	Weighted- average remaining contractual life (years)	Aggregate intrinsic value (\$ ,000 s)
Outstanding, beginning of period	2,879,667	\$ 8.23		
Granted	378,000	\$ 19.98		
Exercised	(365,170)	\$ 6.29		
Cancelled	(46,321)	\$ 15.14		
Outstanding, end of period	2,846,176	\$ 9.93	5.09	\$ 35,158
Exercisable, end of period	2,032,571	\$ 7.41	5.04	\$ 30,229

As of September 30, 2008, the grant date weighted average fair value of stock options granted in 2008 was \$7.01 per share using the Black-Scholes option pricing model. The intrinsic value of options exercised during the nine months ended September 30, 2008 was \$2.3 million.

**Restricted Stock Awards**

Activity in our stock plans related to restricted stock awards during the nine months ended September 30, 2008 is as follows:

Shares	Weighted- average grant date fair value	Remaining cost expected to be recognized
--------	--	--

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

				(\$,000 s)
Outstanding, beginning of period	210,684	\$	14.85	
Awarded	174,500	\$	20.00	
Released	(36,166)	\$	12.91	
Forfeited	(26,250)	\$	16.13	
Outstanding, end of period	322,768	\$	17.75	\$ 5,728

-12-

**Table of Contents**

Of the shares awarded during the period, 159,500 were awarded to U.S. employees of the Company that vest 50% upon the second anniversary of the vesting start date and 25% upon each of the third and fourth anniversaries of the vesting start date, and 15,000 shares were granted to non-employee directors of the Company that vest on the first anniversary of the grant date.

**Restricted Stock Units**

Activity in our stock plans related to the award of restricted stock units during the nine months ended September 30, 2008 is as follows:

	Shares	Weighted- average remaining contractual life (years)	Aggregate intrinsic value (\$ ,000 s)
Outstanding, beginning of period	13,000		
Awarded	23,000		
Released	(1,000)		
Forfeited			
Outstanding, end of period	35,000	2.17	\$ 780

All of the 23,000 units awarded during the period was awarded to non-U.S. employees of the Company that vest 50% upon the second anniversary of the vesting start date and 25% upon each of the third and fourth anniversaries of the vesting start date.

**8 - Other income (expense), net**

Other income (expense), net consists of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Investment income	\$ 435	\$ 182	\$ 803	\$ 552
Interest expense	(28)		(814)	
Foreign currency exchange gain	64		689	14
Other	96	31	276	122
Total	\$ 567	\$ 213	\$ 954	\$ 688

**9 - Income Taxes****Provision for Income Tax**

The Company recorded a provision for income tax of \$2.7 million and \$6.8 million for the three and nine months ended September 30, 2008, respectively. The Company's effective tax rate was 36.1% and 37.8% for the three and nine months ended September 30, 2008, respectively. The Company expects that its effective tax rate for the full year 2008 will be approximately 38%.

The Company's effective tax rate was 32.0% and 35.2% for the three and nine months ended September 30, 2007, respectively.

**Deferred Income Taxes**

The Company accounts for income taxes in accordance with SFAS 109, *Accounting for Income Taxes*, which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets

and liabilities. SFAS 109 also requires that deferred tax

**Table of Contents**

assets be reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax assets will not be realized. A valuation allowance is not provided for the majority of the Company's deferred tax assets, as the Company believes that it is more likely than not that those deferred tax assets will be fully realized.

**Uncertain Tax Positions**

The Company has cumulatively accrued approximately \$422,000 for estimated interest and penalties related to uncertain tax positions at September 30, 2008. The Company recorded approximately \$69,000 and \$207,000 of interest and penalties related to unrecognized tax positions as a component of income tax expense during the three and nine months ended September 30, 2008, respectively.

The Company's tax returns remain open to examination as follows: U.S. federal, 2004 through 2007; U.S. states, generally 2003 through 2007; significant foreign jurisdictions, generally 2005 through 2007.

**10 - Restructuring Reserve**

On February 11, 2008, the Company adopted an integration and restructuring plan that is designed to eliminate redundant costs resulting from prior acquisitions and to improve efficiencies in operations. Under the plan, the Company centralized the research and development activities supporting each of the Company's three main product families, as follows:

Activities associated with North American diagnostic neurology product lines were consolidated at the Xltek facility in Oakville, Ontario, Canada;

Activities associated with newborn hearing screening and diagnostic hearing product lines were consolidated at the Bio-logic facility in Mundelein, Illinois; and

Activities associated with other newborn care products were consolidated at the Olympic Medical facility in Seattle, Washington. In addition, the Company has eliminated redundancies in North American field sales and service personnel resulting from the acquisition of Xltek. Finally, the Company is eliminating certain production resources as it continues to outsource assemblies to contract manufacturers. In addition to the termination of employees in some facilities, the plan provides for the hiring of new employees in other facilities to staff up the required functions.

These actions were phased in during the first nine months of 2008. The Company accrued severance costs under the plan in the amount of \$301,000 ratably from the adoption of the plan through the date of separation of employment of individual employees. The Company accounts for restructuring costs in accordance with SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The balance of the reserve is included in accrued liabilities on the accompanying balance sheets.

Detail of activity in the restructuring reserve is as follows, (in thousands):

	Balance January 31, 2008	Charged to expense	Amounts paid	Balance September 30, 2008
Employee termination benefits	\$	301	243	\$ 58

In addition to the above severance costs of approximately \$301,000 that were accrued ratably pursuant to SFAS 146, the Company has incurred other costs directly associated with the restructuring that do not qualify for accrual and reporting under SFAS 146. These costs are charged to expense as incurred and consist primarily of stay bonuses paid to employees upon termination of their employment. The Company charged to expense \$73,000 and \$183,000 of such costs during the three and nine months ended September 30, 2008, respectively.



**Table of Contents****11 - Debt and Credit Arrangements**

Long-term borrowings are composed of the following (dollars in thousands):

	September 30, 2008	December 31, 2007
Term loan \$25,000 interest at LIBOR rate plus 1.50%, due November 28, 2010 with principal repayable in quarterly installments of \$2,100	\$	\$ 25,000
Revolving line of credit \$13,000 interest at LIBOR rate plus 1.75%, with principal due on November 28, 2009		10,000
Term loan Canadian ( CAD ) 2,900, interest at cost of funds plus 2.5%, due September 15, 2014 with principal repayable in monthly installments of \$16 until August 15, 2014, and one final payment of \$404 collateralized by a first lien on the land and building owned by Xltek	1,453	1,704
Term loan CAD 300, interest at cost of funds plus 2.5%, due November 15, 2010 with principal repayable in monthly installments of \$2 until October 10, 2010 and one final payment of \$36 collateralized by various assets of Xltek	86	112
Total long-term debt (including current portion)	1,539	36,816
Less: current portion of long-term debt	(206)	(18,554)
Total long-term debt	\$ 1,333	\$ 18,262

On September 2, 2008, the Company executed the Second Amendment to its Amended and Restated Credit Agreement (the Second Amendment ) with Wells Fargo Bank, National Association ( Wells Fargo ). The Second Amendment increases the borrowing limit of the Company s Revolving Line of Credit to \$25 million and makes other changes to the terms of the credit facility. The credit facility contains covenants, including covenants relating to liquidity and other financial measurements, and provides for events of default, including failure to pay any interest when due, failure to perform or observe covenants, bankruptcy or insolvency events and the occurrence of a material adverse effect. The Company has granted Wells Fargo a security interest in all of the assets of the Company. As of September 30, 2008 there were no outstanding borrowings on the credit facility.

**12 - Segment, Customer and Geographic Information**

The Company operates in one reportable segment in which it provides healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care, including jaundice, brain injury, and metabolic testing.

Our end-user customer base includes hospitals, clinics, laboratories, physicians, nurses, audiologists, and governmental agencies. Most of our international sales are to distributors, who in turn, resell our products to end users or sub-distributors.

Revenue and long-lived asset information by geographic region is as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Revenue:				
United States	\$ 29,924	\$ 19,738	\$ 83,219	\$ 57,122
Foreign countries	11,790	9,092	35,216	27,018



Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Totals

\$ 41,714 \$ 28,830 \$ 118,435 \$ 84,140

	September 30, 2008	December 31, 2007
Long lived assets:		
United States	\$ 7,851	\$ 7,547
Foreign countries	7,406	6,957
Totals	\$ 15,257	\$ 14,504

-15-

**Table of Contents**

Long-lived assets consist principally of property and equipment. No single customer or foreign country contributed to more than 10% of revenue during the three and nine months ended September 30, 2008, and revenue from services was less than 10% of revenue during the same periods.

**13 - Fair Value of Financial Instruments**

The Company's cash equivalents and short-term investments consist principally of commercial paper with a rating of A-1/A-1+. Pursuant to SFAS 157, *Fair Value Measurements*, these investments are classified as Level 2, where value is based on quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the underlying investment.

The Company's assets measured at fair value on a recurring basis subject to the disclosure requirements of SFAS 157 are as follows (in thousands):

	September 30, 2008	December 31, 2007
Cash equivalents	\$ 60,696	\$ 11,916
Short-term investments	970	
<b>Totals</b>	<b>\$ 61,666</b>	<b>\$ 11,916</b>

Fair values are based on observable data such as dealer quotes, market spreads, cash flows, market consensus prepayment speeds, credit information, and the investment's terms and conditions, among other factors.

