

NATUS MEDICAL INC
Form 10-Q
May 09, 2008
Table of Contents

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

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2008

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____

Commission file number: 000-33001

NATUS MEDICAL INCORPORATED

(Exact name of registrant as specified in its charter)

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

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

(650) 802-0400

(Registrant's telephone number, including area code)

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

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

Large Accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The number of issued and outstanding shares of the registrant's Common Stock, \$0.001 par value, as of May 2, 2008 was 22,917,090.

Table of Contents

NATUS MEDICAL INCORPORATED

TABLE OF CONTENTS

	Page No.
PART I. <u>FINANCIAL INFORMATION</u>	3
Item 1. <u>Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets as of March 31, 2008 and December 31, 2007 (unaudited)</u>	3
<u>Condensed Consolidated Statements of Operations for the three months ended March 31, 2008 and 2007 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2008 and 2007 (unaudited)</u>	5
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	20
Item 4. <u>Controls and Procedures</u>	20
PART II. <u>OTHER INFORMATION</u>	22
Item 1. <u>Legal Proceedings</u>	22
Item 1A. <u>Risk Factors</u>	22
Item 6. <u>Exhibits</u>	31
<u>Signatures</u>	33

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, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 12,600	\$ 11,916
Accounts receivable, net of allowance for doubtful accounts of \$1,003 and \$993	27,909	27,018
Inventories	20,557	19,264
Prepaid expenses and other current assets	2,969	3,402
Deferred income taxes	3,974	3,974
Total current assets	68,009	65,574
Property and equipment, net	14,481	14,504
Intangible assets	53,201	54,177
Goodwill	53,128	54,961
Other non-current assets	27	355
Total assets	\$ 188,846	\$ 189,571
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Accounts payable	\$ 8,884	\$ 9,763
Current portion of long-term debt	19,546	18,554
Accrued liabilities	11,667	13,362
Deferred revenue	5,466	4,732
Total current liabilities	45,563	46,411
Long-term debt	16,064	18,262
Other liabilities	2,636	2,636
Deferred income tax	6,544	6,544
Total liabilities	70,807	73,853
Stockholders equity:		
Common Stock, \$0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 21,958,804 and 21,923,509	139,226	137,837
Accumulated deficit	(20,188)	(22,815)
Accumulated other comprehensive income	(999)	696
Total stockholders equity	118,039	115,718
Total liabilities and stockholders equity	\$ 188,846	\$ 189,571

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

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

-3-

Table of Contents

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

(in thousands, except per share amounts)

	Three Months Ended March 31,	
	2008	2007
Revenue	\$ 36,859	\$ 27,050
Cost of revenue	14,005	10,175
Gross profit	22,854	16,875
Operating expenses:		
Marketing and selling	9,876	6,496
Research and development	3,827	3,824
General and administrative	4,856	4,108
Total operating expenses	18,559	14,428
Income from operations	4,295	2,447
Other income, net	1	241
Income before provision for income tax	4,296	2,688
Provision for income tax	1,669	1,169
Net income	\$ 2,627	\$ 1,519
Earnings per share:		
Basic	\$ 0.12	\$ 0.07
Diluted	\$ 0.11	\$ 0.07
Weighted average shares used in the calculation of net income per share:		
Basic	21,742	21,466
Diluted	22,977	22,734

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)

	Three Months Ended March 31,	
	2008	2007
Operating activities:		
Net income	\$ 2,627	\$ 1,519
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,468	1,168
Accounts receivable reserves	145	25
Warranty reserves	121	56
Share-based compensation	721	375
Excess tax benefits on the exercise of options	(203)	(611)
Changes in operating assets and liabilities:		
Accounts receivable	(1,036)	632
Inventories	(1,293)	(1,677)
Prepaid expenses and other assets	761	1,119
Accounts payable	(1,003)	(303)
Accrued liabilities and deferred revenue	(230)	(751)
Net cash provided by operating activities	2,078	1,552
Investing activities:		
Acquisition of property and equipment	(854)	(1,037)
Capitalized software development costs	(479)	
Acquisition of business, net of cash acquired	(67)	
Net cash used in investing activities	(1,400)	(1,037)
Financing activities:		
Proceeds from stock option exercises and ESPP purchases	466	520
Excess tax benefits upon the exercise of options	203	611
Borrowing on revolving credit facility	1,000	
Payment on revolving credit facility	(2,207)	
Net cash (used in) provided by financing activities	(538)	1,131
Exchange rate effect on cash and cash equivalents	544	(254)
Net increase in cash and cash equivalents	684	1,392
Cash and cash equivalents, beginning of period	11,916	15,392
Cash and cash equivalents, end of period	\$ 12,600	\$ 16,784
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 545	\$
Cash paid for income taxes	\$ 537	\$ 621

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

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

-5-

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

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

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

Internal Use Software Development Costs

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

Comprehensive Income

The following are the components of comprehensive income (in thousands):

	Three Months Ended March 31,	
	2008	2007
Net income	\$ 2,627	\$ 1,519
Foreign currency translation adjustment	(1,696)	(254)
Comprehensive income	\$ 931	\$ 1,265

Stockholders Equity

The following are the changes in stockholders equity (in thousands):

