

NATUS MEDICAL INC  
Form 10-Q  
May 07, 2009  
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 March 31, 2009
- .. **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)	
<b>(650) 802-0400</b>	

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See 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   
(Do not check if a smaller

Smaller reporting company

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 May 1, 2009 was 27,981,581.

---

**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 March 31, 2009 and December 31, 2008 (unaudited)</u>	3
<u>Condensed Consolidated Statements of Operations for the three months ended March 31, 2009 and 2008 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2009 and 2008 (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>	14
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	20
Item 4. <u>Controls and Procedures</u>	20
<b>PART II. <u>OTHER INFORMATION</u></b>	<b>21</b>
Item 1. <u>Legal Proceedings</u>	21
Item 1A. <u>Risk Factors</u>	21
Item 6. <u>Exhibits</u>	30
<u>Signatures</u>	30

**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)

	March 31, 2009	December 31, 2008
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 61,430	\$ 56,915
Short-term investments	795	
Accounts receivable, net of allowance for doubtful accounts of \$1,606 and \$1,126	30,747	36,242
Inventories	25,525	25,009
Prepaid expenses and other current assets	2,684	3,554
Deferred income tax	4,082	3,928
<b>Total current assets</b>	<b>125,263</b>	<b>125,648</b>
Property and equipment, net	14,090	14,002
Intangible assets	56,606	57,729
Goodwill	60,955	60,858
Other assets		385
<b>Total assets</b>	<b>\$ 256,914</b>	<b>\$ 258,622</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 6,842	\$ 7,375
Current portion of long-term debt	173	206
Accrued liabilities	8,923	11,895
Deferred revenue	3,821	3,836
<b>Total current liabilities</b>	<b>19,759</b>	<b>23,312</b>
Long-term liabilities		
Other liabilities	4,534	4,586
Long-term debt	1,071	1,082
Deferred income tax	3,307	3,148
<b>Total liabilities</b>	<b>28,671</b>	<b>32,128</b>
Stockholders equity:		
Common Stock, \$0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 27,963,019 in 2009 and 27,959,919 in 2008	246,299	245,476
Accumulated deficit	(4,555)	(5,342)
Accumulated other comprehensive loss	(13,501)	(13,640)
<b>Total stockholders equity</b>	<b>228,243</b>	<b>226,494</b>

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Total liabilities and stockholders' equity	\$ 256,914	\$ 258,622
--	------------	------------

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 OPERATIONS (unaudited)**

(in thousands, except per share amounts)

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
Revenue	\$ 33,357	\$ 36,859
Cost of revenue	13,049	14,005
<b>Gross profit</b>	<b>20,308</b>	<b>22,854</b>
Operating expenses:		
Marketing and selling	9,987	9,876
Research and development	3,714	3,827
General and administrative	5,504	4,856
Total operating expenses	19,205	18,559
Income from operations	1,103	4,295
Other income, net	126	1
Income before provision for income tax	1,229	4,296
Provision for income tax	442	1,669
Net income	\$ 787	\$ 2,627
Earnings per share:		
Basic	\$ 0.03	\$ 0.12
Diluted	\$ 0.03	\$ 0.11
Weighted average shares used in the calculation of earnings per share:		
Basic	27,606	21,742
Diluted	28,136	22,977

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>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>Operating activities:</b>		
Net income	\$ 787	\$ 2,627
Adjustments to reconcile net income to net cash provided by operating activities:		
Accounts receivable reserves	664	145
Excess tax benefits on the exercise of options		(203)
Depreciation and amortization	2,486	1,468
Warranty reserve	218	121
Share-based compensation	818	721
Changes in operating assets and liabilities:		
Accounts receivable	4,831	(1,036)
Inventories	(516)	(1,293)
Prepaid expenses and other assets	1,059	761
Accounts payable	(533)	(1,003)
Accrued liabilities and deferred revenue	(3,240)	(230)
<b>Net cash provided by operating activities</b>	<b>6,574</b>	<b>2,078</b>
<b>Investing activities:</b>		
Acquisition of business, net of cash acquired		(67)
Purchases of property and equipment	(1,386)	(854)
Purchases of marketable securities	(795)	
Capitalized software development costs	(174)	(479)
<b>Net cash (used in) investing activities</b>	<b>(2,355)</b>	<b>(1,400)</b>
<b>Financing activities:</b>		
Proceeds from stock option exercises and ESPP purchases	5	466
Excess tax benefits upon the exercise of options		203
Borrowings on credit facility		1,000
Payments on borrowings	(44)	(2,207)
<b>Net cash (used in) financing activities</b>	<b>(39)</b>	<b>(538)</b>
Exchange rate effect on cash and cash equivalents	335	544
<b>Net increase in cash and cash equivalents</b>	<b>4,515</b>	<b>684</b>
Cash and cash equivalents, beginning of period	56,915	11,916
<b>Cash and cash equivalents, end of period</b>	<b>\$ 61,430</b>	<b>\$ 12,600</b>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	\$ 14	\$ 545
Cash paid for income taxes	\$ 226	\$ 537

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

### Non-cash investing activities:

Acquisition-related earnout obligations included in accrued liabilities	\$	19	\$	422
---	----	----	----	-----

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, 2008.