**14 - Subsequent Events****Acquisition of NeuroCom International, Inc.**

The Company acquired all of the common stock of NeuroCom International, Inc. on October 2, 2008 for \$18 million in cash, excluding direct costs of the acquisition. NeuroCom, based in Clackamas, Oregon, develops and markets computerized systems for the assessment and rehabilitation of balance and mobility disorders. The acquisition adds to the Company's growth opportunities by broadening its product offerings in its neurology business.

**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*Natus*®, *AABR*®, *ABaer*®, *ALGO*®, *AuDX*®, *Biliband*®, *Bio-logic*®, *Ceegrath*®, *CHAMP*®, *Cool-Cap*®, *Ear Couplers*®, *Flexicoupler*®, *MASTER*®, *Navigator*®, *neoBLUE*®, *Oxydome*®, *Sleepscan*®, *Smart Scale*®, *Sonamed*®, *Traveler*®, *Warmette*® and *VAC PAC*® are registered trademarks of Natus Medical Incorporated. *Accuscreen* , *Bili-Lite Pad* , *Bili-Lite* , *Billi Bassinet* , *Bili Mask* , *Bili Meter* , *Circumstraint* , *EchoLink* , *MiniMuffs* , *Neometrics* , *Papoose Board* , *Smartpack* , *Sonamed Clarity* , and *Warm Lamp* are non-registered trademarks of Natus. *Solutions for Newborn CareSM* is a non-registered service mark of Natus. *Deltamed*® and *Coherence*® are registered trademarks of Deltamed SA. *Fischer-Zoth*®, *AOAE*®, *Cochlea Scan*® and *Echo Screen*® are registered trademarks of Fischer-Zoth GmbH. *Sleeprite*® is a registered trademark of Excel-Tech Ltd. *Neuromax* and *Xltek* are non-registered trademarks of Excel-Tech Ltd.

**Overview**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) supplements the MD&A in the Annual Report on Form 10-K for the year ended December 31, 2007 of Natus Medical Incorporated ( Natus, we, us, or our Company ), and presumes that readers have read or have access to the discussion and analysis in the Company's Annual Report. Management's discussion and analysis should be read in conjunction with the Company's condensed consolidated financial statements and accompanying footnotes, the discussion of certain risks and uncertainties contained in Part II, Item 1A of this report, and the cautionary information regarding forward-looking statements at the end of this section. MD&A includes the following sections:

**Our Business.** A general description of the Company's business;

---

**Table of Contents**

**2008 Third Quarter Overview.** A summary of key information concerning the financial results for the three months ended September 30, 2008;

**Application of Critical Accounting Policies.** A discussion of the accounting policies that are most important to the portrayal of the Company's financial condition and results of operations and that require significant estimates, assumptions, and judgments;

**Results of Operations.** An analysis of the Company's results of operations for the periods presented in the financial statements;

**Liquidity and Capital Resources.** An analysis of capital resources, sources and uses of cash, investing and financing activities, off-balance sheet arrangements, contractual obligations and interest rate hedging;

**Recent Accounting Pronouncements.** See Note 1 to our Condensed Consolidated Financial Statements for a discussion of new accounting pronouncements that affect us; and

**Cautionary Information Regarding Forward-Looking Statements.** Cautionary information about forward-looking statements.

**Business**

Natus is a provider of healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care. We develop, manufacture, and market advanced neurodiagnostic and newborn care products to healthcare professionals in over 100 countries. Our product offerings include computerized neurodiagnostic systems for audiology, neurology, polysomnography, and neonatology, as well as newborn care products such as hearing screening systems, phototherapy devices for the treatment of newborn jaundice, head-cooling products for the treatment of brain injury in newborns, and software systems for managing and tracking disorders and diseases for public health laboratories.

We have completed a number of acquisitions since 2003, consisting of either the purchase of a company, substantially all of the assets of a company, or individual products or product lines. The businesses we have acquired include Neometrics in 2003, Fischer-Zoth in 2004, Bio-logic, Deltamed, and Olympic in 2006, Xltex in 2007 and Sonamed and the neurology business of Schwarzer GmbH as of September 30, 2008.

***Product Families***

We categorize our products into the following product families, which are more fully described in our Annual Report on Form 10-K for the year ended December 31 2007:

***Hearing*** Includes products for newborn hearing screening and diagnostic hearing assessment.

***Newborn Care*** Includes products for the treatment of brain injury and jaundice in newborns.

***Neurology*** Includes product lines for diagnostic electroencephalography ( EEG ) analysis, diagnostic sleep analysis ( PSG ), electromyography ( EMG ), intra-operative monitoring ( IOM ), and newborn brain monitoring.

***Segment and Geographic Information***

We operate in one reportable segment in which we provide healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders and newborn care, including jaundice, brain injury, and metabolic testing.

## Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Our end-user customer base includes hospitals, clinics, laboratories, physicians, nurses, audiologists, and governmental agencies. Most of our international sales are to distributors who resell our products to end users or sub-distributors.

Information regarding our sales and long-lived assets in the U.S. and in countries outside the U.S. is contained in Note 12 *Segment, Customer and Geographic Information* of our condensed consolidated financial statements included in this report.

**Table of Contents****Revenue by Product Category**

We generate our revenue either from sales of Devices and Systems, which are generally non-recurring, and from related Supplies and Services, which are generally recurring. The products that are attributable to these categories are described in our Annual Report on Form 10-K for the year ended December 31, 2007. Revenue from Devices and Systems, and Supplies and Services, as a percent of total revenue for the three and nine months ended September 30, 2008 and 2007 is as follows:

	Devices and Systems	Supplies and Services	Other	Total
Three months ended September 30,				
2008	61%	37%	2%	100%
2007	62%	37%	1%	100%
Nine months ended September 30,				
2008	62%	36%	2%	100%
2007	60%	38%	2%	100%

Sales to no single end-user customer comprised more than 10% of our revenue, and revenue from services was less than 10% of our revenue in all periods presented.

We sell our products primarily through a direct sales force in the U.S. and to distributors who sell our products in over 100 other countries. We intend to continue expansion of our international operations because we believe international markets represent a significant growth opportunity. International sales made to distributors are characterized by lower gross profits due to the discount from our list prices that the distributors receive. International sales contributed to 28% and 30% of our revenue during the three and nine months ended September 30, 2008, respectively, and to 31% and 32% of our revenue during the same periods in 2007. We anticipate that international revenue will increase as a percentage of revenue in the future.

**2008 Third Quarter Overview**

Our revenue increased 44.7% to \$41.7 million in the third quarter ended September 30, 2008, compared to \$28.8 million reported in the comparable quarter of the previous year. Net income increased 51.8% to \$4.8 million, or \$0.17 per diluted share, for the third quarter of 2008, compared with net income of \$3.2 million, or \$0.14 per diluted share, for the third quarter of 2007.

On July 2, 2008, we acquired Schwarzer Neurology, a division of Schwarzer GmbH for EUR 4.4 million, or approximately \$6.9 million including direct costs of the acquisition. Schwarzer Neurology develops and markets computer-based electrodiagnostic systems and disposable supplies used by medical practitioners to aid in the detection, diagnosis, and monitoring of neurologic disorders.

On October 2, 2008 we acquired all of the common stock of NeuroCom International, Inc. ( NeuroCom ) for \$18 million in cash, excluding direct costs of the acquisition. NeuroCom, based in Clackamas, Oregon, develops and markets computerized systems for the assessment and rehabilitation of balance and mobility disorders.

**Application of Critical Accounting Policies**

We prepare our financial statements in accordance with accounting principles generally accepted in the United States of America ( GAAP ). In so doing, we must often make estimates and use assumptions that can be subjective and, consequently, our actual results could differ from those estimates. For any given individual estimate or assumption we make, there may also be other estimates or assumptions that are reasonable.

We believe that the following critical accounting policies require the use of significant estimates, assumptions, and judgments. The use of different estimates, assumptions, and judgments could have a material effect on the reported amounts of assets, liabilities, revenue, expenses, and related disclosures as of the date of the financial statements and during the reporting period.

Revenue recognition

Allowance for doubtful accounts

Inventory is carried at the lower of cost or market value

Carrying value of intangible assets

-18-

**Table of Contents**

Liability for product warranties

Share-based compensation

These critical accounting policies are described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2007, under Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*. There have been no changes to these policies during the three and nine months ended September 30, 2008.

**Results of Operations**

The following table sets forth, for the periods indicated, selected consolidated statements of operations data as a percentage of total revenue. Our historical operating results are not necessarily indicative of the results for any future period.

	Three Months Ended June 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	38.0	35.1	38.2	36.2
Gross profit	62.0	64.9	61.8	63.8
Operating expenses:				
Marketing and selling	23.9	23.4	24.5	23.9
Research and development	9.7	13.5	10.1	14.4
General and administrative	11.8	12.7	12.8	13.5
Total operating expenses	45.4	49.6	47.4	51.8
Income from operations	16.6	15.3	14.4	12.0
Other income, net	1.4	0.7	0.8	0.8
Income before provision for income tax	18.0	16.0	15.2	12.8
Income tax provision	6.5	5.0	5.7	4.5
Net income	11.5%	11.0%	9.5%	8.3%

We acquired Xltek in November 2007, Sonamed in May 2008, and Schwarzer Neurology in July 2008. Where significant, we have noted the impact of these acquisitions on our results of operations for the three and nine months ended September 30, 2008, as compared to the same periods in 2007.