	Three Months Ended March 31,	
	2008	2007
Balance, beginning of period	\$ 115,718	\$ 101,026
Net income	2,627	1,519
Proceeds from stock option exercises and ESPP	466	520

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Share-based compensation expense	721	375
Tax effect of option exercises	203	611
Adoption of FIN 48		(917)
Comprehensive income	(1,696)	(254)
Balance, end of period	\$ 118,039	\$ 102,880

-6-

Table of Contents**Recent Accounting Pronouncements**

The Company adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. (SFAS) 157, *Fair Value Measurements* effective January 1, 2008. The provisions of SFAS 157 define fair value, establish a framework for measuring fair value in generally accepted accounting principles, and expand disclosures about fair value measurements. The provisions of FAS 157 are effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position (FSP) 157-2 which defers the effective date of FAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FSP 157-2 will apply to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The adoption of SFAS No. 157 had no effect on the Company's consolidated financial position or results of operations.

The Company adopted SFAS 159, *Fair Value Option of Financial Assets and Financial Liabilities* effective January 1, 2008. This statement provides companies with an option to report selected financial assets and liabilities at fair value. The Company did not elect the fair value option for any of such eligible financial assets or financial liabilities as of March 31, 2008.

In December 2007, the FASB issued SFAS 141R (revised 2007), *Business Combinations*, which replaces SFAS 141. SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and the goodwill acquired. SFAS 141R also establishes disclosure requirements that will enable users to evaluate the nature and financial effects of the business combination. SFAS 141R will apply to business combinations completed by the Company after January 1, 2009.

2- Business Combinations, Goodwill, and Intangible Assets

Xltek On November 29, 2007, the Company completed the acquisition of Excel-Tech Ltd. (Xltek), based in Oakville, Ontario, Canada for \$64 million. Xltek develops and markets computer-based electrodiagnostic systems and disposable supplies used by medical practitioners to aid in the detection, diagnosis, and monitoring of neurologic and sleep disorders. The acquisition adds to the Company's growth opportunities by broadening its product offerings in neurology, including Xltek's products for the diagnosis of peripheral nervous system dysfunction.

The Company recognized \$1.1 million of pre-acquisition deferred tax assets during the three months ended March 31, 2008, for which the Company had previously provided a full valuation allowance, which resulted in a decrease in goodwill. The Company recorded \$60,000 of additional direct costs of the acquisition during the three months ended March 31, 2008, which resulted in an increase in goodwill. In addition, a change in the exchange rate between the U.S. dollar and the Canadian dollar resulted in a decrease in goodwill.

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

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

The Company is obligated to make future payments pursuant to an earnout provision in the purchase agreement of up to \$3.1 million over a three-year period based primarily on the achievement of certain revenue targets for the Olympic Cool-Cap system. The Company recorded \$214,000 of additional purchase consideration during the three months ended March 31, 2008 pursuant to this earnout provision that was recorded as an increase in goodwill.

Nascor The Company completed the purchase of certain product rights, manufacturing and distribution contracts, inventory, and intangible assets from Nascor Pty. Ltd. in September 2006 for \$953,000. The Company previously distributed certain Nascor products in the United States and certain other countries. This acquisition provides the Company with worldwide distribution rights and improved margins on these products.

Table of Contents

The Company is obligated to make future payments pursuant to an earnout provision of the purchase agreement of up to \$675,000 over a three-year period based on the achievement of certain revenue targets. The Company recorded \$208,000 of additional purchase consideration during the three months ended March 31, 2008 pursuant to this earnout provision that was recorded as an increase in goodwill.

Bio-logic The Company acquired Bio-logic Systems Corp. (Bio-logic) in January 2006 for \$69.3 million. The Company made this acquisition to supplement its hearing screening business with the addition of Bio-logic's diagnostic hearing products as well as to open up new market opportunities in the areas of EEG diagnosis and monitoring of neurological dysfunction and sleep disorders.

The Company recorded a reduction in pre-acquisition deferred tax assets of \$6,000 during the three months ended March 31, 2008 with an offsetting increase in goodwill.

Goodwill

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

	Three Months Ended March 31,	
	2008	2007
Balance, beginning of period	\$ 54,961	\$ 25,790
Purchase accounting adjustments	19	187
Adjustments associated with earnout provisions	422	120
Adjustment of pre-acquisition deferred tax assets	(1,065)	503
Change in foreign currency exchange rates	(1,209)	
Balance, end of period	\$ 53,128	\$ 26,600

Amortization of Intangible Assets Acquired Through Business Combinations

Amortization of intangible assets associated with the Company's business combinations was \$851,000 and \$687,000 for the three months ended March 31, 2008 and 2007, respectively.

Capitalized Software Development Costs

During the three months ended March 31, 2008, the Company capitalized \$157,000 of software development costs pursuant to SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*, and \$447,000 of software development costs pursuant to SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Such costs were reported as a component of intangible assets.

