

NATUS MEDICAL INC  
Form 10-Q  
May 10, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 31, 2007

.. **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

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**NATUS MEDICAL INCORPORATED**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction  
of incorporation or organization)

**1501 Industrial Road, San Carlos, CA 94070**

(Address of principal executive offices) (Zip Code)

**(650) 802-0400**

(Registrant's telephone number, including area code)

**77-0154833**  
(I.R.S. Employer

Identification No.)

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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 or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer  Accelerated filer  Non-accelerated filer

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 07, 2007, was 21,573,847.

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**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,  | December 31, |
|---|------------|--------------|
|   | 2007       | 2006         |
| <b>ASSETS</b>   |            |              |
| Current assets:   |            |              |
| Cash and cash equivalents   | \$ 16,784  | \$ 15,392    |
| Accounts receivable, net of allowance for doubtful accounts of \$491 and \$552  | 19,690     | 20,347       |
| Inventories   | 13,421     | 11,743       |
| Prepaid expenses and other current assets   | 2,271      | 1,874        |
| Deferred income taxes   | 2,240      | 2,240        |
| Total current assets  | 54,406     | 51,596       |
| Property and equipment, net   | 8,452      | 7,897        |
| Intangible assets   | 36,610     | 37,297       |
| Goodwill  | 26,600     | 25,790       |
| Other non-current assets  | 66         | 1,583        |
| Total assets  | \$ 126,134 | \$ 124,163   |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |            |              |
| Current liabilities:  |            |              |
| Accounts payable  | \$ 7,933   | \$ 8,236     |
| Accrued liabilities   | 8,864      | 10,470       |
| Deferred revenue  | 2,170      | 2,087        |
| Total current liabilities   | 18,967     | 20,793       |
| Deferred income taxes   | 3,236      | 2,344        |
| Other non-current liabilities   | 1,051      |              |
| Total liabilities   | 23,254     | 23,137       |
| Stockholders' equity:   |            |              |
| Common Stock, \$0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 21,520,373 and 21,391,091 | 134,577    | 133,071      |
| Accumulated deficit   | (31,075)   | (31,677)     |
| Accumulated other comprehensive income (loss)   | (622)      | (368)        |
| Total stockholders' equity  | 102,880    | 101,026      |

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|  |            |            |
|--|------------|------------|
| Total liabilities and stockholders' equity | \$ 126,134 | \$ 124,163 |
|--|------------|------------|

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

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

(in thousands, except per share amounts)

|  | <b>Three Months Ended March 31,</b> |               |
|--|-------------------------------------|---------------|
|  | <b>2007</b>                         | <b>2006</b>   |
| Revenue  | \$ 27,050                           | \$ 19,383     |
| Cost of revenue  | 10,175                              | 7,294         |
| <b>Gross profit</b>  | <b>16,875</b>                       | <b>12,089</b> |
| Operating expenses:  |                                     |               |
| Marketing and selling  | 6,496                               | 5,161         |
| Research and development   | 3,824                               | 2,490         |
| General and administrative   | 4,108                               | 2,155         |
| Acquired in-process research and development                                   |                                     | 5,900         |
| <b>Total operating expenses</b>  | <b>14,428</b>                       | <b>15,706</b> |
| Income (loss) from operations  | 2,447                               | (3,617)       |
| Other income (expense), net  | 241                                 | (113)         |
| Income (loss) before provision for income tax                                  | 2,688                               | (3,730)       |
| Provision for income tax   | 1,169                               | 949           |
| Net income (loss)  | \$ 1,519                            | \$ (4,679)    |
| Earnings (loss) per share:   |                                     |               |
| Basic  | \$ 0.07                             | \$ (0.25)     |
| Diluted  | \$ 0.07                             | \$ (0.25)     |
| Weighted average shares used in the calculation of net income (loss) per share |                                     |               |
| Basic  | 21,466                              | 18,485        |
| Diluted  | 22,734                              | 18,485        |

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,<br>2007  | 2006             |
| Operating activities:   |                    |                  |
| Net income (loss)   | \$ 1,519           | \$ (4,679)       |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                    |                  |
| Acquired in-process research and development  |                    | 5,900            |
| Depreciation and amortization   | 1,168              | 1,003            |
| Accounts receivable reserves  | 25                 | 28               |
| Inventory reserves  | 207                | 96               |
| Warranty reserves   | 56                 | 226              |
| Share-based compensation  | 375                | 357              |
| Excess tax benefits on the exercise of options  | (611)              | (670)            |
| Changes in operating assets and liabilities:  |                    |                  |
| Accounts receivable   | 632                | (270)            |
| Inventories   | (1,884)            | (1,833)          |
| Prepaid expenses and other current assets   | 1,119              | 371              |
| Accounts payable  | (303)              | 1,455            |
| Accrued liabilities and deferred revenue  | (751)              | (3,049)          |
| <b>Net cash provided by (used in) operating activities</b>                                | <b>1,552</b>       | <b>(1,065)</b>   |
| Investing activities:   |                    |                  |
| Acquisition of property and equipment   | (1,037)            | (661)            |
| Acquisition of business, net of cash acquired   |                    | (51,580)         |
| Deposits and other assets   |                    | 523              |
| Sales of short-term investments   |                    | 12,165           |
| <b>Net cash used in investing activities</b>  | <b>(1,037)</b>     | <b>(39,553)</b>  |
| Financing activities:   |                    |                  |
| Proceeds from stock option exercises and ESPP   | 520                | 680              |
| Excess tax benefits upon the exercise of options  | 611                | 670              |
| Borrowing on credit facility  |                    | 10,000           |
| Payments on borrowings  |                    | (625)            |
| <b>Net cash provided by financing activities</b>  | <b>1,131</b>       | <b>10,725</b>    |
| Exchange rate effect on cash and cash equivalents   | (254)              | (153)            |
| <b>Net increase (decrease) in cash and cash equivalents</b>                               | <b>1,392</b>       | <b>(30,046)</b>  |
| Cash and cash equivalents, beginning of period  | 15,392             | 40,046           |
| <b>Cash and cash equivalents, end of period</b>   | <b>\$ 16,784</b>   | <b>\$ 10,000</b> |

