NATUS MEDICAL INC
Form 10-Q
November 09, 2006
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2006

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

Commission file number: 000-33001

NATUS MEDICAL INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware	**77-0154833**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1501 Industrial Road, San Carlos, CA 94070

(Address of principal executive offices) (Zip Code)

(650) 802-0400

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and 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 x 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 x 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 x

The number of issued and outstanding shares of the registrant s Common Stock, $0.001 par value, as of November 6, 2006, was 21,304,636.

Table of Contents

NATUS MEDICAL INCORPORATED

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(in thousands, except share amounts)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 37,155	$ 40,046
Short-term investments		12,163
Accounts receivable, net of allowance for doubtful accounts of $506 and $173	16,107	8,460
Inventories	8,912	3,482
Deferred income taxes	562	
Prepaid expenses and other current assets	1,402	1,041
Total current assets	64,138	65,192
Property and equipment, net	7,510	2,116
Intangible assets	30,131	6,174
Goodwill	22,372	3,836
Deferred income taxes	410	
Other assets	871	78
Total assets	$ 125,432	$ 77,396
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Accounts payable	$ 5,228	$ 1,817
Accrued liabilities	11,985	5,441
Current portion of note payable	7,125	
Deferred revenue	1,810	439
Total current liabilities	26,148	7,697
Deferred income taxes		734
Total liabilities	26,148	8,431
Commitments and contingencies (note 14)		
Stockholders equity:		
Common Stock, $0.001 par value, 120,000,000 shares authorized; shares issued and outstanding: 21,274,917 and 18,444,753	131,720	99,634
Accumulated deficit	(32,189)	(30,750)
Accumulated other comprehensive income (loss)	(247)	81

Total stockholders equity	99,284	68,965
Total liabilities and stockholders equity	$ 125,432	$ 77,396

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

Table of Contents

NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenue	$ 21,806	$ 10,551	$ 61,156	$ 30,422
Cost of revenue	8,299	3,645	22,809	11,435
Gross profit	13,507	6,906	38,347	18,987
Operating expenses:				
Marketing and selling	4,809	2,916	14,965	8,355
Research and development	2,438	1,162	7,387	3,233
General and administrative	2,994	1,521	7,928	4,071
Acquired in-process research and development			5,900	
Total operating expenses	10,241	5,599	36,180	15,659
Income from operations	3,266	1,307	2,167	3,328
Other income, net	146	319	16	787
Income before provision for income tax	3,412	1,626	2,183	4,115
Provision for income tax	1,543	111	3,622	426
Net income (loss)	$ 1,869	$ 1,515	$ (1,439)	$ 3,689
Earnings (loss) per share:				
Basic	$ 0.09	$ 0.09	$ (0.08)	$ 0.21
Diluted	$ 0.09	$ 0.08	$ (0.08)	$ 0.20
Weighted average shares used in the calculation of net income (loss) per share:				
Basic	19,749	17,292	18,949	17,224
Diluted	20,860	18,877	18,949	18,574

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)

	Nine Months Ended September 30,	
	2006	2005
Operating activities:		
Net income (loss)	$ (1,439)	$ 3,689
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Acquired in-process research and development	5,900	
Accounts receivable reserves	60	(22)
Excess tax benefits on the exercise of stock options	730	
Inventory reserves	262	(278)
Depreciation and amortization	2,914	1,556
Warranty reserves	479	(41)
Share based compensation	965	
Changes in operating assets and liabilities, net of assets and liabilities acquired in acquisitions:		
Accounts receivable	(3,174)	783
Inventories	(2,286)	737
Other assets	(280)	160
Accounts payable	434	(270)
Accrued liabilities Accounts payable	(2,521)	154
Deferred revenue	551	38
Net cash provided by (used in) operating activities	2,595	6,506
Investing activities:		
Acquisition of businesses, net of cash acquired	(56,478)	
Sale of land, net of costs	2,492	
Acquisition of property and equipment	(2,204)	(829)
Deposits and other assets	626	13
Purchases of short-term investments		(24,866)
Sales of short-term investments	12,165	30,703
Net cash provided by (used in) investing activities	(43,339)	5,021
Financing activities:		
Proceeds from stock option exercises and ESPP	1,078	759
Borrowing on credit facility	10,000	
Proceeds from issuance of common stock, net of issuance cost	29,313	
Excess tax benefits on the exercise of stock options	730	
Payments on borrowings	(2,875)	
Net cash provided by financing activities	38,246	759
Exchange rate effect on cash and cash equivalents	(333)	(358)

Net increase (decrease) in cash and cash equivalents	(2,891)	11,928
Cash and cash equivalents, beginning of period	40,046	16,239
Cash and cash equivalents, end of period	$ 37,155	$ 28,167
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 498	$
Cash paid for income taxes	$ 1,094	$ 121

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

Table of Contents

NATUS MEDICAL INCORPORATED

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 Sates 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, 2005.

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 fair presentation of our financial position, results of operations and cash flows for the interim periods presented. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

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

Shipping Terms

Note 1 to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 contains the Company s revenue recognition policies. Those policies remain unchanged, except that shipping terms for some neurology and sleep-diagnostic systems are FOB destination, reflecting that title and risk of loss are assumed by the purchaser upon delivery.

Comprehensive Income (Loss)

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Net income (loss)	$ 1,869	$ 1,515	$ (1,439)	$ 3,689
Unrealized gain (loss) on available-for-sale securities	3	(24)	5	(20)
Foreign currency translation adjustment	(38)	258	(333)	(358)
Comprehensive income (loss)	$ 1,834	$ 1,749	$ (1,767)	$ 3,311

Table of Contents

Stockholders Equity

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Beginning Balance	$ 67,636	$ 54,861	$ 68,965	$ 52,728
Net income (loss)	1,869	1,515	(1,439)	3,689
Proceeds from stock option exercises and ESPP	37	188	1,078	759
Proceeds from stock offering	29,313		29,313	
Share-based compensation expense	419		965	
Tax benefit upon exercise of non-qualified stock options	45		730	
Comprehensive income (loss)	(35)	234	(328)	(378)
Ending balance	$ 99,284	$ 56,798	$ 99,284	$ 56,798

Stockholder Rights Plan

The Company adopted a Stockholder Rights Plan in September 2002 (the Rights Plan), as amended in October 2002, February 2003, March 2005, and September 2006. Pursuant to the Rights Plan, the Company declared a dividend of one Preferred Stock Purchase Right per share of Common Stock (the Rights) and each such Right has an exercise price of $23.00. The Rights become exercisable, unless redeemed by the Company, upon the occurrence of certain events, including the announcement of a tender offer or exchange offer for the Company s Common Stock or the acquisition of a specified percentage of the Company s Common Stock by a third party.

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

The Company computes net income (loss) per share in accordance with Statement of Financial Accounting Standards (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 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 September 30, 2006, common stock equivalents of approximately 1,111,000 shares were included in the weighted average shares outstanding used to calculate diluted income per share. For the nine months ended September 30, 2006, common stock equivalents of approximately 1,350,000, shares were excluded from the calculation of diluted net loss per share because of their anti-dilutive effect. For the three months ended September 30, 2006, common stock equivalents of 174,000 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.

For the three and nine months ended September 30, 2005, common stock equivalents of approximately 1,585,000 shares and 1,349,000 shares, respectively, were included in the weighted average shares outstanding used to calculate diluted income per share. For the three and nine months ended September 30, 2005, common stock equivalents of approximately 888,000 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 respective periods.

Table of Contents

3- Business Combinations

Nascor

In September 2006 the Company completed the purchase of certain product rights, manufacturing and distribution contracts, inventory, and intangible assets from Nascor Pty. Ltd. (the Nascor assets) for $953,000 in cash including direct costs of the acquisition. In addition, the Company is also obligated to make future payments of up to $675,000 over a three-year period based primarily on the achievement of certain revenue targets. If the required achievements are met, the additional payments will be recorded as goodwill associated with the purchase. The Company previously distributed certain Nascor products, including the Biliband and Oxydome, in the United States and certain other countries. This acquisition provides the Company with worldwide distribution rights and is expected to improve its margins.

In accordance with SFAS 141, *Business Combinations*, the acquisition has been accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed from Nascor at the date of acquisition are recorded at their respective fair values as of the acquisition date in our consolidated financial statements. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill in the amount of $442,000, which is expected to be deductible for tax purposes. The results of operations from this acquisition are included in our consolidated financial statements from the date of acquisition.

Intangible assets included in the purchase allocation consist of developed technology of $201,000 assigned an economic life of 15 years that are being amortized using the straightline method, and trademarks of $161,000 that have an indefinite life and will not be amortized.

Deltamed S.A.

In September 2006 the Company purchased all the common stock of privately held Deltamed S.A. headquartered in Paris, France, and its wholly owned subsidiaries, Raciar-Alvar, located in Bordeaux, France, and IT-Med, located near Frankfurt, Germany (collectively Deltamed) for approximately $4.1 million cash including direct costs of the acquisition. Deltamed is a leading 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.

In accordance with SFAS 141, *Business Combinations*, the acquisition has been accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed from Deltamed at the date of acquisition are recorded at their respective fair values as of the acquisition date in our consolidated financial statements. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill in the approximate amount of $674,000, which is not expected to be deductible for tax purposes. Deltamed s results of operations are included in our consolidated financial statements from the date of acquisition.

The determination of estimated fair value requires management to make significant estimates and assumptions. The Company hired independent third parties to assist in the valuation of intangible assets and goodwill. The following table summarizes the preliminary purchase price allocation of the fair value of the assets acquired and liabilities assumed at the date of acquisition, as adjusted :

Accounts receivable	$ 355
Property and equipment	635
Inventory	1,054
Deferred tax asset	203
Identifiable intangible assets:	
Patents and developed technology	400
Customer-related intangibles	400
Trademarks and tradenames	500
Goodwill	3,518
Accounts payable	(1,838)
Accrued expenses and other liabilities	(1,083)
Total purchase price	$ 4,144

Table of Contents

Because this acquisition was completed late in the quarter ended September 30, 2006, the purchase price allocation is still preliminary.