**Three Months Ended September 30, 2008 and 2007**

Revenue increased \$12.9 million, or 45%, to \$41.7 million in the three months ended September 30, 2008, compared to \$28.8 million in the same period in 2007. Xltek contributed to \$9.8 million of the increase.

Revenue from devices and systems increased \$7.7 million, or 43%, to \$25.5 million in the three months ended September 30, 2008, compared to \$17.9 million in the same period 2007. Xltek contributed to \$7.5 million of revenue from devices and systems. In addition, we experienced an increase in revenue from our newborn and diagnostic hearing products and newborn care products that was partially offset by reductions in revenue from our Bio-logic diagnostic neurology products.

Revenue from supplies and services increased \$5.1 million, or 50%, to \$15.4 million in the third quarter of 2008 compared to \$10.3 million in the 2007 third quarter. Xltek contributed to \$2.2 million of the increase. Revenue from disposable supplies used with the Company's newborn hearing screening devices increased \$1.8 million, or 22%, to \$9.6 million.



## Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Revenue from sales outside the U.S. increased \$2.7 million, or 30%, to \$11.8 million in the third quarter of 2008 compared to \$9.1 million for the same period in 2007. Xltek and Schwarzer Neurology contributed to \$2.7 million of the increase, respectively.

---

**Table of Contents**

Gross profit as a percentage of revenue was 62.0% for the three months ended September 30, 2008 compared to 64.9% for the respective period in 2007. The results of Schwarzer Neurology and product mix reduced consolidated gross profit for the three months ended September 30, 2008, compared to the same period in 2007. Cost of revenue increased \$5.7 million, or 56%, to \$15.8 million in the three months ended September 30, 2008, from \$10.1 million in 2007. Gross profit increased \$7.2 million, or 38%, to \$25.9 million in 2008 from \$18.7 million in 2007.

Total operating costs increased by \$4.7 million, or 32%, to \$18.9 million in the three months ended September 30, 2008, compared to \$14.3 million in the same period in 2007. The operations of Xltek, Sonamed, and Schwarzer Neurology contributed to \$3.6 million of the increase in operating costs. The net increase in total operating costs from factors other than the foregoing was primarily attributable to increases in outside consulting costs and employee compensation.

Marketing and selling expenses increased \$3.2 million, or 48%, to \$10.0 million in the three months ended September 30, 2008 compared to \$6.8 million in the same period in 2007. The operations of Xltek, Sonamed, and Schwarzer Neurology contributed to \$1.9 million of the increase in marketing and selling expense, including the compensation of Xltek sales personnel who became employees of the Natus domestic sales organization effective January 1, 2008. The remainder of the increase was primarily due to increased sales compensation, related travel expenses, and commission payments to distributors of the Company's diagnostic hearing products.

Research and development expenses increased \$187,000, or 4.8%, to \$4.1 million for in the three months ended September 30, 2008 compared to \$3.9 million in the same period in 2007. The operations of Xltek, Sonamed, and Schwarzer Neurology resulted in an increase of \$969,000 of research and development expenses, which were offset by a reduction in other research and development costs resulting primarily from restructuring activities implemented after the acquisition of Xltek in November 2007. Research and development expenses as a percent of total revenue decreased from 13.5% in the three months ended September 30, 2007 to 9.7% for the three months ended September 30, 2008.

General and administrative expenses increased \$1.3 million, or 34%, to \$4.9 million in the three months ended September 30, 2008 compared to \$3.7 million in the same period in 2007. The operations of Xltek, Sonamed, and Schwarzer Neurology contributed to \$708,000 of the increase in general and administrative expenses. Outside services, consulting costs associated with our information technology infrastructure, and higher compensation costs accounted for the remainder of the cost increase.

The Company adopted an integration and restructuring plan in February 2008 that was designed to eliminate redundant costs resulting from prior acquisitions and to improve efficiencies in operations. These actions were phased in during the first nine months of 2008. Costs under the plan, which were primarily for severance benefits, stay bonuses, and duplicative salaries, totaled approximately \$700,000. These expenses were incurred approximately ratably from the time employees were notified of the plan through their targeted separation-of-employment date. The Company accrued \$64,000 and \$301,000 of employee termination benefits in the three and nine months ended September 30, 2008. The plan is expected to result in annual operating cost reduction of approximately \$2.4 million in 2009 and beyond. The Company had no similar costs in the respective period in 2007.

Other income, net consists of investment income and net capital gains and losses from our investment portfolio, interest expense, net currency exchange gains and losses, and other miscellaneous income and expenses. We reported net other income of \$567,000 in the three months ended September 30, 2008, compared to \$213,000 in the same period in 2007 due primarily to interest income and foreign currency gains, partially offset by interest expense.

We recorded income tax expense of \$2.7 million in the three months ended September 30, 2008, compared to \$1.5 million in the same period in 2007. Our effective tax rate in the third quarter of 2008 was 36.1% compared to an effective rate of 32.0% in the third quarter of 2007. The lower effective tax rate in 2007 was primarily attributable to discrete tax adjustments including a true-up of research and development tax credits for which there were not corresponding items in 2008.

**Nine Months Ended September 30, 2008 and 2007**

Certain reclassifications have been made to the breakdown of revenue from devices and systems versus supplies and services in the results for the nine months ended September 30, 2007 to conform to the current presentation.

Revenue increased \$34.3 million, or 41%, to \$118.4 million in the nine months ended September 30, 2008, compared to \$84.1 million reported in the same period in 2007. Xltek contributed to \$28.3 million of the increase.

Revenue from devices and systems increased \$21.5 million, or 41%, to \$73.8 million in the nine months ended September 30, 2008, compared to \$52.3 million reported in the same period in 2007. Xltek contributed to \$21.1 million of this increase. Revenue from our newborn hearing and newborn care products was partially offset by decreases in revenue from our other diagnostic neurology products.



---

**Table of Contents**

Revenue from supplies and services increased \$12.6 million, or 42%, to \$42.4 million in the nine months ended September 30, 2008, compared to \$29.8 million reported in the same period in 2007. Xltek contributed to \$6.9 million of the increase. Revenue from disposable supplies used with the Company's newborn hearing screening devices increased 15%, to \$26.1 million.

Revenue from sales outside the U.S. increased \$8.9 million, or 34%, to \$35.2 million for the nine months ended September 30, 2008, compared to \$26.3 million reported in the same period in 2007. Xltek and Schwarzer Neurology contributed to \$6.0 million of the increase. Revenue from the Company's newborn care products and hearing screening products also contributed to the increase.

Gross profit as a percentage of revenue was 61.8% for the nine months ended September 30, 2008 compared to 63.8% for the respective period in 2007. The results of Xltek and Schwarzer Neurology, and product mix reduced consolidated gross profit for the nine months ended September 30, 2008, compared to the same period in 2007. Cost of revenue increased \$14.8 million, or 48%, to \$45.2 million in the nine months ended September 30, 2008, from \$30.5 million in 2007. Gross profit increased \$19.6 million, or 36%, to \$73.2 million in 2008 from \$53.7 million in 2007.

Total operating costs increased by \$12.6 million, or 29%, to \$56.2 million in the nine months ended September 30, 2008, compared to \$43.6 million in the same period in 2007. The operations of Xltek, Sonamed, and Schwarzer Neurology contributed to \$9.7 million of the increase in operating costs. The net increase in total operating costs from factors other than the foregoing was primarily attributable to increases in employee compensation and outside consulting costs.

Marketing and selling expenses increased \$8.9 million, or 44%, to \$29.0 million in the nine months ended September 30, 2008 from \$20.1 million in the same period in 2007. The operations of Xltek, Sonamed, and Schwarzer Neurology contributed to \$5.0 million of the increase, including the compensation of Xltek sales personnel who became employees of the Natus domestic sales organization effective January 1, 2008. The remainder of the increase came primarily from increased sales compensation, related travel expenses, and commission payments to distributors of the Company's diagnostic hearing products.

Research and development expenses decreased \$114,000, or 0.9%, to \$12.0 million in the nine months ended September 30, 2008 from \$12.1 million in 2007. The operations of Xltek, Sonamed, and Schwarzer Neurology resulted in an increase of \$2.6 million in research and development expenses, which was offset by a reduction in other research and development costs resulting from leveraging investments in infrastructure made in 2007. Research and development expenses as a percent of total revenue decreased from 14.4% in the nine months ended September 30, 2007, to 10.1% for the respective period in 2008.

General and administrative expenses increased \$3.8 million, or 34%, to \$15.2 million in the nine months ended September 30, 2008 from \$11.4 million in the same period in 2007. The operations of Xltek, Sonamed, and Schwarzer Neurology contributed to \$2.1 million of the increase. A reduction of general and administrative expenses as a percent of total revenue from 13.5% reported for the nine months ended September 30, 2007, to 12.8% for the respective period in 2008 resulted primarily from synergies associated with the acquisition of Xltek and leveraging investments in infrastructure made in 2007.