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### Supplemental disclosure of cash flow information:

|                            |    |     |        |
|----------------------------|----|-----|--------|
| Cash paid for interest     | \$ | \$  | 165    |
| Cash paid for income taxes | \$ | 621 | \$ 342 |

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



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

The accompanying interim condensed consolidated financial statements of Natus Medical Incorporated ( Natus, we, us, or the Company ) have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ). Except as updated below, the accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent in all material respects with those presented in Note 1 to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

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, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. A reclassification has been made to the prior period condensed consolidated statement of cash flows to properly reflect the impact on cash flows from operating activities and financing activities of excess tax benefits on the exercise of options.

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries; intercompany transactions have been eliminated in consolidation.

**Comprehensive Income**

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

|  | <b>Three Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2007</b>                             | <b>2006</b> |
| Net income (loss)                                | \$ 1,519                                | \$ (4,679)  |
| Unrealized gain on available-for-sale securities |   | 2           |
| Foreign currency translation adjustment          | (254)                                   | (153)       |
| Comprehensive income (loss)                      | \$ 1,265                                | \$ (4,830)  |

**Stockholders Equity**

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

|  | <b>Three Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2007</b>                             | <b>2006</b> |
| Beginning balance                              | \$ 101,026                              | \$ 68,965   |
| Net income (loss)                              | 1,519                                   | (4,679)     |
| Proceeds from stock option exercises and ESPP  | 520                                     | 680         |
| Share-based compensation expense               | 375                                     | 357         |
| Excess tax benefits on the exercise of options | 611                                     | 670         |
| Adoption of FIN No. 48                         | (917)                                   |             |
| Comprehensive income (loss)                    | (254)                                   | (151)       |

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|                |            |           |
|----------------|------------|-----------|
| Ending balance | \$ 102,880 | \$ 65,842 |
|----------------|------------|-----------|

### **New Accounting Pronouncements**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 allows entities to voluntarily choose to measure certain financial assets and liabilities at fair value ( fair value option ). The fair value option may be elected on an instrument-by-instrument basis and is irrevocable, unless a new election date occurs.

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If the fair value option is elected for an instrument, SFAS 159 specifies that unrealized gains and losses for that instrument shall be reported in earnings at each subsequent reporting date. SFAS 159 is effective January 1, 2008. We have not determined whether we will adopt the provisions of SFAS 159 nor have we determined the impact on our consolidated financial statements if we were to adopt SFAS 159.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective January 1, 2008. We believe it is unlikely that SFAS 157 will have an impact on our consolidated financial statements because we do not deal in transactions requiring complex fair value measurements.

**Recently Adopted Standards**

In June 2006, the FASB issued Interpretation ( FIN ) No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*. FIN No. 48, establishes a single model to address accounting for uncertain tax positions. FIN No. 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted FIN No. 48 on January 1, 2007. For additional information about the adoption of FIN No. 48, refer to Note 9 *Income Taxes*.

In March 2006, FASB Emerging Issues Task Force ( EITF ) issued EITF 06-03, *How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement*. A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes. The guidance is effective for periods beginning after December 15, 2006. The Company presents sales net of sales taxes, and as such, EITF 06-03 had no impact on our method for recording sales taxes in the consolidated financial statements.

**2- Business Combinations**

**Olympic** The Company acquired privately held Olympic Medical Corp. in October 2006, for \$16.9 million cash, including direct costs of the acquisition. In addition the Company assumed and immediately paid \$2.7 million of Olympic Medical obligations associated with the acquisition. Olympic Medical, 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 neurological function of newborns. The Company is obligated to make future payments pursuant to earnout provisions of 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. During the three months ended March 31, 2007, the Company recorded \$120,000 of additional purchase consideration pursuant to the earnout provision that was recorded as an increase to goodwill.

During the three months ended March 31, 2007, the Company made a \$100,000 adjustment to the preliminary purchase price allocation to recognize accrued expenses that were not properly valued as of the purchase date. The adjustment resulted in an offsetting increase in goodwill.

**Deltamed** The Company purchased all the common stock of privately held Deltamed S.A. headquartered in Paris, France, and its wholly owned subsidiaries, Raciard-Alvar, located in Bordeaux, France, and IT-Med, located near Frankfurt, Germany (collectively Deltamed ) in September 2006 for approximately \$4.1 million cash including direct costs of the acquisition. Deltamed is a European manufacturer of medical devices used in the detection of neurological dysfunction, epilepsy, and sleep disorders through the use of electroencephalograph ( EEG ) and polysomnography ( PSG ) technologies. The acquisition adds to the Company's international growth opportunities by broadening its product offerings and leveraging its distribution organization.

Valuing certain components of the Olympic and Deltamed acquisitions, including primarily inventory valuation, deferred taxes, and accrued expenses, required the Company to make estimates that may be adjusted in the future; consequently the purchase price allocations are considered preliminary. Final determination of these estimates as of the purchase dates could result in adjustments to the preliminary purchase price allocations, with offsetting adjustments to Goodwill.