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 months ended March 31, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

**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 March 31,</b>	
	<b>2009</b>	<b>2008</b>
Net income	\$ 787	\$ 2,627
Foreign currency translation adjustment	139	(1,696)
<b>Comprehensive income</b>	<b>\$ 926</b>	<b>\$ 931</b>

**Stockholders' Equity**

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

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
Balance, beginning of period	\$ 226,494	\$ 115,718
Net income	787	2,627
Proceeds from stock option exercises and ESPP	5	466
Share-based compensation expense	818	721
Tax effect of option exercises		203
Foreign currency translation adjustment	139	(1,696)
<b>Balance, end of period</b>	<b>\$ 228,243</b>	<b>\$ 118,039</b>

**Foreign Currency**

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

Effective January 1, 2009, the Company's Canadian subsidiary, Xltek changed its functional currency to the U.S. dollar. The change in functional currency reflects the fact that Xltek now conducts the majority of its business transactions in U.S. dollars and maintains a significant portion of its balance sheet in U.S. dollar denominated accounts.

-6-

---

**Table of Contents****Recent Accounting Pronouncements**

In April 2009, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position ( FSP ), FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, which provides operational guidance for determining other-than-temporary impairments for debt securities. FSP FAS 115-2 and FAS 124-2 is effective for interim and annual periods ending after June 15, 2009. We are currently evaluating the potential impact, if any, of the application of FSP FAS 115-2 and FSP FAS 124-2 on our consolidated financial position, results of operations and cash flows.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* to require disclosures about fair value of financial instruments in interim period financial statements of publicly traded companies and in summarized financial information required by APB Opinion No. 28, *Interim Financial Reporting*. FSP FAS 107-1 and APB 28-1 is effective for interim and annual reporting periods ending after June 15, 2009. We are currently evaluating the potential impact, if any, of the application of FSP FAS 107-1 and APB 28-1 on our consolidated financial position, results of operations and cash flows.

In April 2009, the FASB issued FSP FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*, which amends the guidance in Statement of Financial Accounting Standards No. ( SFAS ) 141(R) to require contingent assets acquired and liabilities assumed in a business combination to be recognized at fair value on the acquisition date if fair value can be reasonably estimated during the measurement period. If fair value cannot be reasonably estimated during the measurement period, the contingent asset or liability would be recognized in accordance with SFAS No. 5, *Accounting for Contingencies*, and FASB Interpretation ( FIN ) No. 14, *Reasonable Estimation of the Amount of a Loss*. Further, this FSP eliminated the specific subsequent accounting guidance for contingent assets and liabilities from SFAS No. 141(R), without significantly revising the guidance in SFAS No. 141. However, contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination would still be initially and subsequently measured at fair value in accordance with SFAS No. 141(R). This FSP is effective for all business acquisitions occurring on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We are currently evaluating the potential impact, if any, of the adoption of FAS 141(R)-1 on our consolidated financial position, results of operations and cash flows.

In October 2008, the FASB issued FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*. FSP 157-3 clarifies the application of FASB Statement No. 157, *Fair Value Measurements*, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective upon issuance, including for prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application are accounted for as a change in accounting estimate following the guidance in SFAS 154, *Accounting Changes and Error Corrections*. However, the disclosure provisions in SFAS 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application. We believe the impact of this pronouncement on our consolidated financial statements to be immaterial.

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 did not have a material impact on our 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 earnings. We adopted SFAS 159 effective January 1, 2008 and have elected not to measure any financial instruments or other items at fair value.

In December 2007, the FASB issued SFAS 141R (revised 2007), *Business Combinations*, which replaces SFAS 141. SFAS 141R expands the definition of a business combination and requires the fair value of the purchase price of an acquisition, including the issuance of equity securities, to be determined on the acquisition date. SFAS 141R also requires that all assets, liabilities, contingent consideration and contingencies of an acquired business to be recorded at fair value at the acquisition date. In addition, SFAS 141R requires that acquisition costs generally be expensed as incurred, restructuring costs generally be expensed in periods subsequent to the acquisition date, and changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period that impacts income tax expense. SFAS 141R is effective for fiscal years beginning after December 15, 2008 with early adoption prohibited. We adopted SFAS 141R at the beginning of fiscal 2009 and will change our accounting treatment for business combinations on a prospective basis.



---

## **Table of Contents**

In September 2007, the FASB issued SFAS 157, *Fair Value Measurements*. SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. It does not require any new fair value measurements, but does require expanded disclosures to provide information about the extent to which fair value is used to measure assets and liabilities, the methods and assumptions used to measure fair value, and the effect of fair value measures on earnings. SFAS 157 is effective for financial assets and financial liabilities for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FSP 157-2, *Effective Date of FASB Statement No. 157*. FSP 157-2 delayed, for one year, the effective date of SFAS 157 for all nonfinancial assets and liabilities, except those that are recognized or disclosed in the financial statements on at least an annual basis. The implementation of SFAS 157 for financial assets and financial liabilities, effective January 1, 2008, did not have a material impact on our consolidated financial position and results of operations. We have disclosed the fair value of our financial assets in Note 12. We are currently assessing the impact of adopting FAS 157 for nonfinancial assets and nonfinancial liabilities on our consolidated financial position and results of operations.

## **2 - Business Combinations, Goodwill, and Intangible Assets**

### **NeuroCom**

On October 2, 2008 we completed the acquisition of all of the outstanding shares of NeuroCom International, Inc. ( NeuroCom ) for \$18.2 million including 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 added to our growth opportunities by broadening the product offerings in our neurology business.