The Company adopted an integration and restructuring plan in February 2008 that was designed to eliminate redundant costs resulting from prior acquisitions and to improve efficiencies in operations. These actions were phased in during the first nine months of 2008. Costs under the plan, which were primarily for severance benefits, stay bonuses, and duplicative salaries, totaled approximately \$700,000. These expenses were incurred approximately ratably from the time employees were notified of the plan through their targeted separation-of-employment date. The Company accrued \$64,000 and \$301,000 of employee termination benefits in the three and nine months ended September 30, 2008. The plan is expected to result in annual operating cost reduction of approximately \$2.4 million in 2009 and beyond. The Company had no similar costs in the respective period in 2007.

Other income, net consists of investment income and net capital gains and losses from our investment portfolio, interest expense, net currency exchange gains and losses, and other miscellaneous income and expenses. We reported net other income of \$954,000 in the nine months ended September 30, 2008, compared to \$688,000 in the same period in 2007 due primarily to interest income and foreign currency gains, partially offset by interest expense.

We recorded income tax expense of \$6.8 million in the nine months ended September 30, 2008, compared to \$3.8 million in the same period in 2007. Our effective tax rate in the first nine months of 2008 was 37.8% compared to an effective rate of 35.2% in the first nine months of 2007. The lower effective tax rate in 2007 was primarily attributable to discrete tax adjustments including a true-up of research & development tax credits for which there were no corresponding items in 2008.



---

**Table of Contents**

**Liquidity and Capital Resources**

Liquidity is our ability to generate sufficient cash flows from operating activities to meet our obligations and commitments. In addition, liquidity includes the ability to obtain appropriate financing or to raise capital. Therefore, liquidity cannot be considered separately from capital resources that consist of our current funds and the potential to increase those funds in the future. We plan to use our capital resources in meeting our commitments and in achieving our business objectives.

As of September 30, 2008, we had cash and cash equivalents of \$68.0 million, short-term investments of \$1.0 million, stockholders' equity of \$229.0 million, and working capital of \$107.2 million, compared with cash and cash equivalents of \$11.9 million, stockholders' equity of \$115.7 million, and working capital of \$19.2 million as of December 31, 2007. In early October 2008 we completed the acquisition of NeuroCom for \$18 million in cash, excluding costs of the acquisition.

We believe that our current cash, cash equivalents, and short-term balances, including cash generated from the underwritten sales of our common stock in April and May 2008, and any cash generated from operations, will be sufficient to meet our ongoing operating and capital requirements for the foreseeable future. We have completed three acquisitions in 2008, including the NeuroCom acquisition in the fourth quarter of 2008, one in 2007 and three in 2006. We intend to continue to acquire additional technologies, products or businesses, and these acquisitions could be significant. These actions would likely affect our future capital requirements and the adequacy of our available funds. We may be required to raise additional funds through public or private financings, strategic relationships, or other arrangements. Any equity financing may be dilutive to stockholders, and debt financing, if available, may involve restrictive covenants and increase our cost of capital.

On September 2, 2008, the Company executed the Second Amendment to its Amended and Restated Credit Agreement (the "Second Amendment") with Wells Fargo Bank, National Association ("Wells Fargo"). The Second Amendment increases the borrowing limit of the Company's Revolving Line of Credit to \$25 million and makes other changes to the terms of the credit facility. The credit facility contains covenants, including covenants relating to liquidity and other financial measurements, and provides for events of default, including failure to pay any interest when due, failure to perform or observe covenants, bankruptcy or insolvency events and the occurrence of a material adverse effect. The Company has granted Wells Fargo a security interest in all of the assets of the Company.

Cash provided by operations decreased by \$1.5 million for the nine months ended September 30, 2008 to \$4.2 million, compared to \$5.7 million for the same period in 2007. The sum of our net income and non-cash expense items, such as reserves, depreciation and amortization, and stock based compensation, was approximately \$16.7 million in the 2008 period, compared to \$11.4 million in 2007. The overall impact of changes in certain operating assets and liabilities on total operating cash flows resulted in a cash outflow of \$12.5 million in 2008 and \$5.7 million in 2007.

Cash used in investing activities was \$18.1 million for the nine months ended September 30, 2008 compared to \$1.8 million for the same period in 2007. We acquired \$2.2 million and \$1.6 million of property and equipment in the nine months ended September 30, 2008 and 2007, respectively. We used \$13.8 million of cash to acquire businesses and we recorded \$1.2 million of internal use software development costs in 2008 with no similar expenditures in 2007. In addition, we purchased \$12.1 million of marketable securities and sold \$11.1 million of marketable securities with no similar activities in 2007.

Cash provided by financing activities was \$68.8 million during the nine months ended September 30, 2008 compared to cash provided by financing activities of \$2.4 million in the same period in 2007. We raised an aggregate of \$99.3 million through underwritten registered public offerings of our common stock in April and May 2008 with no similar transactions in 2007. We raised cash through sales of our stock pursuant to our stock awards plans and our employee stock purchase plan in the amount of \$2.6 million and \$1.4 million in the nine months ended September 30, 2008 and 2007, respectively. We also realized an excess tax benefit of \$2.1 million on the exercise of employee stock options as of September 30, 2008 compared with an excess tax benefit of \$922,000 as of September 30, 2007, that was recorded in both periods as an increase to stockholders' equity. During the nine months ended September 30, 2008, we borrowed \$6.0 million under our revolving line of credit and we repaid \$25.2 million on our term loan and \$16.0 million on our revolving credit facility, resulting in a net cash outflow of \$41.2 million. We had no similar uses of cash for financing activities in the nine months ended September 30, 2007.

---

## **Table of Contents**

Our future liquidity and capital requirements will depend on numerous factors, including the:

Amount and timing of revenue;

Extent to which our existing and new products gain market acceptance;

Extent to which we make acquisitions;

Cost and timing of product development efforts and the success of these development efforts;

Cost and timing of marketing and selling activities; and

Availability of borrowings under line of credit arrangements and the availability of other means of financing.

### **Commitments and Contingencies**

In the normal course of business, we enter into obligations and commitments that require future contractual payments. The commitments primarily result from firm, noncancellable purchase orders placed with contract vendors that manufacture some of the components used in our medical devices and related disposable supply products, as well as commitments for leased office, manufacturing, and warehouse facilities. There have been no material changes to the table of contractual obligations presented in Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, of the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

Under its bylaws, the Company has agreed to indemnify its officers and directors for certain events or occurrences arising as a result of the officer or director serving in such capacity. We have a directors' and officers' liability insurance policy that limits our exposure and enables us to recover a portion of any amounts paid resulting from the indemnification of our directors and officers. In addition, we enter into indemnification agreements with other parties in the ordinary course of business. We believe the estimated fair value of these indemnification agreements is minimal and we have not recorded a liability for these agreements.

### **Recent Accounting Pronouncements**

See Note 1 to our Condensed Consolidated Financial Statements for a discussion of recent accounting pronouncements that affect us.

### **Cautionary Information Regarding Forward Looking Statements**

*This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 about Natus Medical Incorporated. These statements include, among other things, statements concerning our expectations, beliefs, plans, intentions, future operations, financial condition and prospects, and business strategies. The words may, will, continue, estimate, project, intend, believe, expect, anticipate, and other similar expressions generally identify forward-looking statements. Forward-looking statements in this Item 2 include, but are not limited to, statements regarding the following: annual operating cost reductions resulting from restructuring activities, our expectation regarding expansion of our international operations, our expectations regarding our new products, including the ALGO 5, the sufficiency of our current cash, cash equivalents, and short-term investment balances, and any cash generated from operations to meet our ongoing operating and capital requirements for the foreseeable future, and our intent to acquire additional technologies, products, or businesses*

*Forward-looking statements are not guarantees of future performance and are subject to substantial risks and uncertainties that could cause the actual results predicted in the forward-looking statements as well as our future financial condition and results of operations to differ materially from our historical results or currently anticipated results. Investors should carefully review the information contained under the caption Risk Factors contained in Part II, Item 1A of this report for a description of risks and uncertainties. All forward-looking statements are based on*

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

*information available to us on the date hereof, and we assume no obligation to update forward-looking statements.*

-23-



---

**Table of Contents**

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

We develop products in the U.S, Canada, and Europe and sell those products primarily in the U.S., Europe and Asia. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Most of our sales in Europe and Asia are denominated in U.S. dollars and euros, and with the acquisition of Xltek in November 2007, a small portion of our sales are now denominated in Canadian dollars. As our sales in currencies other than the U.S. dollar increase, our exposure to foreign currency fluctuations may increase.

In addition, changes in exchange rates also may affect the end-user prices of our products compared to those of our foreign competitors, who may be selling their products based on local currency pricing. These factors may make our products less competitive in some countries.

If the U.S. dollar uniformly increased or decreased in strength by 10% relative to the currencies in which our sales were denominated, our net income would have correspondingly increased or decreased by an immaterial amount for the nine months ended September 30, 2008. Our interest income is sensitive to changes in the general level of interest rates in the U.S., particularly since the majority of our investments are in short-term instruments and cash equivalents. However, as substantially all of our short-term investments carry a fixed rate of interest, a hypothetical decrease of 10% in market interest rates would not result in a material decrease in interest income earned on investments held at September 30, 2008 through the date of maturity on those investments.