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**Nascor** The Company completed the purchase of certain product rights, manufacturing and distribution contracts, inventory, and intangible assets from Nascor Pty. Ltd. (the Nascor assets) in September 2006 for \$953,000 cash including direct costs of the acquisition. In addition, the Company is obligated to make future payments pursuant to earnout provisions of the purchase agreement of up to \$675,000 over a three-year period based primarily on the achievement of certain revenue targets. 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 is expected to improve its margins.

**Bio-logic** The Company acquired Bio-logic Systems Corp. ( Bio-logic ) in January 2006 for \$69.3 million cash including direct costs of the acquisition. 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.

During the three months ended March 31, 2007, the Company recorded an increase to goodwill of \$503,000 associated with a reduction in deferred tax assets as of the acquisition date related to the Company s research and development tax credit carryforwards, as more fully described in Note 9 *Income Taxes*.

**Fischer-Zoth** The Company purchased all the common stock of privately held Fischer-Zoth Diagnosesysteme GmbH and affiliated entities (Fischer-Zoth), as well as intangible assets held individually by the owners of Fischer-Zoth in September 2004 for \$5.7 million cash including direct costs of the acquisition. Fischer-Zoth is a manufacturer of otoacoustic emissions (OAE) products used to detect hearing impairment in newborns through adults. The acquisition added to the Company s growth opportunities by broadening its product offerings in hearing screening and supporting expansion into new markets. The Company is obligated to make future payments pursuant to earnout provisions of the purchase agreement over a three-year period based primarily on the purchased entities achieving certain performance objectives.

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

Amortization of intangible assets associated with the Company s business combinations for the three months ended March 31, 2007 and 2006 was \$687,000 and \$566,000, respectively.

**3- Basic and Diluted Net Income (Loss) Per Common Share**

Net income (loss) per share is computed in accordance with SFAS No. 128, *Earnings per Share*. Basic net income (loss) per share is based upon the weighted average number of common shares outstanding during the period. Diluted net income (loss) 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 when there is a loss as their effect is anti-dilutive or if the exercise price of such options is greater than the average market price of the stock for the period.

For the three months ended March 31, 2007, common stock equivalents of 1,268,289 shares were included in the weighted average shares outstanding used to calculate diluted income per share. For the three months ended March 31, 2006, common stock equivalents of 31,750 shares 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 period.

**4- Inventories**

Inventories consisted of (in thousands):

|                                 | March 31, | December 31, |
|---------------------------------|-----------|--------------|
|                                 | 2007      | 2006         |
| Raw materials and subassemblies | \$ 9,698  | \$ 7,246     |

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|                |                  |                  |
|----------------|------------------|------------------|
| Finished goods | 3,723            | 4,497            |
| <b>Total</b>   | <b>\$ 13,421</b> | <b>\$ 11,743</b> |

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Property and equipment consisted of (in thousands):

|                                    | March 31,       | December 31,    |
|------------------------------------|-----------------|-----------------|
|                                    | 2007            | 2006            |
| Land                               | \$ 900          | \$ 900          |
| Building                           | 2,200           | 2,200           |
| Leasehold improvements             | 855             | 828             |
| Office furniture and equipment     | 4,211           | 3,942           |
| Computer software and hardware     | 3,471           | 3,022           |
| Demonstration and loaned equipment | 3,610           | 3,289           |
|                                    | 15,247          | 14,181          |
| Accumulated depreciation           | (6,795)         | (6,284)         |
| <b>Total</b>                       | <b>\$ 8,452</b> | <b>\$ 7,897</b> |

Depreciation and amortization of property and equipment for the three months ended March 31, 2007 and 2006 was \$481,000 and \$437,000, respectively.

**6- Reserve For Product Warranties**

The Company provides a warranty on all 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 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 to determine expected warranty cost, 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. The reserve is reduced as warranty costs are incurred.

Activity in the warranty reserve during the three months ended March 31, 2007 and 2006 consisted of (in thousands):

|                                 | Three Months Ended |        |
|---------------------------------|--------------------|--------|
|                                 | March 31,          |        |
|                                 | 2007               | 2006   |
| Balance beginning of period     | \$ 877             | \$ 554 |
| Warranty accrued for the period | 56                 | 226    |
| Repairs for the period          | (116)              | (34)   |
| Balance end of period           | \$ 817             | \$ 746 |

**7- Share-Based Compensation**

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At March 31, 2007, the Company has two active stock option plans, the Amended and Restated 2000 Stock Awards Plan and the 2000 Director Stock Option Plan, and one employee stock purchase plan. The terms of awards granted during the three months ended March 31, 2007 and the Company's methods for determining grant-date fair value of the awards were consistent with those described in our December 31, 2006 annual consolidated financial statements. Following is a recap of activity in our stock option plans during the three months ended March 31, 2007:

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|                                  | Shares    | Weighted<br>Average<br>Exercise<br>Price | Weighted-<br>average<br>remaining<br>contractual<br>life (years) | Aggregate<br>intrinsic<br>value<br>(\$ ,000 s) |
|----------------------------------|-----------|--|--|--|
| Outstanding, beginning of period | 2,910,015 | \$ 7.11                                  |  |  |
| Granted                          | 32,500    | 16.69                                    |  |  |
| Exercised                        | (129,282) | 3.97                                     |  |  |
| Forfeitures                      | (27,376)  | 13.67                                    |  |  |
| Outstanding, end of period       | 2,785,857 | \$ 7.31                                  | 6.48   | \$ 28,897                                      |
| Exercisable, end of period       | 1,735,736 | \$ 6.06                                  | 6.27   | \$ 20,172                                      |

During the three months ended March 31, 2007 the intrinsic value of options exercised amounted to \$1.5 million.