3- Basic and Diluted Net Income Per Common Share

Net income per share is computed in accordance with SFAS 128, *Earnings per Share*. Basic net income per share is based upon the weighted average number of common shares outstanding during the period. Diluted net income per share is based upon the weighted average number of common shares outstanding and dilutive common stock equivalents outstanding during the period. Common stock equivalents are options granted and shares of restricted stock issued under the Company's stock awards plans and are calculated under the treasury stock method. Common equivalent shares from unexercised stock options and restricted stock are excluded from the computation for periods in which the Company incurs 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, 2008 and 2007, common stock equivalents of 1,235,158 and 1,268,289 shares, respectively, were included in the weighted average shares outstanding used to calculate diluted income per share. For the three months ended March 31, 2008 and 2007, common stock equivalents of 345,297 and 31,750 shares, respectively, were excluded from the calculation of diluted income per share because the exercise price of such options was greater than the average market price of the stock for the periods.

Table of Contents**4- Inventories**

Inventories consist of (in thousands):

	March 31, 2008	December 31, 2007
Raw materials and subassemblies	\$ 11,594	\$ 12,186
Finished goods	8,963	7,078
Total	\$ 20,557	\$ 19,264

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

5- Property and Equipment

Property and equipment consist of (in thousands):

	March 31, 2008	December 31, 2007
Land	\$ 3,956	\$ 3,956
Building	5,504	5,504
Leasehold improvements	964	917
Office furniture and equipment	5,095	4,971
Computer hardware and software	3,610	3,218
Demonstration and loaned equipment	3,636	3,605
	22,765	22,171
Accumulated depreciation	(8,284)	(7,667)
Total	\$ 14,481	\$ 14,504

Depreciation and amortization expense of property and equipment for the three months ending March 31, 2008 and 2007 was \$617,000 and \$481,000, respectively.

6- Reserve For Product Warranties

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

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

Table of Contents

Activity in the warranty reserve during the three months ended March 31, 2008 and 2007 consisted of (in thousands):

	Three Months Ended March 31,	
	2008	2007
Balance, beginning of period	\$ 1,000	\$ 877
Warranty accrued for the period	121	56
Repairs for the period	(145)	(116)
Balance, end of period	\$ 976	\$ 817

7- Share-Based Compensation

At March 31, 2008, the Company has the following plans that give rise to share-based compensation: (i) two active stock option plans, the Amended and Restated 2000 Stock Awards Plan and the 2000 Director Stock Option Plan, and (ii) the 2000 Employee Stock Purchase Plan. The terms of awards granted during the three months ended March 31, 2008 and the Company's methods for determining grant-date fair value of the awards were consistent with those described in our December 31, 2007 annual consolidated financial statements. Following is a recap of activity in our stock option plans during the three months ended March 31, 2008:

	Shares	Weighted Average Exercise Price	Weighted- average remaining contractual life (years)	Aggregate intrinsic value (\$,000 s)
Outstanding, beginning of period	2,879,667	\$ 8.23		
Granted	25,000	18.44		
Exercised	(59,545)	7.59		
Cancelled	(15,083)	15.17		
Outstanding, end of period	2,830,039	\$ 8.30	5.55	\$ 27,784
Exercisable, end of period	2,125,345	\$ 6.68	5.53	\$ 24,295

During the three months ended March 31, 2008 the intrinsic value of options exercised amounted to \$665,151.

Share-based compensation expense was recognized as follows, (in thousands):

	Three Months Ended March 31,	
	2008	2007
Cost of revenue	\$ 87	\$ 33
Marketing and sales	231	88
Research and development	40	35
General and administrative	363	219
Total	\$ 721	\$ 375

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

The Company granted 10,000 shares of restricted stock during the three months ended March 31, 2008 with a weighted average value of \$18.58 per share. All of these shares were awarded to employees of the Company that vest 50% upon the second anniversary of the grant and 25% upon each of the following two anniversaries.

-10-

Table of Contents

At March 31, 2008, 214,684 shares of restricted stock were outstanding with \$2.8 million of total cost related to share based compensation that is expected to be recognized. No restricted stock vested during the three months ended March 31, 2008.

8- Other income (expense), net

Other income (expense), net consisted of (in thousands):

	Three Months Ended March 31,	
	2008	2007
Investment income	\$ 138	\$ 186
Interest expense	(545)	
Foreign currency exchange gain	411	14
Other	(3)	41
Total	\$ 1	\$ 241

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

The Company recorded a provision for income tax of \$1.7 million and \$1.2 million for the three months ended March 31, 2008 and 2007, respectively. The Company's effective tax rate was 38.9% and 43.5%, for the three months ended March 31, 2008 and 2007, respectively. The reduction in our effective tax rate for the three months ended March 31, 2008 was associated primarily with a reduction in U.S. state taxes, foreign tax rate reductions, and increased U.S. federal manufacturing tax deductions.

Deferred Income Taxes

The Company accounts for income taxes in accordance with SFAS 109, *Accounting for Income Taxes*, which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax assets will not be realized. A valuation allowance is not provided for the majority of the Company's deferred tax assets, as the Company believes that it is more likely than not that those deferred tax assets will be fully realized.

At March 31, 2008, the Company's deferred tax assets and liabilities consisted of net current deferred tax assets of \$4.0 million and net non-current deferred tax liabilities of \$6.5 million.

Uncertain Tax Positions

The balance of gross unrecognized tax benefits, excluding interest and penalties, as of March 31, 2008 was \$3.3 million. If all of our uncertain tax positions were sustained in our favor, the Company would recognize an aggregate tax benefit of \$1.3 million.