Intangible assets included in the purchase allocation consist of: (1) patents and developed technology of $400,000 assigned a weighted average economic life of 15 years being amortized on the straightline method, (2) customer-related intangibles of $400,000 assigned a weighted average economic life of 10 years being amortized on a graded method, and (3) trademarks valued at $500,000 that have an indefinite life and are not being amortized.

Bio-logic Systems Corp.

On January 5, 2006, the Company acquired Bio-logic Systems Corp. (Bio-logic) pursuant to an Agreement and Plan of Merger dated as of October 16, 2005. 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. Pursuant to the terms of the merger agreement, each outstanding share of Bio-logic common stock was converted into the right to receive $8.77 in cash. Each outstanding option to acquire Bio-logic common stock was cancelled, with the holder of the option receiving for each share covered by the option an amount equal to the excess (if any) of $8.77 over the exercise price per share of the option. The total purchase price was approximately $69.3 million, including the payment of $68.8 million to the former stockholders and option holders of Bio-logic and approximately $430,000 of direct costs associated with the acquisition.

In accordance with SFAS 141, *Business Combinations*, the acquisition has been accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed from Bio-logic at the date of acquisition are recorded at their respective fair values as of the acquisition date in our consolidated financial statements. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill in the amount of $18.4 million. No portion of this goodwill is expected to be deductible for tax purposes. Bio-logic s results of operations are included in our consolidated financial statements from the date of acquisition.

The determination of estimated fair values requires management to make significant estimates and assumptions. The Company hired independent third parties to assist in the valuation of intangible assets, in-process research and development, buildings, and land. During the three months ended September 30, 2006 the Company recorded an adjustment to the preliminary purchase price allocation to account for: (1) the tax benefit of an approximate $9.0 million tax net operating loss carryforward reported in the short-period Federal income tax return of Bio-logic for the period March 1, 2005 through January 5, 2006, and (2) an approximate $3.9 million difference between the fair market value and tax basis of land and a building included in the acquisition. The result of the adjustment was to increase deferred tax assets by $5.4 million and increase deferred tax liabilities by $2.1 million, with an offsetting reduction to goodwill of $3.3 million. The following table summarizes the preliminary purchase price allocation of the fair value of the assets acquired and liabilities assumed at the date of acquisition, as adjusted:

Cash	$ 17,875
Accounts receivable	4,179
Property and equipment	6,258
Identifiable intangible assets:	
Core technology	17,100
Developed technology	4,200
Tradenames	2,500
Goodwill	15,382
Other assets	3,094
Release of preexisting valuation allowance for deferred tax asset	9,930
Deferred tax assets	5,414
Deferred tax liabilities	(13,816)
Change of control and restructuring liabilities	(3,000)
Other liabilities assumed	(5,761)
In-process research and development	5,900
Total purchase price	$ 69,255

Table of Contents

Intangible assets included in the purchase allocation consist of: (1) core technology of $17.1 million assigned a weighted average economic life of 19 years, (2) developed technology of $4.2 million assigned a weighted average economic life of 10 years, and (3) tradenames valued at $2.5 million that have an indefinite life. The core technology is being amortized on a combination of straightline and graded methods of amortization depending upon the extent to which the technology has changed over time. The developed technology is being amortized on a graded method.

There are several methods that can be used to determine the estimated fair value of the acquired intangible assets and in-process research and development (IPR&D). The Company utilized the multi-period excess earnings method (MPEE), which is based on the principle that the value of an intangible asset is equal to the present value of the incremental after-tax cash flows attributable only to the subject intangible assets after deducting contributory asset charges. The incremental after-tax cash flows attributable to the subject intangible assets are then discounted to their present value. The projections are based on factors such as relevant market size and acceptance of the technology, patent protection, historical pricing of similar products and expected industry trends. The MPEE method was applied to six discreet Bio-logic product lines and the IPR&D. We used discount rates ranging from 20% to 23% in valuing the acquired core technology and developed technology, and 28% for the IPR&D.

The IPR&D represents a development project for an ambulatory recorder/amplifier for the Bio-logic Ceegraph and Sleepscan systems. At the date of the acquisition there was a significant risk associated with the technological viability of the device. Failure to bring this product to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on this new technology. In accordance with FIN 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, these IPR&D intangible assets were written off by a charge to income immediately subsequent to the acquisition because the ambulatory recorder/amplifier does not have any alternative future use. This charge is not deductible for tax purposes. The development project is ongoing and activity with respect to the project is not material to our research and development expenses.

The following unaudited pro forma combined results of operations of Natus for the three months ended September 30, 2005, and the nine months ended September 30, 2006 and 2005 are presented as if the acquisition of Bio-logic had occurred on the first day of the periods presented.

Unaudited Pro Forma Financial Information

	Three Months Ended	Nine Months Ended	
	September 30, 2005	September 30, 2006	2005
	(in thousands, except per share data)		
Revenue	$ 19,103	$ 61,258	$ 54,371
Net income (loss)	$ 2,237	$ (4,011)	$ 4,844
Pro forma diluted earnings (loss) per share	$ 0.12	$ (0.21)	$ 0.26
Shares used in computing pro forma basic or diluted earnings (loss) per share	18,877	18,949	18,574

The unaudited pro forma results are provided for comparative purposes only and are not necessarily indicative of what actual results would have been had we acquired Bio-logic on such dates, nor do they give effect to synergies, cost savings, and other changes expected to result from the acquisitions. Accordingly the pro forma financial results do not purport to be indicative of results of operations as of the date hereof, for any period ended on the date hereof, or for any other future date or period.

Table of Contents

For the period from January 1, 2006 through January 4, 2006, the following material, nonrecurring items are included in the pro forma results of operations (in thousands):

Accruals related to integration plan (See Note 13)	$ 2,927
Employer payroll taxes upon acceleration of stock option vesting	487

Neometrics, Inc.

In July 2003, the Company purchased substantially all of the assets of Neometrics, Inc. (Neometrics) for $3.6 million in cash plus the assumption of certain liabilities. During the first quarter 2006, the Company resolved certain claims related to the acquisition and received $400,000 cash from the sellers as a settlement. The amount was recorded as a reduction of goodwill.

Natus Neonatal Ltd.

During the first quarter 2006, the Company ceased selling through a direct sales force in the U.K. and began to sell through a distributor. Related to this action the Company wrote off approximately $75,000 of goodwill associated with the Company s U.K. subsidiary. At September 30, 2006 the U.K. subsidiary had no employees and no significant assets or liabilities other than cash and accounts receivable.

Amortization of Intangible Assets Acquired Through Business Combinations

Amortization of intangible assets associated with the Company s acquisitions of Neometrics, Fischer-Zoth, Bio-logic, the Nascor assets, and Deltamed for the three months ended September 30, 2006 and 2005 were $552,000 and $171,000, respectively, and for the nine months ended September 30, 2006 and 2005 were $1.7 million and $517,000, respectively.

4- Inventories

Inventories consisted of (in thousands):

	September 30, 2006	December 31, 2005
Raw materials and subassemblies	$ 5,327	$ 1,695
Finished goods	3,585	1,787
Total	$ 8,912	$ 3,482

The balances at September 30, 2006 and December 31, 2005 reflect valuation reserves of approximately $854,000 and $143,000, respectively, related primarily to specific inventory that has a cost basis that is potentially greater than its net realizable value.

5- Property and Equipment

Property and equipment consisted of (in thousands):

	September 30, 2006	December 31, 2005
Land	$ 900	$
Building	2,200	
Leasehold improvements	507	499
Office furniture and equipment	4,314	3,223
Computer software and hardware	2,482	2,925

Demonstration and loaned equipment	3,061	2,273
	13,464	8,920
Accumulated depreciation	(5,954)	(6,804)
Total	$ 7,510	$ 2,116

Table of Contents

Approximately $3.4 million of the increase in the cost basis of property and equipment from December 31, 2005 to September 30, 2006 resulted from the acquisition of Bio-logic. During the three months ended September 30, 2006 the Company sold undeveloped land with a cost basis of approximately $2.8 million adjacent to the Bio-logic production facility in Mundelein, Illinois. Because the land was recorded at its fair market value in January 2006, pursuant to the terms of a contingent sale, no gain or loss was recognized upon its sale.

The Company recorded depreciation expense of $358,000 and $1.2 million for the three and nine months ended September 30, 2006, respectively, and $320,000 and $1.0 million for the three and nine months ended September 30, 2005, respectively.

6- Wells Fargo Credit Facility

On January 4, 2006, the Company entered into (i) a Credit Agreement with Wells Fargo Bank, National Association (the Credit Agreement), (ii) a Term Commitment Note in favor of Wells Fargo (the Term Note) and (iii) a Security Agreement in favor of Wells Fargo (collectively, the Term Credit Facility).

Pursuant to the Term Credit Facility, on January 5, 2006, Wells Fargo advanced $10 million to the Company, which obligation is represented by the Note and secured by a security interest in the Company s assets. The proceeds of such advance were used solely to assist in financing the acquisition of Bio-logic. The outstanding principal balance under the Note as of the close of business on January 30, 2006 is payable in installments over forty-eight (48) months, with a final installment consisting of all remaining unpaid principal due and payable in full on December 31, 2009. The outstanding principal balance under the Term Note will bear interest, at either a floating rate or a fixed rate at the election of the Company as follows: (i) a fluctuating rate per annum one-quarter percent (0.25%) above the Prime Rate (as defined in the Note) in effect from time to time, or (ii) a fixed rate per annum determined by Wells Fargo to be two and one-half percent (2.50%) above LIBOR (as defined in the Term Note) in effect on the first day of applicable one-, two- or three-month Fixed Rate Terms (as defined in the Term Note). The Term Note can be prepaid without penalty at any time if the Company elects to have interest determined under a fluctuating rate, or at the completion of any one-, two- or three-month Fixed Rate Term.

The Term Credit Facility contains covenants, including covenants relating to liquidity and other financial measures and provides for events of default, including failure to pay any principal or interest when due, failure to perform or observe covenants, bankruptcy or insolvency events and the occurrence of a material adverse effect. The Company is in compliance with all covenants currently in effect. The Term Credit Facility also contains provisions that limit the ability of the Company to pay dividends.