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

|                            | Three Months Ended |                   |
|----------------------------|--------------------|-------------------|
|                            | March 31,<br>2007  | March 31,<br>2006 |
| Cost of revenue            | \$ 33              | \$ 23             |
| Marketing and sales        | 88                 | 157               |
| Research and development   | 35                 | 40                |
| General and administrative | 219                | 137               |
| Total                      | \$ 375             | \$ 357            |

During the three months ended March 31, 2007 the Company granted 3,350 shares of restricted stock with a weighted average value of \$17.68 per share that vest 50% upon the second anniversary of the grant and 25% upon each of the following two anniversaries.

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

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

|                                       | Three Months Ended |                   |
|---------------------------------------|--------------------|-------------------|
|                                       | March 31,<br>2007  | March 31,<br>2006 |
| Investment income                     | \$ 186             | \$ 169            |
| Interest expense                      |                    | (165)             |
| Foreign currency exchange gain (loss) | 14                 | (128)             |
| Other                                 | 41                 | 11                |
| Total other income (expense), net     | \$ 241             | \$ (113)          |



**9- Income Taxes**

***Provision for Income Tax***

The Company recorded a provision for income tax of \$1.2 million for the quarter ended March 31, 2007, compared to a provision of \$949,000 for the same period in 2006. Our effective tax rates for the quarters ended March 31, 2007 and 2006 were 43.5% and 43.7%, respectively.

***Deferred Income Taxes***

The Company accounts for income taxes in accordance with SFAS No. 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 No. 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.

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During the three months ended March 31, 2007, the Company performed a formal study of its research and development credit carryforwards and determined that the credit carryforwards were overstated by approximately \$503,000 as of December 31, 2005. During the three months ended March 31, 2007, the Company recorded an adjustment to reduce deferred tax assets by \$503,000 offset by an increase in goodwill associated with the acquisition of Bio-logic. At March 31, 2007, the Company's deferred tax assets and liabilities consist of net current deferred tax assets of \$2.2 million and net non-current deferred tax liabilities of \$3.2 million.

**Uncertain Tax Positions**

The Company adopted FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes* – an interpretation of FASB Statement 109 on January 1, 2007. This interpretation clarifies what criteria must be met prior to recognition of the financial statement benefit, in accordance with SFAS No. 109, *Accounting for Income Taxes*, of a position taken in a tax return. Prior to adopting FIN No. 48, the Company's policy was to establish reserves that reflected the probable outcome of known tax contingencies. Favorable resolution was recognized as a reduction to the effective income tax rate in the period of resolution. As compared to a contingency approach, FIN No. 48 is based on a benefit-recognition model. Provided that the tax position is deemed more likely than not of being sustained, FIN No. 48 permits a company to recognize the largest amount of tax benefit that is greater than 50 percent likely of being ultimately realized upon settlement. The tax position must be derecognized when it is no longer more likely than not of being sustained.

The initial application of FIN No. 48 resulted in a reversal of existing reserves accrued under SFAS No. 5, *Contingencies*, of \$523,000. The total amount of uncertain tax positions recorded on January 1, 2007 was \$1.4 million, exclusive of interest and penalties of \$177,000. Interest and penalties associated with uncertain tax positions are reported as a component of income tax expense. If all of our uncertain tax positions were sustained in our favor, we would recognize an aggregate tax benefit of \$1.4 million in the future periods in which the positions were sustained.

During the three months ended March 31, 2007, the liability related to uncertain tax positions had not changed significantly from the January 1, 2007 accrual. 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.

Tax years 2003 through 2006 remain open to examination by the major taxing jurisdictions to which the Company is subject.

**10- 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,<br>2007  | 2006      |
| Revenue:          |                    |           |
| United States     | \$ 18,509          | \$ 13,972 |
| Foreign Countries | 8,541              | 5,411     |
| Totals            | \$ 27,050          | \$ 19,383 |

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|                    | March 31, | December 31, |
|--------------------|-----------|--------------|
|                    | 2007      | 2006         |
| Long-lived assets: |           |              |
| United States      | \$ 60,011 | \$ 58,278    |
| Foreign Countries  | 11,651    | 11,127       |
| Totals             | \$ 71,662 | \$ 69,405    |

Long-lived assets include property and equipment (net), intangible assets, and goodwill. During the three months ended March 31, 2007, no single customer or foreign country contributed to more than 10% of revenue.

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

*Natus®*, *AABR®*, *AOAE®*, *ALGO®*, *Cochlea-Scan®*, *Echo-Screen®*, *Ear Couplers®*, *Flexicoupler®*, *MiniMuffs®* and *neoBLUE®* are registered trademarks of Natus Medical Incorporated. *EchoLink*, *Neometrics*, and *Accuscreen* are non-registered trademarks of Natus. *Solutions for Newborn Care<sup>SM</sup>* is a non-registered service mark of Natus. *Bio-logic®*, *AuDX®*, *ABaer®*, *Ceegrath®*, *MASTER®*, *Navigator®*, *Sleepscan®*, and *Traveler®* are registered trademarks of Bio-logic Systems Corp. *CHAMP* and *Smartpack* are non-registered trademarks of Bio-logic. *Coherence* is a non-registered trademark of Deltamed. *Cool-Cap®* is a registered trademark of Tiara Medical Systems, Inc. *VAC-PAC®* is a registered trademark of Olympic Medical Bili-Lite Pad, *Bili-Lite*, *Billi-Bassinets*, *Bili-Mask*, *Bili-Meter*, *Papoose Boards*, *Circumstraint*, *Warm-Lamp*, and *Warmettes* are non-registered trademarks of Olympic Medical.

**Overview**

The following Management’s Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) supplements the MD&A in the Company’s Annual Report on Form 10-K for the year ended December 31, 2006, 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 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;

**2007 First Quarter Overview.** A summary of key information concerning the financial results for the three months ended March 31, 2007;

**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.** A recap of recently issued accounting pronouncements that may have an impact upon the Company’s results of operations, financial position or cash flows; 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, and

Bio-logic, Deltamed, and Olympic in 2006.