Valuing certain components of the acquisition, including primarily inventory, deferred tax assets and liabilities, accrued warranty costs, and other accrued expenses, required us to make estimates that may be adjusted in the future; consequently, the purchase price allocation is considered preliminary.

### **Schwarzer Neurology**

We 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 broadened our product offerings in the EEG market, allowing us to further leverage its international distribution organization.

Valuing certain components of the acquisition, including primarily inventory, accrued warranty costs, and other accrued expenses, required us to make estimates that may be adjusted in the future; consequently, the purchase price allocation is considered preliminary.

We are obligated to make additional payments pursuant to an earnout provision in the purchase agreement based on the achievement of certain revenue targets. The maximum potential future amount payable under this provision is EUR 900,000 or approximately \$1.2 million if the maximum target sales are achieved during the period April 1, 2009 through September 30, 2009. To date, we have not recorded additional purchase consideration as a result of this provision.

### **Sonamed**

We acquired Sonamed Corporation ( Sonamed ) on May 27, 2008, for \$9.0 million including direct costs of the acquisition. In June 2008 we transitioned substantially all of the operations of Sonamed to our Bio-logic facility in Mundelein, Illinois. The acquisition expands our product offerings in newborn hearing screening.

Valuing certain components of the acquisition, including primarily accrued warranty costs and other accrued expenses, required us to make estimates that may be adjusted in the future; consequently, the purchase price allocation is considered preliminary.

### **Olympic**

We acquired privately held Olympic Medical on October 16, 2006 for \$16.9 million. To date we have recorded \$1.5 million of additional purchase consideration pursuant to an earnout provision in the purchase agreement based on the achievement of certain revenue targets for sales of the Olympic Cool-Cap. At March 31, 2009 the maximum potential future amount payable under this provision, based on sales results from January 1, 2009 through December 31, 2009, is \$1.5 million.



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

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

Balance, January 1, 2009	\$ 60,858
Purchase accounting adjustments	148
Adjustments associated with earnout provisions	19
Change in foreign currency exchange rates	(70)
Balance, March 31, 2009	\$ 60,955

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

Amortization of intangible assets associated with our business combinations was \$1.1 million and \$851,000 for the three months ended March 31, 2009 and 2008, respectively.

**Capitalized Software Development Costs**

Pursuant to SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*, we capitalized \$0 and \$157,000 of software development costs during the three months ended March 31, 2009 and 2008, respectively.

Pursuant to SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, we capitalized \$174,000 and \$447,000 of software development costs during the three months ended March 31, 2009 and 2008, respectively.

We report capitalized software development costs as a component of intangible assets. Amortization of capitalized software development costs was \$132,000 and \$0 for the three months ended March 31, 2009 and 2008, respectively.

**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 our stock awards plans and are calculated under the treasury stock method. Common equivalent shares from unexercised stock options and restricted stock are excluded from the computation when there is a loss as their effect is anti-dilutive, or if the exercise price of such options is greater than the average market price of the stock for the period.

For the three months ended March 31, 2009 and 2008, common stock equivalents of 529,848 and 1,235,158 shares, respectively, were included in the weighted average shares outstanding used to calculate diluted earnings per share. For the three months ended March 31, 2009 and 2008, common stock equivalents of 1,620,307 and 345,297 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.

**4 - Inventories**

Inventories consist of the following (in thousands):

	March 31, 2009	December 31, 2008
Raw materials and subassemblies	\$ 13,538	\$ 13,051
Finished goods	11,987	11,958

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Total	\$ 25,525	\$ 25,009
-------	-----------	-----------

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



**Table of Contents****5 - Property and Equipment**

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

	March 31, 2009	December 31, 2008
Land	\$ 3,480	\$ 3,480
Building	4,766	4,766
Leasehold improvements	963	963
Office furniture and equipment	7,630	6,406
Computer software and hardware	4,771	4,609
Demonstration and loaned equipment	4,620	4,620
	26,230	24,844
Accumulated depreciation	(12,140)	(10,842)
<b>Total</b>	<b>\$ 14,090</b>	<b>\$ 14,002</b>

Depreciation and amortization expense of property and equipment was \$1.3 million and \$617,000 for the three months ended March 31, 2009 and 2008, respectively.

**6 - Reserve for Product Warranties**

We provide a warranty on all medical device products that is generally one year in length. We also sell extended service agreements on our 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.

We have 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 we do 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):

	Three Months Ended March 31,	
	2009	2008
Balance, beginning of period	\$ 1,076	\$ 1,000
Warranty accrued for the period	238	121
Repairs for the period	(291)	(145)
Balance, end of period	\$ 1,023	\$ 976

**7 - Share-Based Compensation**

At March 31, 2009, we have 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 three months ended March 31, 2009 and our 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, 2008.

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

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

	Three Months Ended	
	March 31,	
	2009	2008
Cost of revenue	\$ 37	\$ 87
Marketing and sales	206	231
Research and development	66	40
General and administrative	509	363
<b>Total</b>	<b>\$ 818</b>	<b>\$ 721</b>

-10-

**Table of Contents**

As of March 31, 2009, unrecognized compensation related to the unvested portion of our stock options and other stock awards was approximately \$3.2 million, which is expected to be recognized over a weighted average period of 2.4 years.