At March 31, 2008, the Company has cumulatively accrued approximately \$276,000 for estimated interest and penalties related to uncertain tax positions. During the three months ended March 31, 2008, the Company recorded approximately \$69,000 of interest and penalties related to unrecognized tax positions as a component of income tax expense.

The Company is currently unaware of any uncertain tax positions that could result in significant additional payments, accruals, or other material deviation in this estimate during the fiscal year.

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

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

Table of Contents**10- Restructuring Reserve**

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

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

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

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

These actions will be phased in during the first nine months of 2008. The Company accounts for restructuring costs in accordance with SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The Company expects that severance costs under the plan will total approximately \$264,000 and will be accrued ratably over the period of time from date of notification to individual employees to the employee's targeted separation-of-employment date. The balance of the reserve is included in accrued liabilities on the accompanying balance sheets.

During the three months ended March 31, 2008, activity in the restructuring reserve was as follows, (in thousands),

	Balance January 31, 2008	Charged to expense	Amounts paid	Balance March 31, 2008
Employee termination benefits	\$	96	38	\$ 58

11- Debt and Credit Arrangements

Our total long-term borrowings are composed of the following (in thousands):

	March 31, 2008	December 31, 2007
Term loan \$25,000 interest at LIBOR rate plus 1.75%, due November 28, 2010 with principal repayable in quarterly installments of \$2,100	\$ 22,916	\$ 25,000
Revolving line of credit \$13,000 interest at LIBOR rate plus 1.75%, with principal due on November 28, 2010	11,000	10,000
Term loan \$2,900 Canadian (CAD), interest at cost of funds plus 2.5%, due September 15, 2014 with principal repayable in monthly installments of \$16 until August 15, 2014, and one final payment of \$404 collateralized by a first lien on the land and building owned by Xltek	1,593	1,704
Term loan \$300 CAD, interest at cost of funds plus 2.5%, due November 15, 2010 with principal repayable in monthly installments of \$2 until October 10, 2010 and one final payment of \$36 collateralized by various assets of Xltek	101	112

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Total long-term debt (including current portion)	35,610	36,816
Less: current portion of long-term debt	(19,546)	(18,554)
Total long-term debt	\$ 16,064	\$ 18,262

-12-

Table of Contents**12- Segment, Customer and Geographic Information**

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

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

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

	Three Months Ended March 31,	
	2008	2007
Revenue:		
United States	\$ 24,740	\$ 18,509
Foreign countries	12,119	8,541
Totals	\$ 36,859	\$ 27,050
	March 31, 2008	December 31, 2007
Long lived assets:		
United States	\$ 60,091	\$ 59,447
Foreign countries	60,719	64,195
Totals	\$ 120,810	\$ 123,642

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

13- Subsequent Events**Sale of Common Stock**

On April 9, 2008, the Company issued 885,500 shares of its common stock in an underwritten registered offering. The offering was priced at \$18.27 per share, which was the closing price of the Company's common stock on April 3, 2008, the day the Company entered into the purchase agreement with the underwriter for the offering. The Company raised \$15.4 million, net of underwriting fees and other costs of the offering.

Table of Contents

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

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

Overview

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

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

2008 First Quarter Overview. A summary of key information concerning the financial results for the three months ended March 31, 2008;

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

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

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

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

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

Business

Natus is a provider of healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care. We develop, manufacture, and market advanced neurodiagnostic and newborn care products to healthcare professionals in over 80 countries. Our product offerings include computerized neurodiagnostic systems for audiology, neurology, polysomnography, and neonatology, as well as newborn care products such as hearing screening systems, phototherapy devices for the treatment of newborn jaundice, head-cooling products for the treatment of brain injury in newborns, and software systems for managing and tracking disorders and diseases for public health laboratories.

We have completed a number of acquisitions since 2003, consisting of either the purchase of a company, substantially all of the assets of the 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, and Xltek in 2007.

Table of Contents*Product Families*

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

Hearing Includes product lines for Newborn Hearing Screening and Diagnostic Hearing Assessment.

Neurology Includes product lines for Diagnostic Neurologic Analysis (EEG), Diagnostic Sleep Analysis (PSG), Electromyography (EMG), Intra-operative Monitoring (IOM); and Newborn Brain Monitoring (CFM).

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 such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care, including jaundice, brain injury, and metabolic testing.

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

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

Revenue by Product Category

We generate our revenue either from sales of Devices and Systems, which are generally non-recurring, and of 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. Revenue from Devices and Systems, and Supplies and Services, as a percent of total revenue for the three months ended March 31, 2008 and 2007 is as follows:

	Devices and Systems	Supplies and Services	Other	Total
Three months ended March 31,				
2008	65%	33%	2%	100%
2007	58%	40%	2%	100%

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

We sell our products through a direct sales force in the United States (U.S.), and to distributors who sell our products in over 80 other countries. We intend to continue expansion of our international operations because we believe international markets represent a significant growth opportunity. International sales made to distributors are characterized by lower gross profits due to the discount from our list prices that the distributors receive. International sales contributed to 33% and 32% of our revenue during the three months ended March 31, 2008 and 2007, respectively. We anticipate that international revenue will increase as a percent of revenue in the future.