**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:

Newborn Hearing Screening

Diagnostic Hearing Assessment

Monitoring Systems for Neurology (Electroencephalograph or EEG )

Diagnostic Sleep Analysis (Polysomnography or PSG )

Newborn Care, including treatment for Brain Injury and Jaundice

**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 in turn, 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 10 *Segment, Customer and Geographic Information* of our 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 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, 2007 and 2006 is as follows:

|                            | <b>Devices<br/>and<br/>Systems</b> | <b>Supplies<br/>and<br/>Services</b> | <b>Freight</b> | <b>Total</b> |
|----------------------------|------------------------------------|--------------------------------------|----------------|--------------|
| <b>Three months ended,</b> |                                    |                                      |                |              |
| March 31, 2007             | 58%                                | 40%                                  | 2%             | 100%         |
| March 31, 2006             | 55%                                | 43%                                  | 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 32% of our revenue during the three months ended March 31, 2007 and 28% of our

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revenue during the same period in 2006. The increase in international sales as a percent of total sales in the 2007 period, as compared to 2006, was primarily attributable to our acquisition of Deltamed, as all of their sales are in international markets. We anticipate that international revenue will increase as a percent of revenue in the future.

### **2007 First Quarter Overview**

Natus recognized \$27.1 million of revenue during the three months ended March 31, 2007, an increase of 40% or \$7.7 million, from \$19.4 million in the comparable quarter of the previous year. Revenue from sales outside the U.S. increased 58% to \$8.5 million for the 2007 period, compared with \$5.4 million in the first quarter 2006.

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Our gross profit was 62.4% for both the 2007 and 2006 first quarter periods. Total operating expenses in the first quarter 2006 were \$15.7 million including a charge for in-process research and development ( IPR&D ) of \$5.9 million. Total operating expenses in the first quarter 2006 for expenses other than the IPR&D charge were \$9.8 million. Total operating expenses in the first quarter 2007 were \$14.4 million, representing an increase of \$4.6 million from the aggregate of the 2006 period operating expenses other than the IPR&D charge.

We reported net income of \$1.5 million in the first quarter 2007, compared to a net loss of \$4.7 million reported in the first quarter 2006.

During the first quarter 2007 we began marketing the Olympic Cool-Cap, a Class III medical device. The Cool-Cap system, which is the only FDA-approved device for the treatment of hypoxic ischemic encephalopathy ( HIE ) in term newborns, provides selective head cooling to prevent or reduce the severity of neurologic injury associated with HIE.

**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, 2006, 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, 2007.

**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,**



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|   | 2007        | 2006        |
|---|-------------|-------------|
| Revenue   | 100.0%      | 100.0%      |
| Cost of revenue                                 | 37.6        | 37.6        |
| <b>Gross profit</b>                             | <b>62.4</b> | <b>62.4</b> |
| Operating expenses:                             |             |             |
| Marketing and selling                           | 24.0        | 26.6        |
| Research and development                        | 14.2        | 12.9        |
| General and administrative                      | 15.2        | 11.1        |
| Acquired in-process research and development    |             | 30.4        |
| <b>Total operating expenses</b>                 | <b>53.4</b> | <b>81.0</b> |
| Income (loss) from operations                   | 9.0         | (18.6)      |
| Other income (expense), net                     | .9          | (0.6)       |
| Income (loss) before provision for income taxes | 9.9         | (19.2)      |
| Income tax provision                            | 4.3         | 4.9         |
| Net income (loss)                               | 5.6%        | (24.1)%     |

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**Three Months Ended March 31, 2007 and 2006**

We completed the acquisitions of Deltamed in September 2006 and Olympic Medical in October 2006. Where significant, we have noted the impact of these acquisitions on our results of operations for the three months ended March 31, 2007, as compared to the same period in 2006.

Revenue increased \$7.7 million, or 40%, to \$27.1 million in the three months ended March 31, 2007, from \$19.4 million in the same period in 2006. Olympic and Deltamed contributed to \$7.2 million of the increase.

Revenue from devices and systems increased \$5.2 million, or 48%, to \$15.9 million in 2007 from \$10.7 million in 2006. Olympic and Deltamed contributed to \$5.5 million of devices and systems revenue in 2007. An increase in revenue from the Company's ALGO and Echo Screen devices of \$623,000 was offset by a \$1.0 million decrease in revenue from Bio-logic's EEG and PSG product lines that was partly attributable to the timing of the acquisition of Bio-logic on January 5, 2006.

Revenue from supplies and services increased \$2.4 million, or 29%, to \$10.8 million in 2007, from \$8.4 million in 2006. Olympic and Deltamed contributed to \$1.5 million of the increase; additionally, revenue from disposable supplies used with the Company's newborn hearing screening devices increasing by \$588,000, or 11%, to \$5.7 million. Revenue from services increased 25% to \$1.5 million.

Revenue from sales outside the U.S. was \$8.5 million for the three months ended March 31, 2007, up \$3.1 million, or 58%, from \$5.4 million for the same period in 2006. Olympic and Deltamed contributed to \$2.4 million of the increase while sales of disposable supplies for hearing screening increased 49% to \$1.8 million. These increases were offset by a decrease in revenue from the Bio-logic diagnostic hearing product line.

Cost of revenue increased \$2.9 million, or 40%, to \$10.2 million in the three months ended March 31, 2007, from \$7.3 million in 2006. Gross profit increased \$4.8 million, or 40%, to \$16.9 million in 2007 from \$12.1 million in 2006. Gross profit as a percentage of revenue was 62.4% in both the 2007 and 2006 first quarter periods.