On September 12, 2006, the Company and Wells Fargo Bank entered into the Third Amendment to the Term Credit Facility primarily to modify certain terms and covenants in the agreement associated with the Company s planned acquisition of Deltamed. The Company completed the acquisition of Deltamed on September 13, 2006.

As more fully described in *Note 15 - Subsequent Events*, on November 8, 2006 the Company entered into a $15 million Revolving Credit Facility with Wells Fargo Bank. At that time, the Term Note was paid off and the Term Credit Facility and Term Note were terminated. At September 30, 2006 the outstanding balance of the Term Note has been classified as a current liability.

Balances on the Note were as follows (in thousands):

	Three Months Ended
	September 30, 2006
Term Note payable	$ 7,125
Less current portion	7,125
Non-current portion of note payable	$

Table of Contents

7- Stock Offering

In August 2006, the Company issued 2,645,000 shares of its common stock in a registered offering. The offering was priced at $11.66 per share, which was the closing price of the Company s stock on the day prior to the offering. The Company raised $29.3 million, net of underwriting fees and other costs of the offering.

8- Reserve For Product Warranties

The Company provides a one-year warranty on all medical device products. 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 one-year warranty period. Amounts are added to the reserve on a per-unit basis by reference to historical experience in honoring warranty obligations. On new products, where the Company does not have historical experience of the cost to honor warranties, additions to the reserve are based on a combination of factors including the standard cost of the product and other judgments, such as the degree to which the product incorporates new technology. As warranty costs are incurred, the reserve is reduced.

Activity in the warranty reserve during the three and nine months ended September 30, 2006 and 2005 consisted of (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance - beginning of period	$ 703	$ 223	$ 248	$ 253
Warranty accrued for the period	179	44	479	117
Warranty obligations of acquired businesses	58		364	
Repairs for the period	(74)	(54)	(225)	(157)
Balance end of period	$ 866	$ 213	$ 866	$ 213

Warranty obligations of acquired businesses represent the fair market value of warranty obligations of acquired businesses recorded through business purchase accounting.

9- Other income (expense), net

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Interest income	$ 247	$ 314	$ 491	$ 750
Interest expense	(160)		(498)	
Foreign currency exchange gain (loss)	64		(64)	
Other	(5)	5	87	37
Total other income (expense), net	$ 146	$ 319	$ 16	$ 787

Table of Contents

10- Share-Based Compensation

Share-Based Compensation Prior to January 1, 2006, the Company accounted for employee share-based compensation using the intrinsic value method supplemented by pro forma disclosures in accordance with Accounting Principles Board (APB) No. 25 and SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures.* Since the Company granted options with exercise prices equal to the fair value of the Company s stock on the date of grant, no intrinsic value and therefore no expense was recorded for these options under APB 25.

Effective January 1, 2006, the Company adopted SFAS 123R, *Share-Based Payment*, using the modified prospective approach and, accordingly, prior periods have not been restated to reflect the impact of SFAS 123R. Under SFAS 123R, share-based awards granted prior to its adoption will be expensed over the remaining portion of their vesting period. These awards are being expensed under the single-option straightline method using the same fair value measurements that were used in calculating pro forma share-based compensation expense under SFAS 123. However, in adopting SFAS 123R, the Company reviewed the inputs for volatility under the Black-Scholes valuation methodology and determined that the volatility inputs originally used for grants of options in 2004 and 2005 were higher than they should have been, which had the effect of overstating the pro forma cost of those options presented in supplemental schedules. Accordingly, the Company is now using a historical volatility of 36% to determine the fair value of those options, rather than 71% as originally reported. This change did not have a material impact on the reported pro forma expense associated with those options. For share-based awards granted on or after January 1, 2006, the Company is amortizing share-based compensation expense under the single-option straightline method over the requisite service period, which is generally a four-year vesting period.

For the three and nine months ended September 30, 2006, the Company recorded share-based compensation expense of $419,000 and $965,000, respectively, which reduced gross profit by $47,000 and $116,000, respectively, increased operating expenses by $372,000 and $849,000, respectively, decreased net income for the three months ended September 30, 2006 by $229,000, and increased net loss for the nine months ended September 30, 2006 by $529,000. The impact on basic and diluted net income per share for the three months ended September 30, 2006 was to decrease net income per share by $0.01, and for the nine months ended September 30, 2006, to increase the loss per share by $0.03. For the three and nine months ended September 30, 2005, the Company did not recognize any share-based compensation expense under the intrinsic value method. On a pro forma basis, the Company s share-based compensation during the three and nine months ended September 30, 2005 was $563,000 and $1,348,000, respectively.

Under SFAS No. 123R, the value of each option is estimated on the date of grant using an option pricing model, such as Black-Scholes, which was developed for use in estimating the value of freely traded options. Similar to other option pricing models, it requires the input of highly subjective assumptions, including stock price volatility. Consequently, the Company s employee stock options have characteristics significantly different from those of traded options and changes in the subjective input assumptions can materially affect their estimated fair value.

SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from initial estimates. Share-based compensation expense was recorded net of estimated forfeitures for the three and nine months ended September 30, 2006, such that expense was recorded only for those share-based awards that are expected to vest. Under APB 25, to the extent awards were forfeited prior to vesting, the previously recognized expense was reversed in the period of forfeiture. Upon adoption of SFAS 123R and for the three and nine months ended September 30, 2006, the Company did not record a cumulative adjustment to account for the expected forfeitures of share-based awards granted to non-employees prior to January 1, 2006 (primarily consultants to the Company), for which the Company previously recorded an expense, as the adjustment was not material.

Stock Plans In July 2000, the Board of Directors of the Company adopted the 2000 Stock Option Plan (the 2000 Plan) to be effective upon the closing of the Company s initial public offering and reserved 1,500,000 shares of common stock for issuance thereunder. Each year beginning January 1, 2002, the aggregate number of shares reserved for issuance under the 2000 Plan will automatically increase by the lesser of (i) 1,500,000 shares, (ii) 7% of the shares of common stock outstanding at the end of the preceding year, or (iii) an amount determined by the Board of Directors. In March 2005 and June 2005, respectively, the Board of Directors and the stockholders of the Company approved the Amended and Restated 2000 Stock Awards Plan (the Restated Plan). The Restated Plan was amended to broaden the types of equity awards available for grant thereunder. In particular, the Restated Plan

Table of Contents

now allows for the grant of restricted stock awards, stock bonuses, stock appreciation rights and restricted stock units. On January 1, 2006, the number of shares reserved for issuance under the Restated Plan increased by 1,291,133 shares. The Restated Plan provides for the granting of: (i) incentive stock options to employees, and (ii) nonqualified stock options, restricted stock, stock bonuses, stock appreciation rights and restricted stock units to employees, directors and consultants.

Under the Restated Plan, incentive stock options may be issued at not less than the fair market value of the stock on the date of grant, as determined by the Board of Directors. Options issued under the Restated Plan become exercisable as determined by the Board of Directors and expire no more than 10 years after the date of grant. Most options vest ratably over four years. For those optionees who at the time the option is granted own stock representing more than 10% of the voting power of all classes of stock of the Company, stock options may be issued at not less than 110% of the fair market value of the stock on the date of grant, and the options expire five years after the date of grant.

The Company also has adopted the 1991 Stock Option Plan (the 1991 Plan) and the 2000 Supplemental Stock Option Plan (the Supplemental Plan), which provided for the granting of incentive stock options to employees and nonqualified stock options to employees and consultants. Options outstanding under the 1991 Plan and the Supplemental Plan generally were governed by the same terms as those under the 2000 Plan. At the time of the Company s initial public offering, the 1991 Plan and Supplemental Plan were terminated such that no new options may be granted under these plans. Outstanding options at the date of the initial public offering remained outstanding pursuant to their original terms.

In July 2000, the Company adopted the 2000 Director Stock Option Plan (the Director Plan) to be effective upon the closing of the Company s initial public offering. The Director Plan provides for an initial grant to new nonemployee directors of options to purchase 30,000 shares of common stock. Subsequent to the initial grants, each nonemployee director is granted options to purchase 10,000 shares of common stock at the next meeting of the Board of Directors following the annual meeting of stockholders, if on the date of the annual meeting the Director has served on the Board of Directors for six months. In June 2006, the Board of Directors amended the Directors Plan to reduce the number of shares granted to nonemployee directors upon their appointment to the Board from 30,000 shares to 22,500 shares and to reduce the annual option grants awarded under the Director Plan from 10,000 shares to 7,500 shares. In addition, the Board reduced the term of all options granted under the Director Plan from 10 years to six years. The amendments did not require stockholder approval. The Company reserved a total of 400,000 shares of common stock for issuance under the Director Plan, plus an annual increase to be added on the first day of the Company s fiscal year beginning on January 1, 2002 equal to the lesser of (i) 100,000 shares, (ii) 0.5% of the shares of common stock outstanding on the last day of the preceding fiscal year, or (iii) an amount determined by the Board of Directors. On January 1, 2006, the number of shares reserved for issuance under the Director Plan increased by 92,224 shares.

Employee Stock Purchase Plan In July 2000, the Board of Directors approved the adoption of the 2000 Employee Stock Purchase Plan (the ESPP) effective upon the closing of the Company s initial public offering and reserved 1,000,000 shares of the Company s common stock for issuance thereunder. Each year, beginning January 1, 2002, the aggregate number of shares reserved for issuance under the ESPP will automatically increase by a number of shares equal to the lesser of (i) 650,000 shares, (ii) 4% of the shares of common stock outstanding on the last day of the preceding fiscal year, or (iii) an amount determined by the Board of Directors. Under the ESPP, eligible employees can elect to have salary withholdings of up to 15% of the sum of their W-2 cash compensation and 401(k) contributions withheld during the offering period, to purchase shares of common stock.

On December 29, 2005, the Board of Directors of the Company approved certain amendments to the ESPP to (i) terminate the ongoing 24-month offering periods as of December 31, 2005, (ii) provide for future six-month offering periods to commence on January 1, 2006 (ending on April 30, 2006), and each November 1 and May 1 (respectively ending on each April 30 and October 31) thereafter until further amended, and (iii) further provide that the purchase price for each offering period commencing after December 31, 2005 shall be 85% of the fair market value on the date of purchase rather than 85% of the lower of the fair market value on the first day of the offering period or the last day of the offering period. On January 1, 2006, the number of shares reserved for issuance under the ESPP increased by 650,000 shares.