2008 First Quarter Overview

For the first quarter ended March 31, 2008, revenue increased 36% to \$36.9 million, compared to \$27.1 million reported in the comparable quarter of the previous year. Net income increased 73% to \$2.6 million, or \$0.11 per diluted share, for the first quarter of 2008, compared with net income of \$1.5 million, or \$0.07 per share, for the first quarter of 2007.

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

On February 5, 2008, the Company received FDA approval of its supplement to the premarket approval application for the Olympic Cool-Cap. The Company resumed domestic shipments of the Cool-Cap in the first quarter of 2008.

During the first quarter the Company introduced the ALGO 5, its next generation newborn hearing screener featuring AABR technology. The Company had been marketing its existing hearing screener, the ALGO 3, for seven years. The Company believes the improvements in the ALGO 5 will represent a significant upgrade to its customers. The improvements include user-friendly features such as data management, bar coding, and wireless transfer of data.

-15-

Table of Contents

Subsequent Events

On April 9, 2008, the Company issued 885,500 shares of its common stock in a registered offering. The offering was priced at \$18.27 per share, which was the closing price of the Company's stock on the day prior to the offering. The Company raised \$15.4 million, net of underwriting fees and other costs of the offering.

On April 14, 2008, the Company entered into an agreement for the acquisition of Sonamed Corporation, through the merger of a newly formed subsidiary of the Company with and into Sonamed. This all cash transaction is expected to close in the second quarter of 2008, subject to customary closing conditions. Sonamed manufactures and markets the Clarity Screener and associated disposable supplies that aid medical practitioners in screening for hearing loss in newborns.

Application of Critical Accounting Policies

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

We believe that the following critical accounting policies require the use of significant estimates, assumptions, and judgments. The use of different estimates, assumptions, and judgments could have a material 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

Liability for product warranties

Share-based compensation

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

Results of Operations

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

Three Months Ended
March 31,
2008 2007

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Revenue	100.0%	100.0%
Cost of revenue	38.0	37.6
Gross profit	62.0	62.4
Operating expenses:		
Marketing and selling	26.8	24.0
Research and development	10.4	14.2
General and administrative	13.2	15.2
Total operating expenses	50.4	53.4
Income from operations	11.6	9.0
Other income, net		0.9
Income before provision for income tax	11.6	9.9
Income tax provision	4.5	4.3
Net income	7.1%	5.6%

-16-

Table of Contents

Three Months Ended March 31, 2008 and 2007

We completed the acquisition of Xltek in November 2007. Where significant, we have noted the impact of this acquisition on our results of operations for the three months ended March 31, 2008, as compared to the same period in 2007.

Revenue increased \$9.8 million, or 36%, to \$36.9 million in the three months ended March 31, 2008, from \$27.1 million in the same period in 2007. Xltek contributed to \$8.7 million of the increase.

Revenue from devices and systems increased \$8.0 million, or 51%, to \$23.9 million in the three months ended March 31, 2008, from \$15.9 million reported in 2007. Xltek contributed to \$6.5 million of this increase. Revenue from the Company's Fischer-Zoth and Bio-logic hearing screening products also contributed to the increase partially offset by a decrease in revenue from the Bio-logic EEG product line.

Revenue from supplies and services increased \$1.4 million, or 13%, to \$12.2 million in the first quarter of 2008 from \$10.8 million in the 2007 first quarter. Revenue from disposable supplies used with the Company's newborn hearing screening devices increased 5%, to \$5.7 million, and revenue from other supplies increased 19% to \$2.5 million from \$2.0 million in the 2007 first quarter. Xltek contributed to the remainder of the increase.

Revenue from sales outside the U.S. was \$12.1 million for the three months ended March 31, 2008, up \$3.6 million, or 42%, from \$8.5 million for the comparable period in 2007. Xltek contributed to \$1.7 million of the increase. Revenue from the Fischer-Zoth and Bio-logic hearing screening products also contributed to the increase, partially offset by a 2% reduction in revenue from disposable supplies used with the Company's newborn hearing screening devices.

Gross profit as a percentage of revenue was 62.0% for the three months ended March 31, 2008 and 62.4% for the respective period in 2007. Xltek reported historical gross profits of less than 50% prior to its acquisition by Natus. Although we are deemphasizing sales of certain Xltek low-margin disposable products, sales of Xltek products reduced consolidated gross profit as a percentage of sales for the quarter. Cost of revenue increased \$3.8 million, or 38%, to \$14.0 million in the three months ended March 31, 2008, from \$10.2 million in 2007. Gross profit increased \$6.0 million, or 35%, to \$22.9 million in 2008 from \$16.9 million in 2007.

Total operating costs increased by \$4.1 million, or 29%, to \$18.6 million in the three months ended March 31, 2008, compared to \$14.4 million in the same period in 2007. The operations of Xltek contributed to \$2.3 million of the increase in operating costs. The net increase in total operating costs from factors other than the foregoing was primarily attributable to increases in employee compensation and outside consulting costs.