Total operating costs decreased by \$1.3 million to \$14.4 million in the three months ended March 31, 2007, compared to \$15.7 million in the same period in 2006. Operating costs in the first quarter of 2006 included a \$5.9 million charge for in-process research and development associated with the acquisition of Bio-logic. Total operating expense for the first quarter of 2006 other than the IPR&D charge were \$9.8 million, and operating costs in 2007 exceeded the 2006 amount by \$4.6 million. The operations of Olympic and Deltamed contributed to \$2.7 million of the increase in operating costs. The net increase in total operating costs from factors other than the foregoing was primarily attributable to increases in outside consulting costs of approximately \$1.1 million and employee compensation of approximately \$700,000.

Marketing and selling expenses increased \$1.3 million, or 26%, to \$6.5 million in the three months ended March 31, 2007 from \$5.2 million in the same period in 2006. Olympic and Deltamed contributed to approximately \$900,000 of the increase, with the remainder coming primarily from increases in sales compensation resulting from higher sales.

Our research and development expenses increased \$1.3 million, or 54%, to \$3.8 million in the three months ended March 31, 2007 from \$2.5 million in the same period in 2006. Olympic and Deltamed contributed to \$768,000 of the increase, while outside consulting costs associated primarily with the development of our Bio-logic neurology and Natus ALGO product lines increased by \$446,000.

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General and administrative expenses increased \$2.0 million, or 91%, to \$4.1 million in the three months ended March 31, 2007 from \$2.2 million in the same period in 2006. Olympic and Deltamed contributed to \$1.0 million of the increase. Outside consulting costs associated with improvements to our information technology infrastructure, tax planning and compliance, and accruals for auditing fees for 2007 increased by approximately \$600,000, while compensation costs increased by approximately \$300,000.

During the three months ended March 31, 2006, the Company recorded a \$5.9 million charge for in-process research and development associated with our acquisition of Bio-logic. There was no such charge in 2007.

Other income (expense), 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 \$241,000 in the three months ended March 31, 2007, compared to a net other expense of (\$113,000) in the same period in 2006. The increase in our other income resulted primarily from a decrease in interest expense related to a note payable that was paid off in November 2006.

We recorded income tax expense of \$1.2 million in the three months ended March 31, 2007, compared to \$949,000 in the first quarter 2006. Our effective tax rate in 2007 was 43.5%. Our effective rate in the 2006 period, taking into account the \$5.9 million IPR&D charge which was deemed to be on an after-tax basis, was 43.7%. Our effective tax rate for the full year 2006 was 44.9%. The decrease in our effective tax rate was primarily because the Company ceased granting incentive stock options in 2006 and started granting non-qualified stock options exclusively, as incentive stock options have the impact of increasing our effective tax rate.

## **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, 2007, we had cash and cash equivalents of \$16.8 million, stockholders' equity of \$102.9 million, and working capital of \$35.4 million, compared with cash and cash equivalents of \$15.4 million, stockholders' equity of \$101.0 million, and working capital of \$30.8 million as of December 31, 2006.

We believe that our current cash and cash equivalents balances, and any cash generated from operations will be sufficient to meet our ongoing operating and capital requirements for the foreseeable future. We completed three acquisitions 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 revolving credit facility with Wells Fargo Bank, pursuant to which Wells Fargo has committed to advance to us a maximum of \$15 million. This commitment is evidenced by a revolving credit agreement with Wells Fargo Bank, National Association (Wells Fargo), a credit commitment note in favor of Wells Fargo, and a security agreement in favor of Wells Fargo. At March 31, 2007 there was no outstanding borrowing under the facility.

Cash provided by operations increased by \$2.6 million for the three months ended March 31, 2007 to \$1.6 million, compared to cash used in operations of \$1.1 million for the same period in 2006. The sum of our net income and certain non-cash expense items, such as reserves, depreciation and amortization, purchased in-process research and development, and stock based compensation, was approximately \$2.7 million in the 2007 period, compared to \$2.3 million in 2006. The overall impact of changes in certain operating assets and liabilities on total operating cash flows resulted in a cash outflow of \$1.2 million in the 2007 period compared to an outflow of \$3.3 million in 2006.

We used cash for investing purposes of \$1.0 million for the three months ended March 31, 2007, compared to \$39.6 million in the same period in 2006. Excluding purchases and sales of short-term investments, we used \$51.7 million of cash for investing purpose in the 2006 period. The decrease in the 2007 period is primarily because we acquired Bio-logic in the 2006 period for \$51.6 million, net of cash acquired, and we did not have any acquisitions in the 2007 period. We used \$1.0 million of cash in the 2007 period to acquire property and equipment, including \$410,000 of demonstration equipment used by our sales personnel.



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Cash provided by financing activities was \$520,000 in the three months ended March 31, 2007, compared to \$10.1 million in the same period in 2006. In the 2006 period, we borrowed \$10 million on a senior secured credit facility with Wells Fargo Bank related to our acquisition of Bio-logic; we had not such borrowing in the 2007 period. We raised cash through sales of our stock pursuant to our stock option plans and our employee stock purchase plan, in the amount of \$520,000 and \$680,000 in the three months ended March 31, 2007 and 2006, respectively.

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.

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 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

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**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 allows entities to voluntarily choose to measure certain financial assets and liabilities at fair value ( fair value option ). The fair value option may be elected on an instrument-by-instrument basis and is irrevocable, unless a new election date occurs. If the fair value option is elected for an instrument, SFAS 159 specifies that unrealized gains and losses for that instrument shall be reported in earnings at each subsequent reporting date. SFAS 159 is effective January 1, 2008. We have not determined whether we will adopt the provisions of SFAS 159 nor have we determined the impact on our consolidated financial statements if we were to adopt SFAS 159.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective January 1, 2008. We believe it is unlikely that SFAS 157 will have an impact on our consolidated financial statements because we do not deal in transactions requiring complex fair value measurements.