**Stock Options**

Activity in our stock option plans during the three months ended March 31, 2009 is as follows:

	Shares	Weighted Average Exercise Price	Weighted- average remaining contractual life (years)	Aggregate intrinsic value (\$ ,000 s)
Outstanding, beginning of period	2,876,072	\$ 9.97		
Granted	15,000	8.10		
Exercised	(1,100)	4.35		
Cancelled	(14,479)	14.85		
Outstanding, end of period	2,875,493	9.94	4.62	\$ 4,590
Exercisable, end of period	2,228,530	8.05	4.59	4,588

As of March 31, 2009, the grant date weighted average fair value of stock options granted in 2009 was \$2.72 per share using the Black-Scholes option pricing model. The intrinsic value of options exercised during the three months ended March 31, 2009 was \$4,000.

As of March 31, 2009, there were: (a) 2,804,529 options vested and expected to vest with a weighted average exercise price of \$9.75, an intrinsic value of \$4.6 million, and a weighted average remaining contractual term of 4.6 years.

**Restricted Stock Awards**

Activity in our stock plans related to restricted stock awards during the three months ended March 31, 2009 is as follows:

	Shares	Weighted- average grant date fair value	Remaining cost expected to be recognized (\$ ,000 s)
Unvested, beginning of period	339,518	\$ 17.50	
Granted	5,000	8.22	
Vested	(1,550)	17.69	
Forfeited	(3,000)	19.21	
Unvested, end of period	339,968	17.34	\$ 4,959

All of the shares awarded during the period 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.

**Restricted Stock Units**

Activity in our stock plans related to the award of restricted stock units during the three months ended March 31, 2009 is as follows:

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

	Shares	Weighted- average remaining contractual life (years)	Aggregate intrinsic value (\$ ,000 s)
Outstanding, beginning of period	33,500		
Awarded			
Released			
Forfeited			
Outstanding, end of period	33,500	1.68	\$ 277

-11-

**Table of Contents**

We award restricted stock units 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 consisted of (in thousands):

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2009</b>	<b>2008</b>
Investment income	\$ 105	\$ 138
Interest expense	(14)	(545)
Foreign currency exchange gain	14	411
Other	21	(3)
<b>Total other income (expense), net</b>	<b>\$ 126</b>	<b>\$ 1</b>

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

We recorded a provision for income tax of \$442,000 and \$1.7 million for the three months ended March 31, 2009 and 2008, respectively. Our effective tax rate was 36.0% and 38.9% for the three months ended March 31, 2009 and 2008, respectively. We expect that our effective tax rate for the full year 2009 will be approximately 38%.

**Deferred Income Taxes**

We account 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 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 our deferred tax assets, as we believe that it is more likely than not that those deferred tax assets will be fully realized.

**Uncertain Tax Positions**

We have cumulatively accrued approximately \$537,000 for estimated interest and penalties related to uncertain tax positions at March 31, 2009. We recorded approximately \$51,000 and \$69,000 of interest and penalties related to unrecognized tax positions as a component of income tax expense during the three months ended March 31, 2009 and 2008, respectively.

Our tax returns remain open to examination as follows: U.S. federal, 2004 through 2008; U.S. states, generally 2003 through 2008; significant foreign jurisdictions, generally 2005 through 2008.

**10 - Debt and Credit Arrangements**

Long-term borrowings are comprised of the following (2009 and 2008 columns in thousands):

	<b>March 31,</b>	<b>December 31,</b>
	<b>2009</b>	<b>2008</b>
Term loan \$2.9 million Canadian ( CAD ), interest at cost of funds plus 2.5%, due September 15, 2014 with principle repayable in monthly installments of \$16,000 until	\$ 1,181	\$ 1,220

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

August 15, 2014 and one final payment of \$404,000 collateralized by a first lien on land and building owned by Xltek		
Term loan CAD \$300,000, interest at cost of funds plus 2.5% due November 15, 2010 with principle repayable in monthly installments of \$2,000 until October 10, 2010 and one final payment of \$36,000 collateralized by various assets of Xltek	63	68
<b>Total long-term debt (including current portion)</b>	<b>1,244</b>	<b>1,288</b>
Less: current portion of long-term debt	(173)	(206)
<b>Total long-term debt</b>	<b>\$ 1,071</b>	<b>\$ 1,082</b>

**Table of Contents**

On September 2, 2008, we executed a second amendment to our Amended and Restated Credit Agreement (the Second Amendment) with Wells Fargo Bank, National Association (Wells Fargo). The Second Amendment increases the borrowing limit of our 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. We have granted Wells Fargo a security interest in all of our assets. As of March 31, 2009 there were no outstanding borrowings on the credit facility.

**11 - Segment, Customer 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 in newborn care, hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and balance and mobility disorders.

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.

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

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
Revenue:		
United States	\$ 22,978	\$ 24,740
Foreign countries	10,379	12,119
Totals	\$ 33,357	\$ 36,859

	<b>March 31, 2009</b>	<b>December 31, 2008</b>
Long-lived assets:		
United States	\$ 7,263	\$ 7,579
Foreign countries	6,827	6,423
Totals	\$ 14,090	\$ 14,002

Long-lived assets consist principally of property and equipment (net). During the three months ended March 31, 2009 and 2008, no single customer or foreign country contributed to more than 10% of revenue, and revenue from services was less than 10% of revenue.