Marketing and selling expenses increased \$3.3 million, or 52%, to \$9.9 million in the three months ended March 31, 2008 from \$6.5 million in the same period in 2007. Xltek contributed to \$1.6 million of the increase, including the compensation of Xltek sales personnel who became employees of the Natus domestic sales organization effective January 1, 2008. The remainder of the increase came primarily from increased sales compensation, related travel expenses, and commission payments to distributors of the Company's diagnostic hearing products.

Research and development expenses were unchanged at \$3.8 million for in the three months ended March 31, 2008 and 2007. The acquisition of Xltek resulted in an increase of \$651,000 in research and development expenses, which was offset by a reduction in other research and development costs resulting from leveraging investments in infrastructure made in 2007. Research and development expenses as a percent of total revenue decreased from 14.2% in the three months ended March 31, 2007, to 10.4% for the respective period in 2008.

General and administrative expenses increased \$748,000, or 18%, to \$4.9 million in the three months ended March 31, 2008 from \$4.1 million in the same period in 2007. Xltek contributed to \$661,000 of the increase. A reduction of general and administrative expenses as a percent of total revenue from 15.2% reported for the three months ended March 31, 2007, to 13.2% for the respective period in 2008 resulted primarily from synergies associated with the acquisition of Xltek and leveraging investments in infrastructure made in 2007.

Table of Contents

The Company adopted an integration and restructuring plan on February 11, 2008 that is designed to eliminate redundant costs resulting from prior acquisitions and to improve efficiencies in operations. These actions will be phased in during the first nine months of 2008. The Company expects that severance costs under the plan will total approximately \$264,000, and will be accrued ratably over the period of time from date of notification to individual employees to the employee's targeted separation-of-employment date. Pursuant to the plan, the Company accrued \$96,000 of employee termination benefits in the three months ended March 31, 2008. The plan is expected to result in annual operating cost reduction of approximately \$2.4 million in 2009 and beyond. The Company had no similar costs in the respective period in 2007.

Other income, net consists of investment income and net capital gains and losses from our investment portfolio, interest expense, net currency exchange gains and losses, and other miscellaneous income and expenses. We reported net other income of \$1,000 in the three months ended March 31, 2008, compared to \$241,000 in the same period in 2007 due primarily to interest income and foreign currency gains, partially offset by interest expense.

We recorded income tax expense of \$1.7 million in the three months ended March 31, 2008, compared to \$1.2 million in the same period in 2007. Our effective tax rate in the first quarter of 2008 was 38.9% compared to an effective rate of 43.5% in the first quarter of 2007. The reduction in our effective tax rate for the three months ended March 31, 2008 was associated primarily with a reduction in U.S. state taxes, foreign tax rate reductions, and increased U.S. federal manufacturing tax deductions.

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, 2008, we had cash and cash equivalents of \$12.6 million, stockholders' equity of \$118.0 million, and working capital of \$22.4 million, compared with cash and cash equivalents of \$11.9 million, stockholders' equity of \$115.7 million, and working capital of \$19.2 million as of December 31, 2007.

We believe that our current cash, cash equivalents, and short-term balances, including cash generated from the underwritten sale of our common stock in April 2008, and any cash generated from operations will be sufficient to meet our ongoing operating and capital requirements for the foreseeable future. We completed one acquisition 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.

We currently have a credit facility with Wells Fargo Bank, National Association (Wells Fargo), consisting of a \$25 million term loan and a \$13 million revolving line of credit, both to be used for working capital and general corporate purposes. At March 31, 2008 we had \$2.0 million available for additional borrowing under our revolving line of credit. 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. At March 31, 2008, we were in compliance with these covenants and there was an outstanding balance of \$22.9 million under the term loan and \$11 million under the revolving line of credit. The Company has granted Wells Fargo a security interest in all of the assets of the Company.

In April 2008, we filed a shelf registration statement on Form S-3 with the Securities and Exchange Commission pursuant to which we may sell up to \$150 million of our common stock in one or more offerings. The Securities and Exchange Commission has not yet declared this shelf registration statement effective, and we may not sell any shares of our common stock using this shelf registration statement until it is effective.

Cash provided by operations increased by \$526,000 for the three months ended March 31, 2008 to \$2.1 million, compared to \$1.5 million for the same period in 2007. The sum of our net income and non-cash expense items, such as reserves, depreciation and amortization, and stock based compensation, was approximately \$4.9 million in the 2008 period, compared to \$2.5 million in 2007. The overall impact of changes in certain operating assets and liabilities on total operating cash flows resulted in a cash outflow of \$2.8 million in 2008 and \$1.0 million in 2007.

Table of Contents

Cash used in investing activities was \$1.4 million for the three months ended March 31, 2008 compared to \$1.0 million for the same period in 2007. We acquired \$854,000 and \$1.0 million of property and equipment in the three months ended March 31, 2008 and 2007, respectively. We paid \$479,000 of internal use software development costs in the 2008 period with no similar expenditure in 2007.

Cash used in financing activities was \$538,000 during the three months ended March 31, 2008 compared to cash provided by financing activities of \$1.1 million in the same period in 2007. We raised cash through sales of our stock pursuant to our stock awards plans and our employee stock purchase plan in the amount of \$466,000 and \$520,000 in the three months ended March 31, 2008 and 2007, respectively. We also realized an excess tax benefit of \$203,000 on the exercise of employee stock options as of March 31, 2008 compared with an excess tax benefit of \$611,000 as of March 31, 2007, that was recorded in both periods as an increase to stockholders' equity. During the three months ended March 31, 2008, we increased our borrowings under our revolving line of credit by \$1.0 million and we repaid \$2.2 million on our term loan resulting in a net cash outflow of \$1.2 million.