Table of Contents

Stock Option Activity Stock option activity under the Company s stock awards plans for the nine months ended September 30, 2006 is summarized as follows (in thousands, except per share amounts and as noted):

	Shares	Weighted Average Price Per Share	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	2,684	$ 5.80		
Options granted	527	12.57		
Options exercised	(176)	5.28		
Options canceled/forfeited/expired	(41)	8.41		
Outstanding at September 30, 2006	2,994	6.99	7.27	$ 10,853
Exercisable at September 30, 2006	1,612	5.51	6.70	$ 7,070

The aggregate intrinsic value in the above table represents the total pretax intrinsic value (the aggregate difference between the closing stock price of the Company s common stock on September 30, 2006 and the exercise price for in-the-money options) that would have been received by the option holders if all options had been exercised on September 30, 2006. The total intrinsic value of options exercised in the three and nine months ended September 30, 2006 was $146,000 and $2.3 million respectively. The weighted average grant date fair value of options granted in the three and nine months ended September 30, 2006 was $13.09 and $12.57, respectively, and for the three and nine months ended September 30, 2005 was $10.90 and $9.97, respectively.

Cash received from options exercises and purchases under the ESPP for the three and nine months ended September 30, 2006 was $38,000 and $1.1 million, respectively, and for the three and nine months ended September 30, 2005 was $186,000 and $761,000, respectively.

Restricted Stock Activity The following table summarizes the activity for restricted stock awards during the nine months ended September 30, 2006 (in thousands, except per share amounts and as noted):

	Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2005		
Granted	60	$ 11.32
Vested		
Cancelled		
Unvested at September 30, 2006	60	$ 11.32

The weighted average remaining contractual life for unvested restricted stock awards and units at September 30, 2006 was 3.7 years. No restricted stock awards vested during the three or nine months ended September 30, 2006.

Black-Scholes Inputs The fair value of option grants was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Expected dividend yield	0.0	0.0	0.0	0.0

Risk-free interest rate	4.8%	3.3%	4.8%	3.3%
Expected volatility	36%	67%	36%	67%
Expected term (in years)	5.2	2.5	5.2	2.5
Forfeiture rate	20%	20%	20%	20%

Table of Contents

The Company has no history or expectation of paying dividends on its common stock.

The risk-free interest rate is based on the U.S. Treasury yield for a term consistent with the expected life of the awards in effect at the time of grant.

Expected volatility is based exclusively on historical volatility data of the Company s stock.

The expected term of stock options granted is based exclusively on historical data and represents the period of time that stock options granted are expected to be outstanding. The expected term is calculated for and applied to one group of stock options, as the Company does not currently expect substantially different exercise or post-vesting termination behavior among its employee population. The Company uses the simplified method for calculating expected term allowed by SEC Staff Accounting Bulletin (SAB) No.107.

Prior to June 2006 the Board of Directors of the Company approved grants of options that had a term of 10 years. In June 2006 the Board of Directors determined that future grants of options, including options granted to employees and directors on or after June 15, 2006, will have a term of six years. For the three months ended September 30, 2006, this change in policy had an immaterial impact upon the Black-Scholes input for expected term; however, the Company expects that over time this new policy will have the effect of reducing the input for expected term, which will reduce the fair value of future options calculated under the Black-Scholes method.

Share-based compensation expense recognized in the statement of operations for the three and nine months ended September 30, 2006 is based on awards ultimately expected to vest. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company used a pre-vesting forfeiture rate of 20% in the calculation of share-based compensation expense for the three and nine months ended September 30, 2006, based on weighted average historical forfeiture rates. Under the provisions of SFAS 123R, the Company will record additional expense if the actual forfeiture rate is lower than estimated, and will record a recovery of prior expense if the actual forfeiture is higher than estimated. In the Company s pro forma information required under SFAS 123 for the periods prior to the adoption of SFAS 123R, the Company accounted for forfeitures as they occurred.

Because the ESPP does not have a look back feature, the compensation expense associated with the Plan is not measured by the use of the Black-Scholes pricing model, but rather by measuring the difference between the fair market value of the Company s stock on the last day of the offering period and the purchase price for the offering period, which is 85% of the fair market value. During the three and nine months ended September 30, 2006, the Company recorded $17,000 and $54,000, respectively, of compensation expense associated with the ESPP.

Three and Nine Months ended September 30, 2005 Had compensation expense for the Company s stock option awards been determined based on the Black-Scholes fair value method at grant dates, consistent with the fair value method of SFAS No. 123, the Company would have recorded additional compensation expense and its net income (loss) and earnings (loss) per share would have been equal to the pro forma amounts presented in the following table:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 1,515	$ 3,689
Less: Compensation expense for stock options determined under the fair value method, net of related tax effects	(563)	(1,348)
Pro forma net income	$ 952	$ 2,341
Basic earnings per share:		
As reported	$ 0.09	$ 0.21
Pro forma	$ 0.06	$ 0.14
Diluted earnings per share:		
As reported	$ 0.08	$ 0.20

Pro forma	$ 0.05	$ 0.13

Table of Contents

11- Income Taxes

Provision for Income Tax

The Company recorded provisions for income tax of $1.5 and $3.6 million for the three and nine-months ended September 30, 2006, and $111,000 and $426,000 for the same periods in 2005. Our effective tax rates for the quarters ended September 30, 2006 and 2005 were 45.2% and 6.8%, respectively. In the first quarter 2006 we recorded a $5.9 million IPR&D charge associated with the acquisition of Bio-logic that is on an after-tax basis.

Prior to the acquisition of Bio-logic, the Company generated tax losses and maintained a full valuation allowance on its deferred tax assets. Tax expense historically consisted of a provision for the U.S. Federal corporate alternative minimum tax, minimal domestic state taxes, and foreign taxes at statutory rates. The Company released its valuation allowance through goodwill as part of the purchase accounting for Bio-logic. Since there are no longer any unrecognized deferred tax assets, the 2006 effective tax rate in the three and nine months ended September 30, 2006 increased to near the statutory rates in the jurisdictions in which we file tax returns. The effective tax rate is higher than the statutory rate of approximately 40.5% because of non-deductible expenses in our book income, including share-based compensation expense.

Deferred Income Taxes

At September 30, 2006 the Company reported a net current deferred income tax asset of approximately $562,000 and a net non-current deferred income tax asset of approximately $410,000. At December 31, 2005, the Company reported a net non-current deferred income tax liability of approximately $743,000. A full valuation allowance of approximately $9.9 million was provided for deferred income tax assets at December 31, 2005.

During the three months ended September 30, 2006 the Company recorded an adjustment to its deferred taxes to account for: (1) the tax benefit of an approximate $9.0 million tax net operating loss carryforward reported in the short-period Federal income tax return of Bio-logic for the period March 1, 2005 through January 5, 2006, that had not previously been recognized through purchase accounting, and (2) the tax benefit of an approximate $3.9 million difference between the fair market value and tax basis of land and a building obtained through the acquisition of Bio-logic that had not previously been recognized through purchase accounting. The result of the adjustment was to increase the Company s deferred tax assets by approximately $3.3 million.

12- Segment, Customer and Geographic Information

The Company currently operates in one reportable segment, the Medical Devices and Related Supplies segment. With the exception of our Neometrics newborn screening data management systems (Neometrics Product Line), the nature of the Company s products and production processes as well as type of customers and distribution methods are consistent among all product lines, including the product lines the Company gained through its acquisition of Bio-logic. The Neometrics Product Line is differentiated from our other product lines in that it is not a medical device or related supply product, is not currently regulated by the FDA and revenue is recognized under the percentage of completion basis. For the three and nine months ended September 30, 2006, the Neometrics Product Line did not meet the quantitative thresholds for segment reporting and is therefore included in the all other reconciling line.

The accounting policies of the Company s reportable segment are the same as 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

Table of Contents

December 31, 2005, as updated in this interim report. The Company allocates resources to and evaluates the performance of its reportable segment based on operating income, excluding items that the Company considers non-recurring to the Company s operations, which for the nine months ended September 30, 2006 consists of a $5.9 million charge for in-process research and development recognized in connection with the Company s acquisition of Bio-logic. For management reporting purposes, corporate expenses are charged predominantly to the Medical Devices and Related Supplies segment. The asset totals disclosed by the segment are directly managed by the segment and include accounts receivable, inventory, certain fixed assets, intangible assets and goodwill, and certain other assets. Assets that are not allocated specifically to the segment primarily include cash and cash equivalents, short-term investments and deferred tax assets and liabilities.

The table below presents information about the Company s reportable segment (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenue:				
Medical devices and related supplies	$ 21,261	$ 10,070	$ 59,250	$ 28,821
All other	545	481	1,906	1,601
Total consolidated revenue	$ 21,806	$ 10,551	$ 61,156	$ 30,422
Operating income (loss):				
Medical devices and related supplies	$ 3,235	$ 1,440	$ 7,798	$ 3,708
All other	31	(133)	269	(380)
Segment sub-total	3,266	1,307	8,067	3,328
Acquired in-process research and development			(5,900)	
Total income (loss) from operations	$ 3,266	$ 1,307	$ 2,167	$ 3,328

	September 30, 2006	December 31, 2005
Assets:		
Medical devices and related supplies	$ 84,566	$ 20,955
All other	3,721	4,232
Corporate assets	37,155	52,209
Total consolidated assets	$ 125,432	$ 77,396

The following is revenue and long-lived asset information by geographic region (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenue:				
United States	$ 16,298	$ 6,661	$ 44,938	$ 19,161
Foreign countries	5,508	3,890	16,218	11,261
Totals	$ 21,806	$ 10,551	$ 61,156	$ 30,422

	September 30, 2006	December 31, 2005
Long-lived assets:		
United States	$ 48,807	$ 5,988
Foreign countries	11,206	6,138
Totals	$ 60,013	$ 12,126

Table of Contents

Long-lived assets include property and equipment (net), intangible assets and goodwill. During the three and nine months ended September 30, 2006, no single customer or foreign country contributed to more than 10% of revenue.