During the three months ended March 31, 2009 and 2008, respectively, revenue from devices and systems was \$19.9 and \$22.9 million, while revenue from supplies and services was \$13.3 and \$13.2 million, respectively.

**12 - Fair Value of Financial Instruments**

The fair value of our assets and liabilities subject to fair value measurements are as follows (in thousands):

Fair Value	Fair Value Measurements as of
as of	03/31/09 Using Fair Value Hierarchy

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

	03/31/09	Level 1	Level 2	Level 3
Bank Money Market Investments	\$ 46,998		\$ 46,998	
Guaranteed Investment Certificate	795		795	
<b>Total</b>	<b>\$ 47,793</b>		<b>\$ 47,793</b>	

	Fair Value	Fair Value Measurements as of		
	as of	12/31/08 Using Fair Value Hierarchy		
	12/31/08	Level 1	Level 2	Level 3
Bank Money Market Investments	\$ 45,905		\$ 45,905	
Embedded Derivatives, net	(122)		(122)	
<b>Total</b>	<b>\$ 45,783</b>		<b>\$ 45,783</b>	



## **Table of Contents**

In accordance with SFAS 157, *Fair Value Measurements*, Level 1 evaluations are based on quoted prices in active markets for identical assets or liabilities that we have the ability to access. Level 2 evaluations are based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly. Bank money market accounts have a net asset value of \$1.00 per share and are classified as Level 2 assets. Level 3 evaluations are based on assets and liabilities for which there are no observable inputs that are significant to the overall fair value measurement.

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

*Natus*<sup>®</sup>, *AABR*<sup>®</sup>, *ABaer*<sup>®</sup>, *ALGO*<sup>®</sup>, *AOAE*<sup>®</sup>, *AuDX*<sup>®</sup>, *Balance Manager*<sup>®</sup>, *Balance Master*<sup>®</sup>, *Biliband*<sup>®</sup>, *Bio-logic*<sup>®</sup>, *Ceegrath*<sup>®</sup>, *CHAMP*<sup>®</sup>, *Cochlea Scan*<sup>®</sup>, *Cool Cap*<sup>®</sup>, *Ear Couplers*<sup>®</sup>, *Echo Screen*<sup>®</sup>, *EquiTest*<sup>®</sup>, *Fischer-Zoth*<sup>®</sup>, *Flexicoupler*<sup>®</sup>, *MASTER*<sup>®</sup>, *Navigator*<sup>®</sup>, *neoBLUE*<sup>®</sup>, *NeuroWorks*<sup>®</sup>, *Oxydome*<sup>®</sup>, *Sleepscan*<sup>®</sup>, *Smart Scale*<sup>®</sup>, *Traveler*<sup>®</sup>, *Warmette*<sup>®</sup> and *VAC PAC*<sup>®</sup> are registered trademarks of Natus Medical Incorporated. *Accuscreen*, *Bili-Lite Pad*, *Bili-Lite*, *Biomark*, *Circumstraint*, *Coherence*, *Deltamed*, *inVision*, *MiniMuffs*, *Neometrics* and *Smartpack* are non-registered trademarks of Natus. *Solutions for Newborn CareSM* is a non-registered service mark of Natus. *Neuromax* and *Sleeprite* are registered trademarks of Excel Tech Ltd. *Xltek* is a non-registered trademark 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, 2008 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 our Annual Report. Management's discussion and analysis should be read in conjunction with our 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 our business;

**2009 First Quarter Overview.** A summary of key information concerning the financial results for the three months ended March 31, 2009;

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

**Results of Operations.** An analysis of our 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 leading provider of healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments in newborn care, hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and balance and mobility disorders. Product

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

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.

-14-

**Table of Contents**

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, Xltek in 2007 and Sonamed Corporation, Schwarzer Neurology, a division of Schwarzer GmbH, and NeuroCom International, Inc. in 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 2008:

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

**Monitoring Systems for Neurology** Includes products for diagnostic electroencephalography ( EEG ), diagnostic sleep analysis ( PSG ), electromyography ( EMG ), intra-operative monitoring ( IOM ), newborn brain monitoring, and assessment of balance and mobility disorders.

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

*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 in newborn care, hearing impairment, neurological dysfunction, epilepsy, sleep disorders and balance and mobility disorders.

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 11 *Segment, Customer and Geographic Information* of our condensed consolidated financial statements included in this report.

*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, 2008. Revenue from Devices and Systems, and Supplies and Services, as a percent of total revenue for the three months ended March 31, 2009 and 2008 is as follows:

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2009</b>	<b>2008</b>
Devices and Systems	58%	62%
Supplies and Services	40%	36%
Other	2%	2%
Total	100%	100%

During the three months ended March 31, 2009 and 2008, no single customer or foreign country contributed to more than 10% of revenue, and revenue from services was less than 10% of revenue.

**2009 First Quarter Overview**

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

Our revenue decreased 9.5% to \$33.4 million in the first quarter ended March 31, 2009, compared to \$36.9 million reported in the comparable quarter of the previous year. Net income decreased 70% to \$787,000, or \$0.03 per diluted share, for the first quarter of 2009, compared with net income of \$2.6 million, or \$0.11 per diluted share, for the first quarter of 2008.