**Recently Adopted Standards**

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In June 2006, the FASB issued Interpretation ( FIN ) No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*. FIN No. 48 establishes a single model to address accounting for uncertain tax positions. FIN No. 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted FIN No. 48 on January 1, 2007. For additional information about the adoption of FIN No. 48, refer to Note 9 of the consolidated financial statements contained herein.

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In March 2006, FASB Emerging Issues Task Force ( EITF ) issued EITF 06-03, *How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement*. A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes. The guidance is effective for periods beginning after December 15, 2006. The Company presents sales net of sales taxes, and as such, EITF 06-03 had no impact on our method for recording sales taxes in the consolidated financial statements.

**Table of Contents****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 ( Natus, we, us, or our Company ). These statements include, among other things, statements concerning our expectations, beliefs, plans, intentions, future operations, financial condition and prospects, and business strategies. The words may, will, continue, estimate, project, intend, believe, expect, anticipate, and other similar expressions generally identify forward-looking statements. Forward-looking statements in this Item 2 include, but are not limited to, statements regarding the following: our expectation regarding growth in international sales, our expectations of future profitability and the generation of positive operating cash flows, the effectiveness and advantages of our products, factors relating to demand for and economic advantages of our products, our plan to develop and acquire additional technologies, products or businesses our marketing, technology enhancement, and product development strategies, our intention to enter into agreements with group purchasing organizations, our intention to introduce new products and extend existing product lines, our intention to seek strategic partners, our belief that we bring products to market efficiently, development of technologies into successful products, our estimate of the length of time for patents to issue, identity of our competition and factors for competition, our compliance with regulatory requirements and laws; and our plan to seek approval to sell our products in additional countries.*

*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. and sell those products primarily in the U.S., Europe, Asia, and Oceania. 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. With the acquisition of Fischer-Zoth and Deltamed in September 2004 and September 2006, respectively, a portion of our sales are now denominated in the Euro. 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, 2007. 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. However, as substantially all of our short-term investments and cash-equivalents 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, 2007 through the date of maturity on those investments.

The fair value of our available-for-sale securities and cash equivalents is also sensitive to changes in the general level of interest rates in the U.S., and the fair value of our portfolio 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, 2007, the fair value of our portfolio would decline by an immaterial amount.

All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of March 31, 2007. 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.



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**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, 2007. Our chief executive officer and chief financial officer determined that as of March 31, 2007 our disclosure controls and procedures were effective for the purpose set forth above.

*Changes in Internal Control Over Financial Reporting*

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

There was no change in the Company's internal control over financial reporting that occurred during the fiscal quarter ended March 31, 2007, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**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**

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. In January 2006 we completed the acquisition of Bio-logic. In September and October 2006 we completed the acquisitions Deltamed and Olympic Medical, and certain assets from Nascor.

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 to 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, 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

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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 difficulties, costs, and delays involved in integrating and managing these operations, and the operations of companies we may acquire:

Failure to realize expected synergies;

Inability to effectively integrate acquired products into our business;

Failure to successfully manage relationships with customers and other important business partners;

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;

Challenges encountered in managing larger, more geographically dispersed operations;

The loss of key employees;

Assumption of unknown liabilities;

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

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

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

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

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

**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, 2006, 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

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the competitiveness of our products. Any future determination that these assets are carried at greater than their fair value could result in additional 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

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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.

**In the past, we have relied on sales of our newborn screening products for the majority of our revenue, and these products will continue to contribute to a substantial portion of our revenue; a decline in sales of these products could cause our revenue to fall**

We expect that the revenue from our newborn hearing screening products will continue to account for a substantial portion of our revenue for at least the next year. Any factors adversely affecting the pricing of our newborn hearing screening devices and related supplies, or demand for our newborn hearing screening products, including physician acceptance or the selection of competing products, could cause our revenue to decline and our business to suffer.

**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 new 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 refuse adequate reimbursement unless the patient has demonstrable risk factors. If health care providers cannot obtain sufficient reimbursement from third-party payors for our products or the screenings conducted with our products, we may not achieve significant market acceptance of our products. Acceptance of our products in international markets will depend upon the availability of adequate reimbursement or funding within prevailing health care payment systems. Reimbursement, funding, and health care payment systems vary significantly by country. We may not obtain approvals for reimbursement in a timely manner or at all.

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

**If we fail in our efforts to educate clinicians, government agency personnel, and third-party payors on the effectiveness of our products, we 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 more 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;

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Changing governmental and physician group guidelines;

Performance, quality, price, and total cost of ownership 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 may in the future 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 group purchasing organizations, or GPOs, which negotiate volume purchase prices for medical devices and supplies for member hospitals, group practices and other clinics. While we make sales directly to GPO members, the GPO members receive volume discounts from our normal selling price and may receive other special pricing considerations from us. Sales to members of all GPOs accounted for approximately 31%, 28%, and 46% of our total revenue during 2006, 2005, and 2004, respectively, and sales to members of one GPO, Novation LLC, accounted for approximately 12%, 15%, and 20% of our total revenue in 2006, 2005, and 2004, 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**

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.

**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.

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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.

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### **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 and acquire additional products and technologies for the screening, detection, treatment, monitoring and tracking of common medical ailments. Developing and acquiring 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 business could be harmed if our competitors establish cooperative relationships with large medical device vendors or rapidly acquire market share through industry consolidation**

Large medical device vendors may acquire or establish cooperative relationships with our current competitors. We expect that the medical device industry will continue to consolidate. New competitors or alliances among competitors may emerge and rapidly acquire significant market share, which would harm our business and financial prospects.