13- Restructuring Reserve

On January 9, 2006, the Company initiated an integration plan (the Plan) related to the acquisition of Bio-logic. Under the Plan, the Company reduced the size of its combined workforce by approximately 23 employees, representing approximately 10% of the workforce of the Company. Under the Plan, the Company seeks to eliminate redundant costs resulting from the acquisition of Bio-logic and improve efficiencies in operations. A majority of notifications to employees was completed during the week of January 9, 2006, and substantially all of the staff reductions were completed by September 30, 2006.

The Plan has been accounted for in accordance with FASB, Emerging Issues Task Force Issue 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination.* All costs associated with the Plan were recognized as a liability assumed as of the consummation date of the merger. Substantially all of the costs associated with the Plan will result in the outlay of cash.

Following is a reconciliation of the beginning and ending restructuring reserve balances related to the Plan (in thousands):

	Beginning Balance	Expenses Accrued	Paid	Ending Balance
Nine months ending September 30, 2006				
Employee termination benefits	$	$ 2,827	$ (2,755)	$ 72
Other		100		100
Totals	$	$ 2,927	$ (2,755)	$ 172

14- Commitments and Contingencies

In November 2002, the FASB issued FIN No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantee of Indebtedness of Others*. The Company has determined that certain agreements it has entered into, described below, fall within the scope of FIN 45.

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. The Company has a directors and officers liability insurance policy that limits the Company s exposure and enables it to recover a portion of any amounts paid resulting from the indemnification of its directors and officers. In addition, the Company enters into indemnification agreements with other parties in the ordinary course of business. In some cases the Company has obtained liability insurance providing coverage that limits its exposure for these other indemnified matters. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. The Company believes the estimated fair value of these indemnification agreements is minimal and has not recorded a liability for these agreements as of September 30, 2006.

In the normal course of business, we enter into obligations and commitments that require future contractual payments. The commitments result primarily 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.

Table of Contents

We currently are, and may from time to time, become a party to various legal proceedings or claims that arise in the ordinary course of business. Our management has reviewed the eminent matters and believes that the resolution of them will not have a significant adverse effect on our financial condition.

15- Subsequent Events

Acquisition of Business

On October 16, 2006, the Company acquired privately held Olympic Medical Corp. for approximately $16.6 million cash, plus the immediate satisfaction of approximately $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 (NICU) and pediatric department of the hospital, including devices for the detection of neurologic function of newborns. The acquisition is intended to enhance the Company s growth opportunities by broadening its product offerings, which the Company plans to leverage through its direct sales force in the U.S. and international distribution organization. The Company plans to retain Olympic Medical s operations, as well as their established brands and existing products. Olympic Medical has approximately 100 employees and recorded sales of $16.0 million during calendar year 2005.

Wells Fargo Revolving Credit Facility

On November 8, 2006, the Company entered into (i) a Revolving Credit Agreement with Wells Fargo Bank, National Association (Wells Fargo), (ii) a Credit Commitment Note (the Note) in favor of Wells Fargo and (iii) a Security Agreement in favor of Wells Fargo (collectively, the Revolving Credit Facility).

Pursuant to the Revolving Credit Facility, on November 8, 2006, Wells Fargo committed to advance, from time to time for one year, a maximum of $15 million to the Company, which obligation is represented by the Note and secured by a security interest in the Company s assets. The proceeds of such advances can be used for working capital needs. In addition, the Company can use up to $10 million of the commitment for the acquisition of businesses without prior approval of Wells Fargo. The Revolving Credit Facility carries an unused commitment fee equal to one quarter of one percent of the average unused commitment, payable quarterly. Outstanding advances under the Note will bear interest, at either a floating rate or a fixed rate at the election of the Company as follows: (i) a fluctuating rate per annum one-quarter percent (0.25%) below the Prime Rate (as defined in the Note) in effect from time to time, or (ii) a fixed rate per annum determined by Wells Fargo to be two percent (2%) above LIBOR (as defined in the Note) in effect on the first day of applicable one-, two- or three-month Fixed Rate Terms (as defined in the Note). The Note can be prepaid without penalty at any time if the Company elects to have interest determined under a fluctuating rate, or at the completion of any one-, two- or three-month Fixed Rate Term.

The Revolving Credit Facility contains covenants, including covenants relating to liquidity and other financial measures and provides for events of default, including failure to pay interest when due, failure to perform or observe covenants, bankruptcy or insolvency events and the occurrence of a material adverse effect.

Wells Fargo Term Commitment Note

Concurrent with executing the Revolving Credit Facility, on November 8, 2006, the Company paid off the remaining balance of its Term Note with Wells Fargo and the Term Credit Facility and Term Note were terminated.

Table of Contents

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℠ is a non-registered service mark of Natus. Bio-logic®, AuDX®, ABaer®, Ceegraph®, 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.

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, 2005, 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;

2006 Third Quarter Overview. A summary of key information concerning the financial results for the three and nine months ended September 30, 2006;

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 which require critical judgments and estimates;

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;

Recently Issued 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.

Our Business

Natus is a leading provider of healthcare products used for screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, newborn jaundice and newborn metabolic testing. We design our products to deliver accurate results in a rapid and reliable manner. In addition, our products address guidelines for standard medical practices as adopted by various medical-industry associations such as the American Academy of Pediatrics (AAP) and the Joint Committee on Infant Hearing (JCIH).

Currently, our principal product lines consist of our ALGO and ABaer screening products for newborn hearing screening, our AuDX and Echo-Screen OAE device for hearing screening in newborns and hearing monitoring in young children and adults, our Navigator products for diagnostic hearing assessment in children and adults, our neoBLUE LED line of phototherapy devices for the treatment of newborn jaundice, our

Ceegraph VISION, Sleepscan VISION, and Coherence product lines for electroencephalograph (EEG) and polysomnography (PSG) monitoring and diagnosis of neurologic dysfunction and sleep disorders, and our Neometrics newborn screening data management systems (MSDS).

Table of Contents

Our revenue is generated almost exclusively from the sale of devices and systems, which are generally non-recurring, and related supplies and services, which are generally recurring. Devices and systems revenue results from the sale of our ALGO, ABaer, Echo-Screen, AuDX, Navigator, neoBLUE, Ceegraph, Sleepscan, and Coherence 3NT devices, and installation of our Neometrics newborn screening data management systems. Supplies and services revenue results from sales of disposable supplies used with the abovementioned devices, the Nascor product line, software maintenance agreements for our Neometrics data management systems, as well as extended service agreements on our medical devices.

In the United States we sell our products primarily through a direct sales force. Our diagnostic hearing devices are sold in the U.S. through distributors. We sell our products internationally in over 80 other countries through distributors. 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 27% of our revenue during the three and nine months ended 30, 2006, compared to 37% of our revenue during the respective periods in 2005. The reduction in international sales as a percent of total sales in the 2006 periods, as compared to 2005, was attributable to our acquisition of Bio-logic, as their international sales comprise a lower percentage of their total sales than Natus. We anticipate that international revenue will increase as a percent of revenue in the future.

2006 Third Quarter Overview

In August 2006 we issued 2,645,000 shares of our stock in a registered offering priced at $11.66 per share, raising $29.3 million after deducting costs associated with the offering. In September 2006 we completed the acquisitions of The Nascor assets for cash of $953,000 and Deltamed for cash of $4.1 million. On September 26, we completed the sale of an undeveloped parcel of land we obtained through our acquisition of Bio-logic, netting approximately $2.5 million. In addition, after the end of the third quarter of 2006, on October 16, we completed the acquisition of Olympic Medical for $19.3 million including the immediate satisfaction of $2.7 million dollars of Olympic Medical obligations associated with the acquisition. Olympic Medical has approximately 100 employees and recorded sales of $16.0 million during calendar year 2005.

During the three months ended September 30, 2006, Natus recognized $21.8 million of revenue, an increase of $11.3 million or 107% from $10.6 million in the comparable quarter of the previous year. Revenue from sales outside the U.S. increased 42% to $5.5 million for the third quarter 2006, compared with $3.9 million in the comparable quarter in 2005.

Our gross profit decreased to 61.9% for the three months ended September 30, 2006, compared with 65.4% for the third quarter of 2005. For the three months ended September 30, 2006, total operating expenses increased by $4.6 million, or approximately 82.9%, to $10.2 million, compared with $5.6 million for the third quarter of 2005.

Net income for the three months ended September 30, 2006 was $1.8 million, or $0.09 per diluted share, compared to net income of $1.5 million, or $0.08 per diluted share, reported in the same period in the prior year.

In order to more fully understand the comparison of the results of operations for the third quarter of 2006 as compared to the same period in 2005, it is important to note that we acquired Bio-logic on January 5, 2006, which had a material impact on our results of operations for the three months ended September 30, 2006. The acquisition of Deltamed did not have a significant impact on our results of operations for the three months ended September 30, 2006.

Application of Critical Accounting Policies

We prepare our financial statements in accordance with accounting principles generally accepted in the United Sates 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.

Table of Contents

During the nine months ended September 30, 2006, there were no changes in the application of critical accounting policies as described in our Annual Report on Form 10-K for the year ended December 31, 2005, except for those related to share-based compensation expense associated with our adoption of SFAS 123R as of January 1, 2006, as more fully described below.

Revenue Recognition

We recognize revenue, net of discounts, from sales of medical devices and supplies, including sales to distributors, when a purchase order has been received, when title transfers, when the selling price is fixed or determinable, and when collection of the resulting receivable is reasonably assured. Terms of sale for most domestic sales are FOB origin, reflecting that title and risk of loss are assumed by the purchaser at the shipping point, however, terms of sale for some neurology and sleep-diagnostic systems are FOB destination, reflecting that title and risk of loss are assumed by the purchaser upon delivery. Terms of sales to international distributors are EXW, reflecting that goods are shipped ex works, in which title and risk of loss are assumed by the distributor at the shipping point.

Revenue from the Neometrics newborn screening data management systems, which are generally highly configurable, is recognized on the percentage of completion basis over the development and implementation period of the associated installation, which typically ranges from six to 18 months. Revenue from extended service and maintenance agreements, for both medical devices and data management systems, is recognized ratably over the service period. Advance payments from customers are recorded as deferred revenue and recognized as revenue as otherwise described above. We generally do not provide rights of return on products. We accept trade-ins of our own and competitive medical devices. Trade-ins are recorded as a reduction of the replacement medical device sale. Provisions are made for initial standard warranty obligations of one year, and post-sale training and customer support at the time the related revenue is recognized.