The severe worldwide economic downturn that started to impact our business in December 2008 continued to influence our results for the first quarter of 2009. In the quarter, hospitals in the United States reduced expenditures on capital equipment. This impacted sales of all the Company's product lines except the ALGO newborn hearing screening products. We also saw a reduction in capital equipment spending outside the United States. Revenue from our neurology,

**Table of Contents**

balance and mobility, hearing diagnostic, and newborn care equipment products were all down by at least 15% year over year. We believe this trend will continue through the remainder of the year, but we believe the reduction in capital equipment purchases has stabilized and will not further deteriorate.

**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, or judgments could have a material affect 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 and goodwill

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, 2008, 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 months ended March 31, 2009.

**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.

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2009</b>	<b>2008</b>
Revenue	100.0%	100.0%
Cost of revenue	39.1	38.0
<b>Gross profit</b>	<b>60.9</b>	<b>62.0</b>
Operating expenses:		
Marketing and selling	30.0	26.8

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Research and development	11.1	10.4
General and administrative	16.5	13.2
Total operating expenses	57.6	50.4
Income from operations	3.3	11.6
Other income, net	0.4	
Income before provision for income tax	3.7	11.6
Provision for income tax	1.3	4.5
Net income	2.4%	7.1%

-16-

---

**Table of Contents****Three Months Ended March 31, 2009 and 2008**

Certain reclassifications have been made to the prior period classification of revenue as devices and systems or supplies and services to conform to the current presentation.

We acquired Sonamed in May 2008, Schwarzer Neurology in July 2008 and NeuroCom in October 2008. Where significant, we have noted the impact of these acquisitions on our results of operations for the three months ended March 31, 2009, as compared to the same period in 2008.

Revenue decreased \$3.5 million, or 9.5%, for the three month period ended March 31, 2009 from the comparable 2008 period. The decrease was due primarily to lower capital equipment sales across all of our product lines. We believe that these lower sales resulted from weakness in demand due to the current economic recession and not a loss of market share. Schwarzer Neurology and NeuroCom contributed to \$3.0 million of revenue offset by a \$4.9 million decrease in capital equipment revenue and a \$900,000 decrease in newborn care and neurology supplies revenue.

Device and systems revenue decreased \$3.4 million, or 15.1%, to \$19.5 million in the three months ended March 31, 2009, compared to \$22.9 million in the same period in 2008. Schwarzer Neurology and NeuroCom contributed to \$2.6 million of revenue from devices and systems offset by a \$3.2 million decrease in revenue from other neurology products, a \$2.3 million decrease in revenue from hearing products, and a \$635,000 decrease in revenue from newborn care products. Revenue from devices and systems was 58% of consolidated revenue in the three months ended March 31, 2009 compared to 62% of consolidated revenue for the first quarter of 2008.

Supplies and services revenue increased \$61,000, or 0.5%, to \$13.3 million in the first quarter of 2009 compared to \$13.2 million in the first quarter of 2008. Revenue from hearing screening supplies increased by \$841,000, which was primarily offset by a decrease in revenue from neurology supplies. Revenue from services increased \$81,000 to \$2.2 million in the 2009 period. Revenue from supplies and services was 40% of consolidated revenue in the three months ended March 31, 2009 compared to 36% of consolidated revenue for the first quarter of 2008.

Revenue from sales outside the U.S. decreased \$1.7 million, or 14.4%, to \$10.4 million in the first quarter of 2009 compared to \$12.1 million for the same period in 2008. Schwarzer Neurology and NeuroCom contributed to \$1.5 million of international revenue. A \$540,000 increase in international supplies and service revenue was offset by a \$2.0 million decrease in international device and systems sales reflecting weakness in capital equipment demand in international markets.

Gross profit as a percentage of revenue was 60.9% for the three months ended March 31, 2009 compared to 62.0% for the respective period in 2008. The lower margin earned on products of Schwarzer Neurology, which we acquired at the beginning of the third quarter of 2008, and increased materials costs as a percentage of revenue reduced consolidated gross profit for the 2009 period as compared to the same period in 2008. Cost of revenue decreased \$956,000, or 6.8%, to \$13.0 million in the three months ended March 31, 2009, from \$14.0 million in 2008, reflecting reduced sales in the 2009 period. Gross profit decreased \$2.6 million, or 11.1%, to \$20.3 million in 2009 from \$22.9 million in 2008.

Total operating costs increased by \$646,000 or 3.5%, to \$19.2 million in the three months ended March 31, 2009, compared to \$18.6 million in the same period in 2008. Excluding the operating costs of Schwarzer Neurology and NeuroCom, which were \$2.1 million, total operating costs were approximately 10% lower, or \$1.5 million, in the first quarter of 2009 compared to the same period in 2008. The reduction in operating expenses exclusive of Schwarzer Neurology and Neurocom reflect the impact of our 2008 restructuring plan and the implementation of tighter cost controls.

Marketing and selling expenses increased \$111,000, or 1.1%, to \$10.0 million in the three months ended March 31, 2009 compared to \$9.9 million in the same period in 2008. The operations of Schwarzer Neurology and NeuroCom contributed \$1.3 million of costs, which were offset by reductions in commission payments to sales personnel and distributors, personnel costs resulting from headcount reductions, and travel and outside service costs.

Research and development expenses decreased \$113,000, or 3.0%, to \$3.7 million for in the three months ended March 31, 2009 compared to \$3.8 million in the same period of 2008. The operations of Schwarzer Neurology and NeuroCom contributed \$369,000 of research and development expenses, which were offset by a reduction in salary and associated compensation costs resulting from restructuring activities completed in 2008. Research and development expenses as a percent of total revenue increased from 10.4% in the three months ended March 31, 2008 to 11.2% for the three months ended March 31, 2009 due to lower sales volume.