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

Amount and timing of revenue;

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

Extent to which we make acquisitions;

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

Cost and timing of marketing and selling activities; and

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

Commitments and Contingencies

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

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

Recent Accounting Pronouncements

See Note 1 to our Condensed Consolidated Financial Statements for a discussion of 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

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

expectations, beliefs, plans, intentions, future operations, financial condition and prospects, and business strategies. The words may, will, continue, estimate, project, intend, believe, expect, anticipate, and other similar expressions generally identify forward-looking statements. Forward-looking statements in this Item 2 include, but are not limited to, statements regarding the following: annual operating cost reductions resulting from restructuring activities, our expectation regarding expansion of our international operations, our expectations regarding our new products, including the ALGO 5, the sufficiency of our current cash, cash equivalents, and short-term investment balances, and any cash generated from operations to meet our ongoing operating and capital requirements for the foreseeable future, and our intent to acquire additional technologies, products, or businesses.

-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, 2008. Our interest income is sensitive to changes in the general level of interest rates in the U.S., particularly since the majority of our investments are in short-term instruments and cash equivalents. However, as substantially all of our short-term investments carry a fixed rate of interest, a hypothetical decrease of 10% in market interest rates would not result in a material decrease in interest income earned on investments held at March 31, 2008 through the date of maturity on those investments.

When able, the Company invests excess cash in short-term investments. The fair value of short-term investments and cash equivalents (investments) is sensitive to changes in the general level of interest rates in the U.S., and the fair value of these investments will fall if market interest rates increase. However, since we generally have the ability to hold these investments to maturity, these declines in fair value may never be realized. If market interest rates were to increase by 10% from levels at March 31, 2008, the fair value of our investments would decline by an immaterial amount. At March 31, 2008 we did not hold any short-term investments or cash equivalents with maturities greater than 90 days.

All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of March 31, 2008. Actual results may differ as our analysis of the effects of changes in interest rates does not account for, among other things, sales of securities prior to maturity and repurchase of replacement securities, the change in mix or quality of the investments in the portfolio, and changes in the relationship between short-term and long-term interest rates.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Our Company's management, with the participation of our chief executive officer and our chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2008. Our chief executive officer and chief financial officer determined that as of March 31, 2008 our disclosure controls and procedures were effective for the purpose set forth above.

Table of Contents

Changes in Internal Control over Financial Reporting

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

There was no change in the Company's internal control over financial reporting that occurred during the fiscal quarter ended March 31, 2008, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

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

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

ITEM 1A. Risk Factors

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

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

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

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.

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. Bio-logic's primary offices are located in Illinois, Olympic Medical's operations are in Washington, Xltek's operations are located in Ontario, Canada, Neometrics' operations are located in New York, Deltamed's operations are in France, and Fischer-Zoth's operations are in Germany. The geographical distance between our various facilities may further adversely affect our ability to manage these operations. If we fail to manage these disparate operations effectively, our results of operations could be harmed, employee morale could decline, key employees could leave, and customers could cancel existing orders or choose not to place new ones. In addition, we may not achieve the synergies or other benefits of the acquisition 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;

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

Assumption of unknown liabilities;

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

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;

-22-

Table of Contents

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.

In November 2007 we completed the acquisition of Xltek for cash and used substantially all of our then-available cash and entered into a credit facility to fund the acquisition

We used virtually all of our then-available cash resources to complete the acquisition of Xltek, and also incurred indebtedness under a new bank facility for a portion of the purchase price. This usage of cash had an adverse impact on our liquidity and forces 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, 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.

The senior secured borrowing facility that we established to obtain a portion of the funds needed to complete the acquisition of Xltek contains various covenants that directly or indirectly restrict our ability to engage in activities that we may otherwise believe to be in the best interest of the Company. The loan is secured by the assets of the Company, and this security interest may also negatively impact our flexibility to engage in financing or other activities in future periods.

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

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

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

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

The realignment of our domestic sales organization could be disruptive to our sales efforts while this new structure is implemented, and once implemented may not be effective. In addition, our integration and restructuring activities may not result in the acquisition synergies or cost savings these activities are designed to produce and could, among other things, impair new products development and our support of existing products.

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.

Table of Contents

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

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

At December 31, 2007, we had significant intangible assets, including goodwill and other acquired intangible assets. The determination of related estimated useful lives and whether these assets are impaired involves significant judgments. Our ability to accurately predict future cash flows related to these intangible assets might be hindered by events over which we have no control. Due to the highly competitive nature of the medical device industry, new technologies could impair the value of our intangible assets if they create market conditions that adversely affect the competitiveness of our products. Any future determination that these assets are carried at greater than their fair value could result in substantial impairment charges, which could significantly impact our operating results.