When able, we invest excess cash in short-term investments. The fair value of short-term investments and cash equivalents ( investments ) is sensitive to changes in the general level of interest rates in the U.S., and the fair value of these investments will fall if market interest rates increase. However, since we generally have the ability to hold these investments to maturity, these declines in fair value may never be realized. If market interest rates were to increase by 10% from levels at September 30, 2008, the fair value of our investments would decline by an immaterial amount.

All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of September 30, 2008. Actual results may differ as our analysis of the effects of changes in interest rates does not account for, among other things, sales of securities prior to maturity and repurchase of replacement securities, the change in mix or quality of the investments in the portfolio, and changes in the relationship between short-term and long-term interest rates.

**ITEM 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

Under the rules of the Securities and Exchange Commission, disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in our reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Our Company s management, with the participation of our chief executive officer and our chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2008. Our chief executive officer and chief financial officer determined that as of September 30, 2008 our disclosure controls and procedures were effective for the purpose set forth above.

*Changes in Internal Control over Financial Reporting*

Under the rules of the Securities and Exchange Commission, internal control over financial reporting is defined as a process designed by, or under the supervision of, an issuer s principal executive and principal financial officers, and effected by the issuer s board of directors, management and other personnel, to provide reasonable assurances regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

There was no change in the Company s internal control over financial reporting that occurred during the fiscal quarter ended September 30, 2008, 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 1. Legal Proceedings**

On March 27, 2008 a complaint filed in Federal District Court in Seattle, Washington on January 29, 2008, as more fully described in Item 3, Legal Proceedings, of our Annual Report on Form 10-K for the year ended December 31, 2007 was dismissed. On March 31, 2008 the same plaintiff filed a complaint in the Superior Court of Washington. The new complaint is substantially the same as the prior federal complaint, except that no claim is asserted under the federal False Claims Act.

We may from time to time become a party to various other legal proceedings or claims that arise in the ordinary course of business. Our management monitors these matters if and when they arise.

**ITEM 1A. Risk Factors**

**We have completed a number of acquisitions and expect to complete additional acquisitions in the future. There are numerous risks associated with acquisitions and we may not achieve the expected benefit of any of our acquisitions**

Our acquisitions of products, technology assets, or businesses may have a negative impact on our business if we fail to achieve the anticipated financial, strategic, and other benefits of acquisitions or investments, and our operating results may suffer because of this.

We acquired intellectual property assets and technology patents from Pemstar Pacific Consultants during 2002; we acquired the assets of Neometrics Inc. and affiliated entities during 2003; and we acquired Fischer-Zoth in 2004. We completed the acquisitions of Bio-logic, Deltamed and Olympic, and of certain assets from Nascor in 2006. In November 2007 we completed the acquisition of Xltek and in 2008 we completed the acquisitions of Sonamed, the neurology business assets of Schwarzer GmbH and NeuroCom.

We expect to continue to pursue opportunities to acquire other businesses in future periods. The acquisitions that we have completed may not result in improved operating results for us, or in our achieving a financial condition superior to that which we would have achieved had we not completed them. Our results of operations may be adversely impacted by costs associated with our acquisitions, including one-time charges associated with restructurings or in-process research and development assets. Our acquisitions could fail to produce the benefits that we anticipate, or could have other adverse effects that we currently do not foresee. In addition, some of the assumptions that we have relied upon, such as achievement of operating synergies, may not be realized. In this event, one or more of the acquisitions could result in reduced earnings of Natus as compared to the earnings that would have been achieved by Natus if the acquisition had not occurred.

We have incurred indebtedness to fund some of our acquisitions. The use of debt to fund our acquisitions may have an adverse impact on our liquidity and cause us to place more reliance on cash flow from operations for our liquidity. If our cash flow from operations is not sufficient for our needs, our business could be adversely affected. If we are required to seek additional external financing to support our need for cash to fund future acquisitions, we may not have access to financing on terms that are acceptable to us, or at all. Alternatively, we may feel compelled to access additional financing on terms that are dilutive to existing holders of our common stock or that include covenants that restrict our business, or both. If the recent lack of liquidity in credit markets persists into the future, our ability to obtain debt financing for future acquisitions may be impaired.

If we fail to successfully manage the combined operations of Natus and the businesses we have acquired, we may not realize the potential benefits of the acquisition. Our corporate headquarters are located in San Carlos, California. We also have the following operating divisions: Bio-logic in Illinois, Olympic in Washington, NeuroCom in Oregon, Neometrics in New York; Xltek in Ontario, Canada, Deltamed in France, and Fischer-Zoth, IT-Med and Schwarzer Neurology in Germany. The geographical distance between our various facilities may further adversely affect our ability to manage these operations. If we fail to manage these disparate operations effectively, our results of operations could be harmed, employee morale could decline, key employees could leave, and customers could cancel existing orders or choose not to place new orders. In addition, we may not achieve the synergies or other benefits of these and future acquisitions that we anticipate. We may encounter the following additional difficulties, costs, and delays involved in integrating and managing these operations, and the operations of companies we may acquire:

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Failure of customers to continue using the products and services of the combined company;

Failure to successfully develop the acquired technology into the desired products or enhancements;

-25-

## **Table of Contents**

Assumption of unknown liabilities;

Failure to understand and compete effectively in markets and with products or technologies with which we have limited previous experience;

Impairment charges incurred to write down the carrying amount of intangible assets, including goodwill, generated as a result of the acquisition;

Decreased liquidity, restrictive bank covenants, and incremental financing costs associated with debt we may incur to complete future acquisitions; and

Diversion of the attention of management from other ongoing business concerns.

Our acquisitions of products, technology assets, or businesses may have a negative impact on our business if we fail to achieve the anticipated financial, strategic and other benefits of acquisitions or investments, and our operating results may suffer because of this.

### **Adverse economic conditions in markets in which we operate may harm our business**

Unfavorable changes in U.S. and international economic environments may adversely affect our business and financial results. Economic conditions in the countries in which we operate and sell products have recently become more negative and global financial markets have experienced significant volatility and declines in recent weeks. These conditions stem from slower economic activity, adverse credit conditions, and numerous other factors, and we are unable to foresee when these factors might return to more normal levels. During challenging economic times, and in tight credit markets, our customers may delay or reduce capital expenditures. This could result in reductions in sales of our products, longer sales cycles, difficulties in collection of accounts receivable, slower adoption of new technologies, and increased price competition, all of which could impact our results of operations and financial condition. In addition, we expect these factors will cause us to be more cautious in evaluating potential acquisition opportunities, which could hinder our ability to grow through acquisition while these conditions persist.

### **Our growth in recent years has depended substantially on the completion of acquisitions and we may not be able to complete acquisitions of this nature or of a relative size in the future to support a similar level of growth**

The acquisitions that we have completed have been the primary source of our growth in revenue over the last four years. We expend considerable effort in seeking to identify attractive acquisition candidates and, upon doing so, to convince the potential target to consider a sale to us and, ultimately, to negotiate mutually agreeable acquisition terms. If we are not successful in these efforts in the future, our growth rate will not increase at a rate corresponding to that which we have achieved in recent years. Further, as we grow larger it will be necessary to complete the acquisition of larger companies and product lines to support a growth similar to that which we have achieved in the past. The market for attractive acquisitions is competitive and others with greater financial resources than we have may be better positioned than we are to acquire desirable targets. Further, we may not be able to negotiate acquisition terms with target companies that will allow us to achieve positive financial returns from the transaction.

### **Following our acquisitions we have implemented integration and restructuring activities that could be disruptive to our operations, and we could fail to achieve the synergies and cost savings the activities are designed to produce**

Following our acquisition of Xltek we initiated an integration plan that resulted in a reduction in force and realignment of our domestic sales force. In addition, in February 2008, we adopted an integration and restructuring plan that is designed to eliminate redundant costs resulting from our acquisitions and to improve efficiencies in operations. This plan has been implemented over the first three quarters of 2008.

The realignment of our domestic sales organization could be disruptive to our sales efforts and may not deliver the results we anticipate. In addition, our integration and restructuring activities may not result in the acquisition synergies or cost savings these activities are designed to produce and could, among other things, impair new product development and our support of existing products.

### **We have initiated changes to our information systems that could disrupt our business and our financial results**

## Edgar Filing: NATUS MEDICAL INC - Form 10-Q

We plan to continuously improve our enterprise resource planning, customer relationship management, and document lifecycle management systems to support the form, functionality, and scale of our business. These types of transitions frequently prove disruptive to the underlying business of an enterprise and may cause us to incur higher costs than we anticipate. Failure to manage a smooth transition to the new systems and the ongoing operations and support of the new systems could materially harm our business operations.

-26-

---

## **Table of Contents**

For example, we are currently in the process of implementing the rollout of an enterprise resource planning application ( ERP ) in our North American operating divisions. Until we have completed the ERP implementation, we will be dependent on multiple platforms. We may experience difficulties in implementing the ERP and we may fail to gain the efficiencies the implementation is designed to produce. The implementation could also be disruptive to our operations, including the ability to timely ship and track product orders to customers, project inventory requirements, manage our supply chain, and otherwise adequately service our customers.