General and administrative expenses increased \$648,000, or 13.3%, to \$5.5 million in the three months ended March 31, 2009 compared to \$4.9 million in the same period in 2008. The operations of Schwarzer Neurology and NeuroCom contributed \$406,000 of general and administrative expenses, coupled with higher payroll, insurance and outside accounting costs.





---

**Table of Contents**

We adopted an integration and restructuring plan in February 2008 that was designed to reduce 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 plan is expected to result in annual operating cost reductions of approximately \$2.4 million in 2009 and beyond. Pursuant to the plan, we accrued \$96,000 of employee termination benefits in the three months ended March 31, 2008. We had no similar costs in the respective period in 2009.

Other income, net consists of investment income from our investment portfolio, interest expense, net currency exchange gains and losses, and other miscellaneous income and expenses. We reported net other income of \$126,000 in the three months ended March 31, 2009, compared to \$1,000 in the same period in 2008 due primarily to interest income in 2009 as compared with investment income and net currency gains offset by interest expense in the first quarter of 2008.

We recorded income tax expense of \$442,000 in the three months ended March 31, 2009, compared to \$1.7 million in the same period in 2008. Our effective tax rate in the first quarter of 2009 was 36.0% compared to an effective rate of 38.9% in the first quarter of 2008. The lower effective tax rate in 2009 was primarily attributable to discrete tax adjustments as we expect that our effective tax rate for the full-year 2009 will be approximately 38%.

Effective January 1, 2009, the Company's Canadian subsidiary, Xltek changed its functional currency to the U.S. dollar. The change in functional currency reflects the fact that Xltek now conducts the majority of its business transactions in U.S. dollars and maintains a significant portion of its balance sheet in U.S. dollar denominated accounts.

**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 March 31, 2009, we had cash and cash equivalents of \$61.4 million, short-term investments of \$795,000, stockholders' equity of \$228.2 million, and working capital of \$105.5 million, compared with cash and cash equivalents of \$56.9 million, stockholders' equity of \$226.5 million, and working capital of \$102.3 million as of December 31, 2008.

We believe that our current cash, cash equivalents, and short-term balances, including cash generated from operations, will be sufficient to meet our ongoing operating and capital requirements for the foreseeable future. We completed three acquisitions in 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, we executed a second amendment to our Amended and Restated Credit Agreement (the "Second Amendment") with Wells Fargo Bank, National Association ("Wells Fargo"). The Second Amendment increases the borrowing limit of our 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. We have granted Wells Fargo a security interest in all of our assets.

Cash provided by operations increased by \$4.5 million for the three months ended March 31, 2009 to \$6.6 million, compared to \$2.1 million for the same period in 2008. The sum of our net income and non-cash expense items, such as reserves, depreciation and amortization, and stock based compensation, was approximately \$5.0 million in the 2009 period, compared to \$4.9 million in 2008. The overall impact of changes in certain operating assets and liabilities on total operating cash flows resulted in a cash inflow of \$1.6 million in 2009 compared with a cash outflow of \$2.8 million in 2008.

---

**Table of Contents**

Cash used in investing activities was \$2.4 million for the three months ended March 31, 2009 compared to \$1.4 million for the same period in 2008. We recorded \$174,000 of internal use software development costs in 2009, compared to \$479,000 in the same period of 2008.

Cash used in financing activities was \$39,000 during the three months ended March 31, 2009, compared to \$538,000 in the same period in 2008. We raised cash through sales of our stock pursuant to our stock awards plans and our employee stock purchase plan in the amount of \$5,000 and \$466,000 in the three months ended March 31, 2009 and 2008, respectively. We also realized an excess tax benefit of \$203,000 on the exercise of employee stock options for the three months ended March 31, 2008 that was recorded as an increase to stockholders' equity, with no comparable tax benefit in the first quarter of 2009. During the three months ended March 31, 2008, we increased our borrowings under our credit facility by \$1.0 million and made payments on our long-term debt in the amount of \$2.2 million resulting in a net cash outflow of \$1.2 million for the three months ended March 31, 2008, compared with payments of \$44,000 for the three months ended March 31, 2009.

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 our Annual Report on Form 10-K for the year ended December 31, 2008.

Under our bylaws, we have agreed to indemnify our 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 new 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,"*

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

*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: our effective tax rate for 2009, our expectation that the reduction in capital equipment purchases has stabilized and will not further deteriorate, our expectation regarding expansion of our international operations, our expectations regarding our new products, 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*

-19-

---

**Table of Contents**

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

**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 three months ended March 31, 2009. Our interest income is sensitive to changes in the general level of interest rates in the U.S. However, because current market conditions have resulted in historically low rates of return on our investments, a hypothetical decrease 10% in market interest rates would not result in a material decrease in interest income earned on investments held at March 31, 2009.

When able, we invest excess cash in bank money-market funds or discrete 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 March 31, 2009, 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 March 31, 2009. 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 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 March 31, 2009. Our chief executive officer and chief financial officer determined that as of March 31, 2009 our disclosure controls and procedures were effective for the purpose set forth above.

*Changes in Internal Control over Financial Reporting*

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

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.