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

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

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

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

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

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

Table of Contents

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

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

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

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

Changing governmental and physician group guidelines;

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

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

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

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

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

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

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

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

A majority of customers for our products are hospitals, physician offices, and clinics. Many factors, including public policy spending provisions, available resources, and economic cycles have a significant effect on the capital spending policies of these entities and therefore the amount that they can spend on our equipment products. If budget resources limit the capital spending of our customers, they will be unlikely to either purchase any new equipment from us or upgrade to any of our newer equipment products. These factors can have a significant adverse effect on the demand for our products.

-25-

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

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

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

A 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 the U.S. dollar;

Greater difficulty in accounts receivable collection and longer collection periods;

Table of Contents

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.

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 the phase-in period generally spans several years. The widespread adoption of guidelines depends, in part, on our ability to educate foreign government agencies, neonatologists, pediatricians, third-party payors, and hospital administrators about the benefits of universal newborn hearing screening as well as the use of our products to perform the screening and monitoring. Our revenue from our newborn hearing screening product lines may not grow if foreign governments do not require universal newborn hearing screening prior to hospital discharge, if physicians or hospitals are slow to comply with those guidelines, or if governments provide for a lengthy phase-in period for compliance.

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

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

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

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

Substantially all of our sales contracts with our U.S. based customers provide for payment in U.S. dollars. In addition, sales to most of our international distributors provide for payment in U.S. dollars. However, substantially all of the revenue and expenses of our foreign subsidiaries are denominated in the applicable foreign currency. To date we have not undertaken any significant foreign currency transactions to hedge these currency risks and, as a result, our future revenue and expenses may be subject to volatility due to exchange rate fluctuations that could result in foreign exchange gains and losses associated with foreign currency transactions and the translation of assets and liabilities denominated in foreign currencies.

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

Table of Contents

decision. If the FDA requires us to seek 510(k) clearance or premarket approval application for modification of a previously cleared product for which we have concluded that new clearances or approvals are unnecessary, we may be required to cease marketing or to recall the modified product until we obtain clearance or approval, and we may be subject to significant regulatory fines or penalties. Further, our products could be subject to recall if the FDA determines, for any reason, that our products are not safe or effective.

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

Fines, injunctions and civil penalties;

Recall or seizure of our products;

Issuance of public notices or warnings;

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

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

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

Criminal prosecution.

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

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

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. For example in October 2007 we received a warning letter from the FDA that focused on process deficiencies at our Olympic facility in Seattle, Washington. As a result, we initiated a voluntary plant shutdown of the Olympic facility for the month of November 2007. After reviewing processes at the facility, we responded to the FDA's warning letter in late November 2007. To date, the FDA has not further communicated with us concerning this matter, but they could decide that we undertook insufficient remedial actions. The Company resumed manufacturing at its Olympic facility in December 2007.

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.

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

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

The FDA classifies medical devices into one of three classes, depending on the degree of risk associated with each medical device and the extent of controls that are needed to ensure safety and effectiveness. Devices deemed to pose lower risk are placed in either class I or class II. Devices deemed by the FDA to pose the greatest risk, such as life-sustaining, life-supporting or implantable devices, or a device deemed to be not 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.

-29-

Table of Contents

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

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

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

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

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

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

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

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

Result in costly litigation and damage awards;

Divert our management's attention and resources;

Cause product shipment delays or suspensions; or

Table of Contents

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

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

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

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

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

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

We have experienced seasonality in the sale of our products

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

ITEM 6. Exhibits

(a) Exhibits

Exhibit No.	Exhibit	Filing	Incorporated By Reference		
			Exhibit No.	File No.	File Date
1.01	Purchase Agreement dated as of April 4, 2008 between Natus Medical Incorporated and Roth Capital Partners, LLC	8-K	1.01	000-33001	04/04/2008
4.01	Registration Rights Agreement dated as of April 9, 2008 by and among Natus Medical Incorporated and D3 Family Funds	8-K	4.01	000-33001	04/09/2008
10.01	Amended Employment Agreement between the Company and James B. Hawkins dated April 25, 2008	8-K	99.1	000-33001	04/29/2008

Table of Contents

- 10.02 2000 Director Stock Option Plan, as amended through September 13, 2007
- 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

-32-

Table of Contents

SIGNATURES

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

NATUS MEDICAL INCORPORATED

Dated: May 9, 2008

By: /s/ JAMES B. HAWKINS

James B. Hawkins

President and Chief Executive Officer

(Principal Executive Officer)

Dated: May 9, 2008

By: /s/ STEVEN J. MURPHY

Steven J. Murphy,

Vice President Finance and

Chief Financial Officer

(Principal Financial and

Accounting Officer)

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

Exhibit No.	Exhibit	Filing	Incorporated By Reference		
			Exhibit No.	File No.	File Date
1.01	Purchase Agreement dated as of April 4, 2008 between Natus Medical Incorporated and Roth Capital Partners, LLC	8-K	1.01	000-33001	04/04/2008
4.01	Registration Rights Agreement dated as of April 9, 2008 by and among Natus Medical Incorporated and D3 Family Funds	8-K	4.01	000-33001	04/09/2008
10.01	Amended Employment Agreement between the Company and James B. Hawkins dated April 25, 2008	8-K	99.1	000-33001	04/29/2008
10.02	2000 Director Stock Option Plan, as amended through September 13, 2007				
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				