### **Future changes in technology or market conditions could result in adjustments to our recorded asset balance for intangible assets, including goodwill, resulting in additional charges that could significantly impact our operating results**

Our balance sheet includes significant intangible assets, including goodwill and other acquired intangible assets. The determination of related estimated useful lives and whether these assets are impaired involves significant judgments. Our ability to accurately predict future cash flows related to these intangible assets might be hindered by events over which we have no control. Due to the highly competitive nature of the medical device industry, new technologies could impair the value of our intangible assets if they create market conditions that adversely affect the competitiveness of our products. Any future determination that these assets are carried at greater than their fair value could result in substantial impairment charges, which could significantly impact our operating results.

### **Our acquisitions have included in-process research and development assets ( IPR&D assets ) for which we hope to generate future cash flows; our results of operations could be adversely affected if we are unable to bring these assets to market**

Through our acquisitions of other businesses, we have acquired IPR&D assets from which we hope to generate future cash flows. There is inherent risk in bringing these IPR&D assets to market and we may be unable to realize the full value we have assigned to them. We may be unable to complete the development of these IPR&D assets within a timely manner, or we may encounter technological difficulties that prevent us from completing their development. If we are unable to derive future revenue from our IPR&D assets, our results of operations could be adversely impacted.

### **We may not be able to preserve the value of our intellectual property because we may not be able to protect access to it or we may lose our intellectual property rights due to expiration of our licenses or patents**

If we fail to protect our intellectual property rights or if our intellectual property rights do not adequately cover the technology we employ, other medical device companies could sell products with features similar to ours, and this could reduce demand for our products. We protect our intellectual property through a combination of patent, copyright, trade secret and trademark laws. Despite our efforts to protect our proprietary rights, others may attempt to copy or otherwise improperly obtain and use our products or technology. Policing unauthorized use of our technology is difficult and expensive, and we cannot be certain that the steps we have taken will prevent misappropriation. Our means of protecting our proprietary rights may be inadequate. Enforcing our intellectual property rights could be costly and time consuming and may divert our management's attention and resources. Failing to enforce our intellectual property rights could also result in the loss of those rights.

### **If health care providers are not adequately reimbursed for procedures conducted with our devices or supplies, or if reimbursement policies change adversely, we may not be successful marketing and selling products or technologies**

Clinicians, hospitals, and government agencies are unlikely to purchase our products if clinicians are not adequately reimbursed for the procedures conducted with our devices or supplies. Unless a sufficient amount of conclusive, peer-reviewed clinical data about our products has been published, third-party payors, including insurance companies and government agencies, may refuse to provide reimbursement. Furthermore, even if reimbursement is provided, it may not be adequate to fully compensate the clinicians or hospitals. Some third-party payors may impose restrictions on the procedures for which they will provide reimbursement. If health care providers cannot obtain sufficient reimbursement from third-party payors for our products or the screenings conducted with our products, we may not achieve significant market acceptance of our products. Acceptance of our products in international markets will depend upon the availability of adequate reimbursement or funding within prevailing health care payment systems. Reimbursement, funding, and health care payment systems vary significantly by country. We may not obtain approvals for reimbursement in a timely manner or at all.

---

## **Table of Contents**

Adverse changes in reimbursement policies in general could harm our business. We are unable to predict changes in the reimbursement methods used by third-party health care payors, particularly those in countries and regions outside the U.S. For example, some payors are moving toward a managed care system in which providers contract to provide comprehensive health care for a fixed cost per person. In a managed care system, the cost of our products may not be incorporated into the overall payment for patient care or there may not be adequate reimbursement for our products separate from reimbursement for other procedures.

### **If we fail in our efforts to educate clinicians, government agency personnel, and third-party payors on the effectiveness of our products, we may not achieve future sales growth**

It is critical to the success of our sales efforts that we educate a sufficient number of clinicians, hospital administrators, and government agencies about our products and the costs and benefits of their use. The commercial success of our products depends upon clinician, government agency and other third-party payor confidence in the economic and clinical benefits of our products as well as their comfort with the efficacy, reliability, sensitivity and specificity of our products. We believe that clinicians will not use our products unless they determine, based on published peer-reviewed journal articles and experience, that our products provide an accurate and cost-effective alternative to other means of testing or treatment. Our customers may choose to use competitive products, which may be less expensive or may provide faster results than our devices. Clinicians are traditionally slow to adopt new products, testing practices and clinical treatments, partly because of perceived liability risks and the uncertainty of third-party reimbursement. If clinicians, government agencies and hospital administrators do not adopt our products, we may not maintain profitability. Factors that may adversely affect the medical community's acceptance of our products include:

Publication of clinical study results that demonstrate a lack of efficacy or cost-effectiveness of our products;

Changing governmental and physician group guidelines;

Actual or perceived performance, quality, price, and total cost of ownership deficiencies of our products relative to other competitive products;

Our ability to maintain and enhance our existing relationships and to form new relationships with leading physicians, physician organizations, hospitals, state laboratory personnel, and third-party payors;

Changes in state and third-party payor reimbursement policies for our products; and

Repeal of laws requiring universal newborn hearing screening and metabolic screening.

### **Increased sales through group purchasing organizations and sales to high volume purchasers may reduce our average selling prices, which would reduce our revenue and gross profits**

We have entered, and expect in the future to enter into agreements with customers who purchase high volumes of our products. Our agreements with these customers may contain discounts from our normal selling prices and other special pricing considerations, which could cause our revenue and profits to decline. In addition, we have entered into agreements to sell our products to members of GPOs, which negotiate volume purchase prices for medical devices and supplies for member hospitals, group practices and other clinics. While we make sales directly to GPO members, the GPO members receive volume discounts from our normal selling price and may receive other special pricing considerations from us. Sales to members of all GPOs accounted for approximately 35%, 31% and 28% of our total revenue during 2007, 2006 and 2005, respectively, and sales to members of one GPO, Novation LLC, accounted for approximately 9%, 12% and 15% of our total revenue in 2007, 2006 and 2005, respectively. Other of our existing customers may be members of GPOs with which we do not have agreements. Our sales efforts through GPOs may conflict with our direct sales efforts to our existing customers. If we enter into agreements with new GPOs and some of our existing customers begin purchasing our products through those GPOs, our revenue and profits could decline.

### **Demand for some of our products depends on the capital spending policies of our customers, and changes in these policies could harm our business**



## Edgar Filing: NATUS MEDICAL INC - Form 10-Q

A majority of customers for our products are hospitals, physician offices, and clinics. Many factors, including public policy spending provisions, available resources, and economic cycles have a significant effect on the capital spending

-28-

## **Table of Contents**

policies of these entities and therefore the amount that they can spend on our equipment products. If budget resources limit the capital spending of our customers, they will be unlikely to either purchase any new equipment from us or upgrade to any of our newer equipment products. These factors can have a significant adverse effect on the demand for our products. The recent lack of liquidity in credit markets, and the additional impact of the uncertainty in economic conditions worldwide, may have an adverse effect on the spending patterns of our customers in future periods.

### **Our markets are very competitive and in the United States we sell certain of our products in a mature market**

We face competition from other companies in all of our product lines. Our competitors range from small, privately-held companies to multinational corporations and their product offerings vary in scope and breadth. We do not believe that any single competitor is dominant in any of our product lines.

The markets for certain of our products in the U.S., including the newborn hearing screening and EEG monitoring markets, are mature and we are unlikely to see significant growth for such products in the U.S. In the U.S. we derive a significant portion of our revenue from the sale of disposable supplies that are used with our hearing screening devices. Because these disposable supply products can generate high margins, we expect that our products, particularly our hearing screening disposable supply products, could face increasing competition, including competitors offering lower prices, which could have an adverse affect on our revenue and margins.

We believe that our primary competitive strengths relate to the functionality and reliability of our products, our recognized brands, and our developed sales channels. Our competitors may have certain competitive advantages, which include the ability to devote greater resources to the development, promotion, and sale of their products. Consequently, we may need to increase our efforts, and related expenses, for research and development, marketing, and selling to maintain or improve our position.

We expect recurring sales to our existing customers to generate a majority of our revenue in the future, and if our existing customers do not continue to purchase products from us, our revenue may decline.

### **Our operating results may decline if we do not succeed in developing, acquiring and marketing additional products or improving our existing products**

We intend to develop additional products and technologies, including enhancements of existing products, for the screening, detection, treatment, monitoring and tracking of common medical ailments. Developing new products, and improving our existing products, to meet the needs of current and future customers requires significant investments in research and development. If we fail to successfully sell new products, update our existing products, or timely react to changes in technology, our operating results may decline as our existing products reach the end of their commercial life cycles.

### **Our plan to expand our international operations will result in increased costs and is subject to numerous risks; if our efforts are not successful, this could harm our business**

We have expanded our international operations through acquisitions and plan to expand our international sales and marketing efforts to increase sales of our products in foreign countries. We may not realize corresponding growth in revenue from growth in international unit sales due to the lower average selling prices we receive on sales outside of the U.S. Even if we are able to successfully expand our international selling efforts, we cannot be certain that we will be able to create or increase demand for our products outside of the U.S. Our international operations are subject to other risks, which include:

Impact of possible recessions in economies outside the U.S.;

Political and economic instability, including instability related to war and terrorist attacks in the U.S. and abroad;

Contractual provisions governed by foreign law, such as local law rights to sales commissions by terminated distributors;

## Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Decreased health care spending by foreign governments that would reduce international demand for our products;

Continued strengthening of the U.S. dollar relative to foreign currencies could make our products less competitive because most of our international sales are denominated in the U.S. dollar;

-29-

---

**Table of Contents**

Greater difficulty in accounts receivable collection and longer collection periods;

Difficulties of staffing and managing foreign operations;

Reduced protection for intellectual property rights in some countries and potentially conflicting intellectual property rights of third parties under the laws of various foreign jurisdictions;

Difficulty in obtaining and maintaining foreign regulatory approval; and

Attitudes by clinicians towards use and cost reimbursement policies of disposable supplies that are potentially unfavorable to our business.