### **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 plan to expand our international sales and marketing efforts to increase sales of our products in foreign countries. During the past five years we significantly expanded our distributor network outside the U.S. 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;

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;

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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



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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 governments do not require universal newborn hearing screening prior to hospital discharge, or 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. These payments could be equal to a year or more of gross profit on sales of our products that the distributor would have earned. 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 to 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 foreign currency hedging transactions 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 the translation of assets denominated in foreign currencies.

### **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 2002, we experienced delays on the part of a supplier to provide us with volume production of our Flexicoupler supplies, and in 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 these or other 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.

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### **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 Food and Drug Administration, or the FDA, and by similar regulatory agencies in many other countries in which we do business. 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's Section 510(k) clearance process usually takes from three to 12 months, but can take longer. The process of obtaining premarket approval via Section 515 is much more costly, lengthy and uncertain. Premarket approval generally takes from one to three years, but can take even longer. The FDA may not grant either Section 510(k) clearance or premarket approval for any product we propose to market. Furthermore, if the FDA concludes that future products using our technology do not meet the requirements to obtain Section 510(k) clearance, we would have to seek premarket approval via Section 515. The FDA may impose the more burdensome premarket approval requirement on modifications to our existing products or future products, which in either case could be costly and cause us to divert our attention and resources from the development of new products or the enhancement of existing products.

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 could be harmed if the FDA determines that we have failed to substantially comply with applicable regulations or we do not pass an inspection**

We are subject to inspection and market surveillance by the FDA concerning compliance with pertinent regulatory requirements. 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;

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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.

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Recently the FDA inspected one of our facilities. Upon completing the inspection the FDA issued observations on Form FDA-483. We expect to respond to these observations by the end of May 2007 and expect that the matter will be closed out by the end of June 2007. We do not expect that this matter will have any significant adverse impact on the operations of the Company; however, we cannot be assured of this outcome.

### **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**

In December 2006 we received clearance from the FDA to market the Olympic Cool-Cap, a product designed to lower the cerebral temperature of children 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 oversight 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.

### **If we, or our suppliers, fail to comply with applicable regulations, sales of our products could be delayed and our revenue could be harmed**

Every manufacturer of a finished medical device, including Natus and some of our contract manufacturers and suppliers, is required to demonstrate and maintain compliance with the FDA's quality system regulation and comparable regulations of states and other countries. The FDA enforces the quality system regulation through periodic inspections. We, or our contract manufacturers, may fail to pass future quality system regulation inspections. If we, or our contract manufacturers, fail one of these inspections in the future, our operations could be disrupted and our manufacturing and sales delayed significantly until we demonstrate adequate compliance. If we or our contract manufacturers fail to take adequate corrective action in a timely fashion in response to a quality system regulation inspection, the FDA could shut down our or our contract manufacturers' manufacturing operations or require us, among other things, to recall our products, either of which would harm 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

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

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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.

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**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 a history of losses, variable quarterly results, and seasonality in the sale of our products, and may not maintain profitability in the future**

Since our inception, we have incurred significant net losses, including net losses for the years 2004 and 2003, and we may incur net losses in the future. As of December 31, 2006, we had an accumulated deficit of approximately \$31.7 million. Additionally, our revenue and operating results have varied significantly from quarter to quarter in the past and may continue to fluctuate in the future. The following are among the factors that could cause our revenue, operating results and margins to fluctuate significantly from quarter to quarter:

Budgeting cycle of our customers, particularly government entities;

Size and timing of specific sales, such as large purchases of our devices and systems or our supplies and services by government agencies or hospital systems;

Trade-in allowances or other concessions in connection with the introduction of new products or improvements to existing products;

Length and unpredictability of our sales cycle; and

Market changes caused by rapidly evolving technology.

In addition, 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.

We anticipate that it will become increasingly difficult for us to manage our expenses as we:

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Continue to invest in research and development to enhance our product lines, including products and technologies we have gained through our acquisitions;

Develop additional applications for our current technology;

Increase our marketing and selling activities, particularly outside the U.S.; and

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Develop additional infrastructure and hire required management and other employees to keep pace with our growth. As a result of these factors, we may need to generate proportionately higher revenue to maintain profitability. We cannot be certain that we will be able to sustain profitability in the future.

**We could lose the ability to use net operating loss and credit carryforwards, which may adversely affect our financial results**

As of December 31, 2006, we had total federal net operating loss carryforwards of approximately \$11.2 million and credit carryforwards of approximately \$1.0 million available to reduce future taxable income. These net operating loss and credit carryforwards, if not utilized to offset taxable income in future periods, will expire in various amounts beginning in 2008. In addition, the net operating loss and credit carryforwards are subject to examination by the Internal Revenue Service ( IRS ), and are thus subject to adjustment or disallowance resulting from any such IRS examination. If we are unable to fully utilize our net operating loss carryforwards, our future tax payments could be higher and our financial condition may suffer.

**ITEM 6. Exhibits**

(a) Exhibits

| <b>Exhibit No.</b> | <b>Exhibit</b>   | <b>Filing</b> | <b>Incorporated By Reference</b> |                 |                  |
|--------------------|--|---------------|----------------------------------|-----------------|------------------|
|                    |  |               | <b>Exhibit No.</b>               | <b>File No.</b> | <b>File Date</b> |
| 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 |               |                                  |                 |                  |



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**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 10, 2007

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

**(Principal Executive Officer)**

Dated: May 10, 2007

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

**(Principal Financial and Accounting Officer)**

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**NATUS MEDICAL INCORPORATED**

**INDEX TO EXHIBITS**

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