More than 90% of the hospitals in the U.S. are members of group purchasing organizations (GPO s), which negotiate volume purchase prices for member hospitals, group practices, and other clinics. We have entered into agreements with several GPOs that typically contain preferential terms for the GPO and its members, including provisions for some, if not all, of the following:

- Negotiated pricing for all group members;
- Volume discounts and other preferential terms on their member s direct purchases from us;
- Promotion of Natus products by the GPO to its members;
- Payment of marketing fees by Natus to the GPO, usually based on purchasing experience of group members; and
- Non-recourse cancellation provisions.

We do not sell our products to GPOs. Hospitals, group practices and other clinics that are members of a GPO purchase products directly from us under the terms negotiated by the GPO. Negotiated pricing and discounts are recognized as a reduction of the selling price of our products. Revenue from sales to members of GPOs is otherwise consistent with our general revenue recognition policies as previously described.

We must exercise judgment when assessing the sufficiency of our allowance for estimated uncollectible accounts receivable. Our estimates are based on our historical collection experience within the markets in which we operate, assessment of our average accounts receivable aging days, and any other specific information of which we may be aware, such as bankruptcy filings or liquidity problems of our customers. Any future determination that our allowance for estimated uncollectible accounts receivable is understated could result in increased operating expense and reduce our results of operations.

Inventory is carried at the lower of cost or market value

As a medical device manufacturer, we may be exposed to a number of factors that could result in portions of our inventory becoming either obsolete or in excess of anticipated usage. These factors include, but are not limited to: technological changes in our markets, competitive

pressures in products and prices, and our own introduction of new product lines.

Table of Contents

We regularly evaluate our ability to realize the value of our inventory based on a combination of factors, including historical usage rates, forecasted sales, product life cycles, and market acceptance of new products. When we identify inventory that is obsolete or in excess of anticipated usage we write it down to realizable salvage value or provide for inventory valuation reserves. The estimates we use in projecting future product demand may prove to be incorrect. Any future determination that our inventory is overvalued could result in increases to our cost of sales and decreases to our operating margins and results of operations.

Carrying value of intangible assets

We amortize intangible assets with finite lives over their useful lives; any future changes that would limit their useful lives or any determination that these assets are carried at amounts greater than their fair value could result in additional charges. We carry goodwill and any other intangible assets with indefinite lives at original cost but do not amortize them. Any future determination that these assets are carried at amounts greater than their fair value could result in additional charges, which could significantly impact our operating results.

We test our goodwill and indefinite-lived intangible assets for impairment at least annually as of October 1st of each year; this assessment is also performed whenever there is a change in circumstances that indicates the carrying value of these assets may be impaired. Similarly, we test our definite-lived intangible assets for impairment whenever changes in circumstances indicate the carrying value of these assets may be impaired. Impairment indicators include, but are not limited to, net book value as compared to market capitalization, significant negative industry and economic trends, and significant underperformance relative to historical and projected future operating results. Impairment is considered to have occurred when the estimated undiscounted future cash flows related to the asset are less than its carrying value. Estimates of future cash flows involve consideration of many factors including the marketability of new products, product acceptance and lifecycle, competition, appropriate discount rates, and operating margins. If these estimates or their related assumptions change in the future, we may be required to record impairment charges, which could have a significant impact on our operating results.

Liability for product warranties

Our medical device products are covered by standard one-year product warranty plans. A liability has been established for the expected cost of servicing our medical device products during these service periods. We base the liability in part upon our historical experience; however, estimates of the costs to honor our warranties are often difficult to determine due to uncertainty surrounding the extent to which new products will require servicing and the costs that will be incurred to service those products. Until we have historical experience of the cost to honor warranties on new products, we base additions to the reserve on a combination of factors including the standard cost of the product, experience with similar products, and other judgments, such as the degree to which the product incorporates new technology. The estimates we use in projecting future product warranty costs may prove to be incorrect. Any future determination that our product warranty reserves are understated could result in increases to our cost of sales and reductions in our operating profits and results of operations.

Share-based compensation

On January 1, 2006, the Company adopted the provision of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 123R, *Share-Based Payment*, using the modified prospective approach. With the adoption of SFAS 123R, the Company is required to record the fair value of share-based compensation awards as expenses in the consolidated statement of operations. In order to determine the fair value of stock options on the date of grant, the Company applies the Black-Scholes option-pricing model. Inherent in this model are assumptions related to expected dividend yield, risk-free interest rate, expected stock-price volatility, expected term, and forfeiture rate. While the risk-free interest rate and dividend yield are less subjective assumptions, typically based on factual data derived from public sources, the expected stock-price volatility, expected life, and forfeiture rate assumptions require a greater level of judgment which makes them critical accounting estimates. Following is a summary of the criteria the Company considers when making these estimates:

Table of Contents

Expected volatility is based exclusively on historical volatility data of the Company s common stock, measured by reference to the average of the high and low price of the stock on the same day of each week.

The expected term of stock options granted is based exclusively on historical data and represents the period of time that stock options granted are expected to be outstanding. The expected term is calculated for and applied to one group of stock options, as the Company does not currently expect substantially different exercise or post-vesting termination behavior among its employee population. The Company uses the simplified method for calculating expected term allowed by SAB No. 107.

Share-based compensation expense is based on awards ultimately expected to vest. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company bases its pre-vesting forfeiture rate on weighted average historical forfeiture rates. Under the provisions of SFAS 123R, the Company will record additional expense if the actual forfeiture rate is lower than estimated, and will record a recovery of prior expense if the actual forfeiture is higher than estimated.

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 September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	38.1	34.6	37.3	37.6
Gross profit	61.9	65.4	62.7	62.4
Operating expenses:				
Marketing and selling	22.1	27.6	25.4	27.5
Research and development	11.2	11.0	12.1	10.6
General and administrative	13.7	14.4	13.0	13.4
Acquired in-process research and development			9.6	
Total operating expenses	47.0	53.0	59.2	51.5
Income from operations	14.9	12.4	3.5	10.9
Other income, net	0.7	3.0		2.6
Income before provision for income taxes	15.6	15.4	3.5	13.5
Income tax provision	7.0	1.0	5.9	1.4
Net income (loss)	8.6%	14.4%	(2.4)	%12.1%

Three and Nine Months Ended September 30, 2006 and 2005

Acquisitions

In order to more fully understand the comparison of the results of operations for the three and nine months ended September 30, 2006, as compared to the respective periods in 2005, it is important to note that we acquired Bio-logic on January 5, 2006, which had a material impact on our financial position and results of operations during 2006. The acquisitions of The Nascor assets and Deltamed did not have a significant impact upon our results of operations for the three months ended September 30, 2006.

Table of Contents

Consolidated Results

Our revenue increased $11.3 million, or 106.7%, to $21.8 million in the three months ended September 30, 2006, from $10.6 million in the same period in 2005. Bio-logic contributed to $10.2 million of the increase. Our revenue increased $30.7 million, or 101%, to $61.2 million in the nine months ended September 30, 2006, from $30.4 million in the same period in 2005. Bio-logic contributed to $28.3 million of the increase.

Revenue from devices and systems increased 186% to $12.6 million in the three months ended September 30, 2006, compared to $4.4 million in the same period in 2005. Revenue from Bio-logic s hearing diagnostic, neurology and sleep diagnostic product lines contributed to $7.7 million of the increase. Revenue from devices and systems increased 162% to $34.2 million in the nine months ended September 30, 2006, from $13.0 million in the same period in 2005. Revenue from Bio-logic s hearing diagnostic, neurology and sleep diagnostic product lines contributed to $21.2 million of the increase

Revenue from supplies and services increased $2.8 million, or 46.7%, to $8.9 million in the three months ended September 30, 2006, from $6.0 million in the same period in 2005. Sales of supplies used with Bio-logic s hearing screening and diagnostic devices contributed to $2.4 million of the increase, with the remainder coming primarily from supplies used with our ALGO and Echo-Screen devices. Revenue from supplies and services increased $8.9 million or 52%, to $26 million in the nine months ended September 30, 2006 from $17.1 million in the same period in 2005. Sales of supplies used with Bio-logic s hearing screening and diagnostic devices contributed to $6.9 million of the increase, with the remainder coming primarily from supplies used with our ALGO and Echo-Screen devices. Revenue from supplies and services was 41% and 43%, respectively, of total revenue in the three and nine months ended September 30, 2006, compared to 57% and 56%, in the respective periods in 2005. The decrease in supplies and services revenue as a percent of total revenue in the 2006 periods, compared to the respective periods in 2005, is associated with the product mix of Bio-logic. No end-customer accounted for more than 10% of our revenue in the three or nine months ended September 30, 2006 or 2005.

Revenue from sales outside the U.S. was $5.5 million and $16.2 million, respectively, for the three and nine months ended September 30, 2006, from $3.9 million and $11.3 million in the same periods in 2005. Bio-logic contributed to $1.3 million and $5.3 million, respectively, of the increase in three and nine months ended September 30, 2006.

Our gross profit increased $6.6 million, or 95%, to $13.5 million in the three months ended September 30, 2006, from $6.9 million in 2005. Our gross profit increased $19.4 million, or 102%, to $38.3 million in the nine months ended September 30, 2006, from $19 million in 2005. Gross profit as a percentage of revenue was 61.9% and 62.7%, respectively, in the three and nine months ended September 30, 2006, from 65.4% and 62.4% in the respective periods in 2005. The improvement in our gross profit percentage for the nine months ended September 30, 2006 was primarily attributable to the results of Bio-logic and product mix. The deterioration in our gross profit for the three months ended September 30, 2006 was primarily related to product mix, as well as increases to our warranty and inventory reserves.