In particular, our international sales could be adversely affected by a strengthening of the U.S. dollar relative to other foreign currencies, which makes our products more costly to international customers to whom sales are denominated in U.S. dollars.

**If guidelines mandating universal newborn hearing screening do not continue to develop in foreign countries and governments do not mandate testing of all newborns as we anticipate, or if once mandated, hearing screening programs result in a long phase-in period, our revenue growth could be impacted**

We estimate that approximately 95% of the children born in the U.S. are currently being tested for hearing impairment prior to discharge from the hospital. To date, there has been only limited adoption of newborn hearing screening prior to hospital discharge by foreign governments, and when newborn hearing screening programs are enacted by foreign governments there can be a phase-in period spanning several years. The widespread adoption of guidelines depends, in part, on our ability to educate foreign government agencies, neonatologists, pediatricians, third-party payors, and hospital administrators about the benefits of universal newborn hearing screening as well as the use of our products to perform the screening and monitoring. Our revenue from our newborn hearing screening product lines may not grow if foreign governments do not require universal newborn hearing screening prior to hospital discharge, if physicians or hospitals are slow to comply with those guidelines, or if governments provide for a lengthy phase-in period for compliance.

**Because we rely on distributors or sub-distributors to sell our products in most of our markets outside of the U.S., our revenue could decline if our existing distributors reduce the volume of purchases from us, or if our relationship with any of these distributors is terminated**

We currently rely on our distributors or sub-distributors for a majority of our sales outside the U.S. Our reliance on international distributors has increased because of our decisions in 2004 and 2005 to close our Japanese and U.K. sales subsidiaries and sell through distributors in those countries, and because of our acquisition of Fischer-Zoth, which sells its products through distributors in Europe and Asia. We may also sell Deltamed and Schwarzer Neurology products through distributors in countries outside of France and Germany. Some distributors also assist us with regulatory approvals and education of clinicians and government agencies. We intend to continue our efforts to increase our sales in Europe, Japan, and other developed countries. If we fail to sell our products through our international distributors, we would experience a decline in revenues unless we begin to sell our products directly in those markets. We cannot be certain that we will be able to attract new international distributors to market our products effectively or provide timely and cost-effective customer support and service. Even if we are successful in selling our products through new distributors, the rate of growth of our revenue could be harmed if our existing distributors do not continue to sell a large dollar volume of our products. None of our existing distributors are obligated to continue selling our products.

We may be subject to foreign laws governing our relationships with our international distributors. These laws may require us to make payments to our distributors if we terminate our relationship for any reason, including for cause. Some countries require termination payments under local law or legislation that may supersede our contractual relationship with the distributor. Any required payments would adversely affect our operating results.

**Our operating results may suffer because of our exposure to foreign currency exchange rate fluctuations and may require us to engage in foreign currency hedging**

## Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Substantially all of our sales contracts with our U.S. based customers provide for payment in U.S. dollars. In addition, sales to most of our international distributors provide for payment in U.S. dollars. However, with the exception of Xltek, substantially all of the revenue and expenses of our foreign subsidiaries are denominated in the applicable foreign currency. To date we have executed only limited foreign currency contracts to hedge these currency risks and, as a result, our future revenue and expenses may be subject to volatility due to exchange rate fluctuations that could result in foreign exchange gains and losses associated with foreign currency transactions and the translation of assets and liabilities denominated in foreign currencies.

-30-

---

**Table of Contents**

**If we lose our relationship with any supplier of key product components or our relationship with a supplier deteriorates or key components are not available in sufficient quantities, our manufacturing could be delayed and our business could suffer**

We contract with third parties for the supply of some of the components used in our products and the production of our disposable products. Some of our suppliers are not obligated to continue to supply us. We have relatively few sources of supply for some of the components used in our products and in some cases we rely entirely on sole-source suppliers. In addition, the lead-time involved in the manufacturing of some of these components can be lengthy and unpredictable. For example, during 2005, we relied on a single supplier of cables used in our ALGO hearing screening devices to help us complete a field replacement program of those cables. If our suppliers become unwilling or unable to supply us with components meeting our requirements, it might be difficult to establish additional or replacement suppliers in a timely manner, or at all. This would cause our product sales to be disrupted and our revenue and operating results to suffer.

Replacement or alternative sources might not be readily obtainable due to regulatory requirements and other factors applicable to our manufacturing operations. Incorporation of components from a new supplier into our products may require a new or supplemental filing with applicable regulatory authorities and clearance or approval of the filing before we could resume product sales. This process may take a substantial period of time, and we may not be able to obtain the necessary regulatory clearance or approval. This could create supply disruptions that would harm our product sales and operating results.

**We depend upon key employees in a competitive market for skilled personnel, and, without additional employees, we cannot grow or maintain profitability**

Our products and technologies are complex, and we depend substantially on the continued service of our senior management team. The loss of any of our key employees could adversely affect our business and slow our product development process. Our future success also will depend, in part, on the continued service of our key management personnel, software engineers, and other research and development employees and our ability to identify, hire, and retain additional personnel, including customer service, marketing, and sales staff. Hiring research and development, engineering, sales, marketing and customer service personnel in our industry is very competitive due to the limited number of people available with the necessary technical skills and understanding of our product technologies. We may be unable to attract and retain personnel necessary for the development of our business.

**Our ability to market and sell products depends upon receipt of domestic and foreign regulatory approval of our products and manufacturing operations. Our failure to obtain or maintain regulatory approvals and compliance could negatively affect our business**

Our products and manufacturing operations are subject to extensive regulation in the United States by the FDA and by similar regulatory agencies in many other countries in which we do business. Our products are classified as medical devices. Medical devices are subject to extensive regulation by the FDA pursuant to regulations that are wide ranging and govern, among other things: design and development; manufacturing and testing; labeling; storage and record keeping; advertising, promotion, marketing, sales, distribution, and export; and surveillance and reporting of deaths or serious injuries.

Unless an exemption applies, each medical device that we propose to market in the U.S. must first receive one of the following types of FDA premarket review authorizations:

Clearance via Section 510(k) of the Food, Drug, and Cosmetics Act of 1938, as amended; or

Premarket approval via Section 515 of the Food, Drug, and Cosmetics Act if the FDA has determined that the medical device in question poses a greater risk of injury.

The FDA will clear marketing of a medical device through the 510(k) process if it is demonstrated that the new product is substantially equivalent to other 510(k)-cleared products. The premarket approval application process is more costly, lengthy and uncertain than the 510(k) process, and must be supported by extensive data from preclinical studies and human clinical trials. The FDA may not grant either 510(k) clearance or premarket approval for any product we

## Table of Contents

propose to market. Further, any modification to a 510(k)-cleared device that could significantly affect its safety or effectiveness, or that would constitute a major change in its intended use, design, or manufacture, requires a new 510(k) clearance or, possibly, approval of a premarket approval application. The FDA requires every manufacturer to make this determination in the first instance, but the FDA may review any manufacturer's decision. If the FDA requires us to seek 510(k) clearance or premarket approval for modification of a previously cleared product for which we have concluded that new clearances or approvals are unnecessary, we may be required to cease marketing or to recall the modified product until we obtain clearance or approval, and we may be subject to significant regulatory fines or penalties. Further, our products could be subject to recall if the FDA determines, for any reason, that our products are not safe or effective.

Delays in receipt or failure to receive clearances or approvals, the loss of previously received clearances or approvals, or the failure to comply with existing or future regulatory requirements could adversely impact our operating results. If the FDA finds that we have failed to comply with these requirements, the Agency can institute a wide variety of enforcement actions, ranging from a public warning letter to more severe sanctions such as:

Fines, injunctions and civil penalties;

Recall or seizure of our products;

Issuance of public notices or warnings;

Imposition of operating restrictions, partial suspension, or total shutdown of production;

Refusal of our requests for Section 510(k) clearance or premarket approval of new products;

Withdrawal of Section 510(k) clearance or premarket approvals already granted; or

Criminal prosecution.

Domestic regulation of our products and manufacturing operations, other than that which is administered by the FDA, includes the Environmental Protection Act, the Occupational Safety and Health Act, and state and local counterparts to these Acts.

### **Our business would be harmed if the FDA determines that we have failed to comply with applicable regulations governing the manufacture of our products and/or we do not pass an inspection.**

Our suppliers and we are required to demonstrate and maintain compliance with the FDA's Quality System Regulation. The Quality System Regulation sets forth the FDA's requirements for good manufacturing practices of medical devices and includes requirements for, among other things, the design, testing, production processes, controls, quality assurance, labeling, packaging, storage and shipping of such products. In addition, we and our suppliers must engage in extensive recordkeeping and reporting and must make available our manufacturing facility and records for periodic unscheduled inspections by federal, state, and foreign agencies, including the FDA.