-20-

---

## Table of Contents

There was no change in our internal control over financial reporting that occurred during the fiscal quarter ended March 31, 2009, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **ITEM 1. Legal Proceedings**

We may from time to time become a party to various legal proceedings or claims that arise in the ordinary course of business. Our management reviews these matters if and when they arise and believes that the resolution of any of these matters will not have a significant adverse effect on our financial condition.

### **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, Neometrics Inc. and affiliated entities in 2003; Fischer-Zoth in 2004, Bio-logic, Deltamed, and Olympic Medical, and certain assets of Nascor in 2006, Xltex in 2007, and Sonamed, Schwarzer Neurology, and NeuroCom in 2008.

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, Xltex in Ontario, Canada, Deltamed in France, and Fischer-Zoth, IT Med and Schwarzer Neurology in Germany. 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 ones. 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:

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

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

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

Assumption of unknown liabilities;

---

## **Table of Contents**

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 months. These conditions stem from slower economic activity, adverse credit conditions, and numerous other factors, and we are unable to foresee when, or if, 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. These conditions began to adversely affect our operating results in December 2008 and had a more significant impact in the first quarter of 2009 and could continue to 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. In addition, these factors have caused us to be more cautious in evaluating potential acquisition opportunities, which could hinder our ability to grow through acquisition while these conditions persist.

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

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 policies of these entities and the amount that they can spend on our products. If one or more of these factors limit the capital spending of our customers, they will be less likely to purchase new equipment from us or to upgrade to any of our newer equipment products. We believe that the recent lack of liquidity in credit markets, increasing unemployment, and additional effects of the uncertainty in economic conditions worldwide, have had an adverse effect on the spending patterns of our customers and may continue to have such an effect in future periods. This, in turn, can have a significant adverse effect on our operating results and financial position.

### **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 in recent 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.

### **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**



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

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

-22-

---

**Table of Contents**

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. We test our intangible assets, including goodwill, in the fourth quarter of each year, but we may test more frequently if there is a change in circumstances that indicates that the carrying value of these assets may be impaired. 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 ) from 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 in 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 our 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.

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

## Table of Contents

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 31%, 35% and 31% of our total revenue during 2008, 2007 and 2006, respectively, and sales to members of one GPO, Novation LLC, accounted for approximately 10%, 9% and 12% of our total revenue in 2008, 2007 and 2006, 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.

### **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.

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

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.

-24-

## **Table of Contents**

### **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 adverse conditions including 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;

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 that could make our products less competitive because most of our international sales are denominated in U.S. dollars;

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, and cost reimbursement policies, towards use 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.

**Our operating results may suffer because of our exposure to foreign currency exchange rate fluctuations**

While substantially all of the sales contracts of Natus Medical Incorporated and our North American subsidiaries provide for payment in U.S. dollars, substantially all of the revenue and expenses of our subsidiaries outside of North America are denominated in the local currency. To date we have executed only limited foreign currency contracts to hedge these currency risks. 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.

Substantially all our sales from our U.S. operations to our international distributors also provide for payment in U.S. dollars. A strengthening of the U.S. dollar relative to other foreign currencies could increase the effective cost of our products to our international distributors as their functional currency is typically not the U.S. dollar. This could have a potential adverse effect on our ability to increase or maintain average selling prices of our products to our foreign-based customers.

## **Table of Contents**

### **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 those guidelines have a long phase-in period, our revenue may be adversely 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. 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.

### **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. 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





---

**Table of Contents**

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 much 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 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;

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

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.

-27-

## **Table of Contents**

### **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**

We and our suppliers 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.

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.

### **Our Olympic Cool-Cap product is subject 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.

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 if 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, 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 Medicare or Medicaid, (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, and/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 their federal counterparts in significant ways, thus complicating compliance efforts.



## **Table of Contents**

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 is 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;

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**

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

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.

-29-

**Table of Contents****We have initiated changes to our information systems that could disrupt our business and our financial results.**

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.

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.

**ITEM 6. Exhibits**

## (a) Exhibits

Exhibit No.	Exhibit	Incorporated By Reference			
		Filing	No.	File No.	File Date
10.1	Third Amendment to Amended and Restated Credit Agreement between Natus Medical Incorporated and Wells Fargo Bank National Association	10-K	10.16	000-33001	03/10/2009
10.02	Amended and Restated Security Agreement dated February 19, 2009 in favor of Wells Fargo Bank National Association	10-K	10.17	000-33001	03/10/2009
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				

**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: May 7, 2009

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

Dated: May 7, 2009

By: */s/* STEVEN J. MURPHY  
Steven J. Murphy,**Vice President Finance and**

**Chief Financial Officer**

**(Principal Financial and**

**Accounting Officer)**

-30-



**Table of Contents**

**NATUS MEDICAL INCORPORATED**

**INDEX TO EXHIBITS**

<b>Exhibit No.</b>	<b>Exhibit</b>	<b>Incorporated By Reference Exhibit</b>			
		<b>Filing</b>	<b>No.</b>	<b>File No.</b>	<b>File Date</b>
10.1	Third Amendment to Amended and Restated Credit Agreement between Natus Medical Incorporated and Wells Fargo Bank National Association	10-K	10.16	000-33001	03/10/2009
10.02	Amended and Restated Security Agreement dated February 19, 2009 in favor of Wells Fargo Bank National Association	10-K	10.17	000-33001	03/10/2009
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				