Total operating costs increased by $4.6 million to $10.2 million in the three months ended September 30, 2006, from $5.6 million in the same period in 2005. Total operating costs increased by $20.5 million, to $36.2 million, in the nine months ended September 30, 2006, from $15.7 million in the same period in 2005. The increase in the nine-month period in 2006 was primarily attributable to $12.1 million of Bio-logic operating costs and a $5.9 million charge for in-process research and development associated with our acquisition of Bio-logic. Operating costs of Bio-logic contributed to $3.8 million of the increase for the three months ended in September 2006. During the three and nine months ended September 30, 2006, we also recorded $372,000 and $849,000, respectively, of employee share-based compensation expense. We did not record employee equity based compensation in 2005. The net increase in total operating costs from factors other than the foregoing was primarily attributable to an increase in outside consulting fees of $432,000 and $1.2 million, respectively, in the three and nine months ended September 30, 2006, and, to a lesser extent, increased domestic sales compensation in the 2006 periods.

Our marketing and selling expenses increased $1.9 million, or 64.9%, to $4.8 million in the three months ended September 30, 2006, from $2.9 million in the same period in 2005. Marketing and selling expenses increased $6.6 million, or 79%, to $15.0 million in the nine months ended September 30, 2006, from $8.3 million in the same

Table of Contents

period in 2005. The increases in both periods were attributable to Bio-logic, which contributed to $2.0 million and $6.6 million, respectively, of the increase in the three and nine months ended September 30, 2006, compared to the same periods in 2005.

Our research and development expenses increased $1.3 million, or 109%, to $2.4 million in the three months ended September 30, 2006, from $1.2 million in the same period in 2005. Research and development expenses increased 129%, or $4.2 million, to $7.4 million, in the nine months ended September 30, 2006, compared to $3.2 million in the comparable period in 2005. Bio-logic contributed to $1.3 million and $4.0 million, respectively, of the increase for the three and nine months ended September 30, 2006, with the remainder of the increase coming primarily from salaries and outside consulting costs.

Our general and administrative expenses increased $1.5 million, or 97%, to $3 million in the three months ended September 30, 2006, from $1.5 million in the same period in 2005. General and administrative expenses increased by $3.9 million, or 95%, to $7.9 million for the nine months ended September 30, 2006, compared to $4.1 million reported in the same period in 2005. Bio-logic contributed to $583,000 and $1.5 million, respectively, of the increase in the three and nine months ended September 30, 2006. Employee share-based compensation expense was $230,000 and $490,000 for the three and nine months ended September 30, 2006, while we had no employee share-based compensation expense in 2005. Outside consulting costs also increased by $360,000 and $870,000, respectively, in the three and nine months ended September 30, 2006, compared to the same periods in 2005.

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 a net other expense of $146,000 in the three months ended September 30, 2006, compared to net other income of $319,000 in the same period in 2005. Net other expense for the nine months ended September 30, 2006 was $16,000 compared to net other income of $787,000 in the same period in 2005. The reduction in other income (expense) resulted primarily from the decrease in our investment portfolio and an increase in interest expense related to our note payable, both of which were related to our acquisition of Bio-logic.

We recorded a provision for income tax of $1.5 million for the quarter ended September 30, 2006, compared to a provision of $111,000 for the same period in 2005. For the nine months ended September 30, 2006 we recorded a provision for income tax of $3.6 million, compared to $426,000 recorded in the same period in 2005. Our effective tax rates for the quarters ended September 30, 2006 and 2005 were 45.2% and 6.8%, respectively. In the first quarter 2006 we recorded a $5.9 million IPR&D charge associated with the acquisition of Bio-logic that is on an after-tax basis.

Prior to the acquisition of Bio-logic, the Company generated tax losses and maintained a full valuation allowance on its deferred tax assets. Tax expense historically consisted of: (i) a provision for the U.S. Federal corporate alternative minimum tax, (ii) minimal domestic state taxes, and (iii) foreign taxes at statutory rates. The Company released its valuation allowance through goodwill as part of the purchase accounting for Bio-logic. Since there are no longer any unrecognized deferred tax assets, the 2006 effective tax rate in the three and nine months ended September 30, 2006 increased to near the statutory rates in the jurisdictions in which we file tax returns. The effective tax rate is higher than the statutory rate of approximately 40.5% because of non-deductible expenses in our book income, including share-based compensation expense.

Segment Results

We currently operate in one reportable segment, our Medical Devices and Related Supplies segment. Additional financial information about our segment is set forth in *Note 12 Segment, Customer and Geographic Information*, of our condensed consolidated financial statements contained in this report.

Medical Devices and Related Supplies Segment

Revenue from the medical devices and related supplies segment increased by $11.2 million, or 111%, to $21.3 million in the three months ended September 30, 2006, from $10.1 million in the same period in 2005. For the nine

Table of Contents

months ended September 30, 2006, revenue from our medical devices and related supplies segment increased by $30.4 million, or 106%, to $59.2 million from $28.8 million in the same period in 2005. Bio-logic contributed to $8.6 million and $18 million of the increase, respectively, for the three and nine month periods. The higher sales in 2006 were also due to an increase in sales of our neoBLUE phototherapy lights.

The medical device and related supplies segment reported income from operations of $3.2 million in the three months ended September 30, 2006, including approximately $1.0 million of depreciation and amortization costs, compared to $1.4 million in the same period in 2005. The segment reported income from operations of $7.8 million in the nine months ended September 30, 2006, including approximately $2.9 million of depreciation and amortization costs, compared to $3.7 million in the same period in 2005. The results in 2006 were favorably impacted by the operations of Bio-logic.

All Other

Information regarding segment operating results is set forth in *Note 12 Segment, Customer, and Geographic Information* of our consolidated financial statements contained in this report.

Liquidity and Capital Resources

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

As of September 30, 2006, we had cash, cash equivalents, and short-term investments of $37.2 million, stockholders equity of $99.3 million, and working capital of $38.0 million, compared with cash, cash equivalents, and short-term investments of $52.2 million, stockholders equity of $69.0 million, and working capital of $57.5 million as of December 31, 2005. The reduction in our cash, cash equivalents and short-term investments is primarily related to our acquisition of Bio-logic on January 5, 2006 for approximately $69.3 million for which we used $51.4 million of our cash.

In August 2006, we issued 2,645,000 shares of our common stock in a registered offering. The offering was priced at $11.66 per share, which was the closing price of our stock on the day prior to the offering. We raised $29.3 million, net of underwriting fees and other costs of the offering.

On October 16, 2006, we acquired privately held Olympic Medical Corp. in a cash acquisition valued at approximately $19.3 million, including the immediate satisfaction of approximately $2.7 million of Olympic Medical obligations associated with the acquisition. We used approximately $1.2 million of Olympic Medical cash to complete the acquisition. Olympic Medical has approximately 100 employees and recorded sales of $16.0 million during calendar 2005.

On November 8, 2006 we entered into a $15 million revolving credit facility, at which time we paid off the outstanding principal balance of an existing term credit facility. The revolving credit facility contains covenants, including covenants relating to liquidity and other financial measurements and provides for events of default, including failure to pay any interest when due, failure to perform or observe covenants, bankruptcy or insolvency events and the occurrence of a material adverse effect. We were in compliance with all covenants of our term credit facility during the three months ended September 30, 2006.

Following our acquisitions of Bio-logic, Deltamed, and Olympic Medical, our cash reserves and working capital have been significantly reduced. However, we believe that our current cash, cash equivalents, and short-term investment balances, and any cash generated from operations will be sufficient to meet our ongoing operating and capital requirements for the foreseeable future. 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 additional equity financing may be dilutive to stockholders, and debt financing, if available, may involve restrictive covenants and increase our cost of capital.

Table of Contents

For the nine months ended September 30, 2006, net cash used in operations was $2.6 million compared to net cash provided by operations of $6.5 million for the same period in 2005. In the 2006 period, the Company reduced accrued liabilities by $2.5 million, which were primarily related to the acquisition of Bio-logic, including $2.7 million of obligations related to change of control provisions in Bio-logic employment agreements, as well as other integration plan and acquisition-related costs. In addition accounts receivable and inventories increased by $3.2 million and $2.3 million, respectively, in the 2006 period, primarily related to the increased activities of Bio-logic.

Excluding purchases and sales of short-term investments, and approximately $56.5 million of the Company s cash used to acquire Bio-logic, DeltaMed and the Nascor assets, cash used in investing activities in the nine months ended September 30, 2006 was $2.0 million, primarily to acquire equipment, offset by proceeds from the sale of land of $2.5 million and a reduction in deposits and other assets. This compares to $816,000 of cash used in investing activities for the nine months ended September 30, 2005.

Cash provided by financing activities was $38.2 million in the nine months ended September 30, 2006, compared to $759,000 in the same period in 2005. During the 2006 period, we raised $29.3 million in a common stock offering and borrowed $10 million on a note under a senior secured credit facility with Wells Fargo Bank. Other sources of cash from financing activities were primarily from exercises of stock options pursuant to our stock option plans and employee contributions to our Employee Stock Purchase Plan in the amount of $1.1 million and $759,000 in the nine months ended September 30, 2006 and 2005, respectively. We also realized an excess tax benefit of $730,000 on the exercise of employee stock options for the nine months ended September 30, 2006 that was recorded as an increase to stockholders equity.

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 result primarily 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. In January 2006 we borrowed $10.0 million on a senior credit facility with Wells Fargo Bank, reflected as note payable in the table below. The impact that our contractual obligations and commercial commitments as of September 30, 2006 are expected to have on our liquidity and cash flow in future periods is as follows:

		Payments Due by Period			
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Unconditional purchase obligations	$ 7,664	$ 7,638	$ 26	$	$
Note payable	7,125	7,125			
Operating lease obligations	1,905	533	1,372		

Total	$ 16,694	$ 15,276	$ 1,398	$	$

Table of Contents

Unconditional purchase obligations relate primarily to purchase orders with our suppliers for materials used in our production processes. The table above does not include obligations under employment agreements for services rendered in the normal course of business.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*. On March 29, 2005, the SEC issued SAB No. 107, which provides guidance regarding the adoption of SFAS No. 123R and disclosures in Management s Discussion and Analysis.

The Company adopted SFAS No. 123R on January 2006 using the modified prospective method, whereby the Company will expense the remaining portion of the requisite service period under previously granted unvested awards outstanding as of January 1, 2006 and new share-based payment awards granted or modified after January 1, 2006. The Company expects that implementation of SFAS No. 123R will result in additional expense related to share-based compensation of approximately $1.4 million before tax in 2006. The actual expense in 2006 will depend on a number of factors, including the extent to which existing unvested awards expire pursuant to the terms of the awards, the fair value of future awards at the time of grant, and the number of share-based awards granted in 2006.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition of a cumulative effect adjustment within net income of the period of the change. SFAS 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, it does not change the transition provisions of any existing accounting pronouncements. The Company does not expect that this statement will have a material impact on our results of operations, financial position, or cash flows.