We cannot assure you that we and our suppliers are or will continue to be in full compliance with the Quality System Regulation, and that we will not encounter any manufacturing difficulties. For example, in October 2007 we received a warning letter from the FDA that focused on process deficiencies at our Olympic facility in Seattle, Washington. As a result, we initiated a voluntary plant shutdown of the Olympic facility on November 1, 2007. After reviewing processes at the facility, we responded to the FDA's warning letter in late November 2007. We resumed manufacturing at our Olympic facility on November 27, 2007. In June 2008, we received a response letter from the FDA requesting further clarification on three of the eight responses in our November 2007 letter. We have responded to the FDA's additional requests.

## Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Failure of our third party suppliers and manufacturers or us to comply with applicable regulations could result in sanctions being imposed on us, including, among other things, fines, injunctions, civil penalties, failure of regulatory authorities to grant marketing approval of our products, delays, suspension or withdrawal of approvals, seizures or recalls of products, and manufacturing restrictions, any of which could harm our business.

### **We have received clearance from the FDA to market a new product that will potentially expose us to greater products liability exposure and FDA regulation**

The FDA classifies medical devices into one of three classes, depending on the degree of risk associated with each medical device and the extent of controls that are needed to ensure safety and effectiveness. Devices deemed to pose lower risk are placed in either class I or class II. Devices deemed by the FDA to pose the greatest risk, such as life-sustaining, life supporting or implantable devices, or a device deemed to not be substantially equivalent to a previously cleared 510(k) device, are placed in class III, and generally require premarket approval from the FDA before they may be marketed.

-32-



---

## **Table of Contents**

In December 2006 we received premarket approval from the FDA to market the Olympic Cool-Cap, a product designed to lower the cerebral temperature of newborns born with a particular medical condition. This product is a class III minimally invasive medical device, and as such we may be subject to an increased product liability risk relative to our other class I and class II non-invasive products. In addition, this type of product is subject to greater FDA oversight than our other products and there is greater risk that sales of the product could be interrupted due to the premarket approval processes of the FDA and other regulatory bodies.

### **Our business may suffer if we are required to revise our labeling or promotional materials, or the FDA takes an enforcement action against us for off-label uses**

We are prohibited by the FDA from promoting or advertising our medical device products for uses not within the scope of our clearances or approvals, or from making unsupported promotional claims about the benefits of our products. If the FDA determines that our claims are outside the scope of our clearances, or are unsupported, it could require us to revise our promotional claims or take enforcement action against us. If we were subject to such an action by the FDA, our sales could be delayed, our revenue could decline, and our reputation among clinicians could be harmed. Likewise, if we acquire new products, either through the purchase of products, technology assets, or businesses, that are subsequently deemed to have inadequate supporting data, then we may be required to: (i) obtain adequate data, which could be costly and impede our ability to market these products, or (ii) modify the labeling on these products, which could impair their marketability, as described above.

### **If we fail to comply with healthcare regulations, we could face substantial penalties and our business, operations and financial condition could be adversely affected**

We do not provide healthcare services, control the referral of patients for healthcare services, nor bill Medicare, Medicaid or other third-party payors; however, due to the breadth of many healthcare laws and regulations, we could be subject to healthcare fraud regulation and enforcement by both the federal government and the states in which we conduct our business. The laws that may affect our ability to operate include: (i) the federal healthcare programs Anti-Kickback Law, which prohibits, among other things, persons from knowingly and willfully soliciting, receiving, offering or paying remuneration, directly or indirectly, in exchange for or to induce either the referral of an individual for, or the purchase, order, or recommendation of, any good or service for which payment may be made under federal healthcare programs such as the Medicare and Medicaid programs; (ii) federal false claims laws which prohibit, among other things, individuals or entities from knowingly presenting, or causing to be presented, claims for payment from Medicare, Medicaid, or other third-party payors that are false or fraudulent, and which may apply to entities like us which provide coding and billing advice to customers; or (iii) state law equivalents of each of the above federal laws, such as anti-kickback and false claims laws which may apply to items or services reimbursed by any third-party payor, including commercial insurers, many of which differ from each other in significant ways, thus complicating compliance efforts.

If our operations are found to be in violation of any of the laws described above or any other governmental regulations that apply to us, we may be subject to penalties, including civil and criminal penalties, damages, fines and the curtailment or restructuring of our operations. Any penalties, damages, fines, curtailment or restructuring of our operations could adversely affect our ability to operate our business and our financial results. The risk of our being found in violation of these laws is increased by the fact that their provisions are open to a variety of interpretations. Any action against us for violation of these laws, even if we successfully defend against it, could cause us to incur significant legal expenses and divert our management's attention from the operation of our business.

### **Our operating results would suffer if we were subject to a protracted infringement claim**

The medical technology industry has, in the past, been characterized by a substantial amount of litigation and related administrative proceedings regarding patents and intellectual property rights. We expect that medical screening and diagnostic products may become increasingly subject to third-party infringement claims as the number of competitors in our industry segment grows and the functionality of products in different industry segments overlap. Third parties such as individuals, educational institutions or other medical device companies may claim that we infringe their intellectual property rights. Any claims, with or without merit, could have any of the following negative consequences:

Result in costly litigation and damage awards;

## **Table of Contents**

Divert our management's attention and resources;

Cause product shipment delays or suspensions; or

Require us to seek to enter into royalty or licensing agreements.

A successful claim of infringement against us could result in a substantial damage award and materially harm our financial condition. Our failure or inability to license the infringed or similar technology, or design and build non-infringing products, could prevent us from selling our products and adversely affect our business and financial results.

### **We license intellectual property rights from third parties and would be adversely affected if our licensors do not appropriately defend their proprietary rights or if we breach any of the agreements under which we license commercialization rights to products or technology from others**

We license rights from third parties for products and technology that are important to our business. If our licensors are unsuccessful in asserting and defending their proprietary rights, including patent rights and trade secrets, we may lose the competitive advantages we have through selling products that we license from third parties. Additionally, if it is found that our licensors infringe on the proprietary rights of others, we may be prohibited from marketing our existing products that incorporate those proprietary rights. Under our licenses, we are subject to commercialization and development, sublicensing, royalty, insurance and other obligations. If we fail to comply with any of these requirements, or otherwise breach a license agreement, the licensor may have the right to terminate the license in whole or to terminate the exclusive nature of the license.

### **Product liability suits against us could result in expensive and time consuming litigation, payment of substantial damages, and an increase in our insurance rates**

The sale and use of our products could lead to the filing of a product liability claim by someone claiming to have been injured using one of our products or claiming that one of our products failed to perform properly. A product liability claim could result in substantial damages and be costly and time consuming to defend, either of which could materially harm our business reputation or financial condition. Our product liability insurance may not protect our assets from the financial impact of defending a product liability claim. Any product liability claim brought against us, with or without merit, could increase our product liability insurance rates or prevent us from securing any coverage in the future.

### **We have experienced seasonality in the sale of our products**

We experience seasonality in our revenue. For example, our sales typically decline from our fourth fiscal quarter to our first fiscal quarter, due to patterns in the capital budgeting and purchasing cycles of our current and prospective customers, many of which are government agencies. We may also experience declining sales in the third fiscal quarter due to summer holiday and vacation schedules. We anticipate that we will continue to experience these seasonal fluctuations, which may lead to fluctuations in our quarterly operating results. We believe that you should not rely on our results of operations for interim periods as an indication of our expected results in any future period.

**Table of Contents****ITEM 6. Exhibits**

(a) Exhibits

Exhibit No.	Exhibit	Filing	Incorporated By Reference		
			Exhibit No.	File No.	File Date
10.01	First Amendment to Amended and Restated Credit Agreement between Natus Medical Incorporated and Wells Fargo Bank National Association	8-K	10.1	000-33001	08/06/2008
10.02	Second Amendment to Amended and Restated Credit Agreement between Natus Medical Incorporated and Wells Fargo Bank National Association	8-K	10.1	000-33001	09/05/2008
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				

**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.

NATUS MEDICAL INCORPORATED

Dated: November 6, 2008

By: /s/ James B. Hawkins  
**James B. Hawkins**  
**President and Chief Executive Officer**  
**(Principal Executive Officer)**

Dated: November 6, 2008

By: /s/ Steven J. Murphy  
**Steven J. Murphy,**  
**Vice President Finance and**  
**Chief Financial Officer**  
**(Principal Financial and**  
**Accounting Officer)**

**Table of Contents****NATUS MEDICAL INCORPORATED****INDEX TO EXHIBITS**

<b>Exhibit No.</b>	<b>Exhibit</b>	<b>Filing</b>	<b>Incorporated By Reference</b>		
			<b>Exhibit No.</b>	<b>File No.</b>	<b>File Date</b>
10.01	First Amendment to Amended and Restated Credit Agreement between Natus Medical Incorporated and Wells Fargo Bank N.A.	8-K	10.1	000-33001	08/06/2008
10.02	Second Amendment to Amended and Restated Credit Agreement between Natus Medical Incorporated and Wells Fargo Bank N.A.	8-K	10.1	000-33001	09/05/2008
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				