In June 2006, the FASB issued Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes.* FIN No. 48 is an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*, and must be adopted by the Company no later than January 1, 2007. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting, and disclosing in the financial statements uncertain tax positions that the Company has taken or expects to take in its tax returns. The Company is evaluating the impact of adopting FIN 48.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is evaluating the impact of adopting SFAS 157.

In September 2006, the SEC issued SAB No. 108, *Guidance re: the Use of a Cumulative Effect Adjustment to Correct Immaterial Misstatements*. Registrants are required to apply the provisions of SAB No. 108 no later than the annual financial statements for their first fiscal year ending after November 15, 2006. The application of SAB No. 108 is not expected to have a material impact on the Company s 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 ability to service our debt; our effective tax rate in 2006, the cost of share-based compensation expense under SFAS 123R, 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 expectation regarding growth in international sales, 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 in September 2004 and Deltamed in September 2006, a portion of our sales is 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 September 30, 2006. 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 September 30, 2006 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 September 30, 2006, the fair value of our portfolio would decline by an immaterial amount.

Table of Contents

All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of September 30, 2006. 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.

We invest our excess cash in short-term investments that carry relatively short maturities because our intent is to have cash resources available for potential acquisitions of additional technologies, products, or businesses, and these acquisitions could be significant.

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, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in our reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Our company s management, with the participation of our chief executive officer and our chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2006. Solely because of the material weakness in our internal control over financial reporting described in the following paragraph, our chief executive officer and chief financial officer determined that as of September 30, 2006 our disclosure controls and procedures were not effective for the purpose set forth above.

The Company identified control deficiencies relating to purchase price allocation under SFAS 141, *Business Combinations,* as it relates to accounting for deferred income taxes. These deficiencies include a lack of sufficient internal tax accounting expertise, inadequate internal staffing for tax accounting, inadequate communication with outside tax consultants that assist the Company in purchase accounting, and inadequate review of the work of outside tax consultants. The Company has determined that these matters represented a material weakness in its internal control over financial reporting as of September 30, 2006. A material weakness is a significant deficiency, as defined in Public Company Accounting Oversight Board Auditing Standard No. 2, or combination of significant deficiencies, that results in a more than remote likelihood that a material misstatement of a company s annual or interim financial statements would not be prevented or detected by company personnel in the normal course of performing their assigned functions. The Company has begun to develop a remediation plan to address these deficiencies.

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 have not been any changes in our internal control over financial reporting during the quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

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

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 financial condition superior to that which we would have achieved had we not completed them. 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, the acquisition could result in reduced earnings of Natus as compared to the earnings that would have been achieved by Natus if the acquisitions 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. Bio-logic s primary offices are located in Mundelein, Illinois, Deltamed s operations are in France and Germany, and Olympic Medical s operations are in Seattle, Washington. The geographical distance between our various facilities may further adversely affect our ability to manage these operations. If we fail to manage these disparate operations effectively, our results of operations could be harmed, employee morale could decline, key employees could leave, and customers could cancel existing orders or choose not to place new ones. In addition, we may not achieve the synergies or other benefits of the acquisition that we anticipate. We may encounter the following difficulties, costs and delays involved in managing these operations:

- 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;
- The loss of key employees;
- Challenges encountered in managing larger, more geographically dispersed operations;
- Diversion of the attention of management from other ongoing business concerns; and
- Potential impairment charges incurred to write down the carrying amount of intangible assets generated as a result of the acquisition.

Our acquisitions have included in-process research and development assets (IPR&D assets) for which we have assigned significant value; 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 for which we have assigned significant value. 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 impacted.

We acquired Olympic Medical in October 2006, including their Cool-Cap product, which is in the final stage of an FDA Premarket Approval (PMA) process. If cleared by the FDA, this product will likely be classified as a class III medical device

Olympic Medical is in the final stage of an FDA PMA process for a product called the Cool-Cap. This is a product that has been under development for more than 8 years and is designed to mitigate the effects of

Table of Contents

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 2003 and 2004, and we may incur net losses in the future. As of September 30, 2006, we had an accumulated deficit of approximately $34.0 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
- Marked 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:

- Continue to invest in research and development to enhance our hearing-screening and phototherapy product lines, the technologies we acquired from Bio-logic, and other products and technologies;
- Develop additional applications for our current technology;
- Increase our marketing and selling activities, particularly outside the U.S.;
- 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.

Our operations may be restricted by the terms of our debt, which could adversely affect us

We have entered into a credit facility with a commercial lending institution and in the future may enter into new credit facilities. These credit facilities contain covenants that could adversely affect us by limiting our ability to plan for or react to market conditions or to meet our capital

needs. These covenants may, among other things, restrict our ability to:

Incur more debt;

Create liens;

Pay dividends and make distributions or repurchase stock;

Table of Contents

Make large capital expenditures; and

Merge, consolidate, or make other changes to our corporate structure, or transfer or sell assets.

In addition, our credit agreement requires us to maintain certain financial ratios and meet other financial covenants. Our failure to comply with these ratios or covenants would cause a default that, if not cured or waived, could result in our being required to repay the borrowing under our credit facility before its due date. If we are unable to make this repayment or otherwise refinance the borrowing, the lender under our credit agreement could foreclose on our assets. If we refinance the borrowing on less favorable terms, our results of operations and financial condition could be adversely impacted by increased costs and rates. In addition, our failure to maintain covenants related to our credit agreement could have an impact on our other contractual arrangements that require us to maintain third-party credit-related covenants.

We may be unable to service our debt or maintain sufficient liquidity and working capital

Our ability to make required payments on or to refinance our obligations with respect to our debt will depend on our financial and operating performance. We cannot assure you that our business will generate sufficient cash flow from operations or that future borrowings will be available to us to enable us to service our debt or to fund our other liquidity and working capital needs. If we are unable to meet our debt obligations or fund our other liquidity and working capital needs, we may need to restructure or refinance all or a portion of our debt or sell certain of our assets. We cannot assure you that we would be able to restructure or refinance any of our debt on commercially reasonable terms, if at all, which could cause us to default on our debt obligations and impair our liquidity. Any refinancing of our debt could be at higher interest rates and may require us to comply with less favorable covenants, which could further restrict our business operations.

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.

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 strength relates to the functionality and reliability of our products. 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, to maintain or improve our position.

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

Table of Contents

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 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.

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;
- 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
- Rescission of laws requiring universal newborn hearing screening and metabolic screening.

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 effect on the demand for our products.

Table of Contents

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

The domestic market for our newborn hearing screening products is mature and we plan to expand our international sales and marketing efforts to increase sales of our products in foreign countries. We have only begun over the past five years to significantly develop 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 produces;
- 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;
- 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 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 revenues may not grow

We estimate that approximately 90% to 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 varies from several months to several years. The widespread adoption of these 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 screening as well as the use of our products to perform the screening and monitoring. Our revenues may not grow if governments do not require universal newborn 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

Table of Contents

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. We have terminated our relationship with certain distributors in the past. To date, we have not been required to make any material termination payments under local laws. Any required payments would adversely affect our operating results.

In order to accurately recognize revenue on long-term development and implementation contracts associated with our Neometrics newborn screening data management systems, we must be able to accurately estimate the total cost of completing a project. In arriving at these estimates, we must make assumptions about future costs that may prove to be inaccurate

We recognize revenue from our Neometrics newborn screening data management systems, which are generally highly configurable, on the percentage of completion basis over the development and implementation period of the associated installation. The development and implementation period typically ranges from six to nine months. In order to determine percentage of completion, we must be able to accurately estimate the total cost of the development and implementation process. If our estimates of the future costs to be incurred are understated, our future gross profit would be negatively impacted, and the impact could be material to our results of operations.

Our operating results may suffer because of 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 unpredictable 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 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 infant 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, it is unlikely that our products will ever achieve significant market acceptance. Acceptance of our products in international markets will depend upon the availability of adequate reimbursement or funding within prevailing health care payment systems. Reimbursement, funding and health care payment systems vary significantly by country. We may not obtain approvals for reimbursement in a timely manner or at all.

Table of Contents

Adverse changes in reimbursement policies in general could harm our business. We are unable to predict changes in the reimbursement methods used by third-party health care payors, particularly those in countries and regions outside the U.S. For example, some payors are moving toward a managed care system in which providers contract to provide comprehensive health care for a fixed cost per person. In a managed care system the cost of our products may not be incorporated into the overall payment for childbirth and newborn care or there may not be adequate reimbursement for our products separate from reimbursement for the procedure. Unless the cost of screening or treatment is reimbursed as a standard component of newborn care, universal screening is unlikely to occur and the number of infants likely to be screened with our products will be substantially reduced.

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.

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

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 one GPO, Novation LLC, accounted for approximately 15%, 20%, and 22%, of our total revenue in the twelve months ended December 31, 2005, 2004 and 2003, respectively. Sales to members of GPOs accounted for approximately 28%, 46%, and 39% of our total revenue during the 12 months ended December 31, 2005, 2004, and 2003, 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.

If material weaknesses in the adequacy of our internal control over financial reporting are identified and reported as a result of the assessment required by Section 404 of the Sarbanes-Oxley Act of 2002, investors could lose confidence in the reliability of our financial statements

As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission adopted rules requiring public companies to include a report of management on the company s internal control over financial reporting in their annual reports on Form 10-K, and the first such report of our management is contained in our Annual Report on Form 10-K for the year ended December 31, 2005.

Table of Contents

While we have expended significant resources in developing the necessary documentation and testing procedures required by Section 404, there is a risk that in the future we will not comply with all of the requirements imposed by Section 404. In this regard, we have reported that a material weakness existed in our internal control over financial reporting as of September 30, 2006. If we do not maintain an effectively designed and operating system of internal control, we may be unable to comply with the requirements of Section 404 in the future. This could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements.

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 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 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 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 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.

Our business would be harmed if the FDA determines that we have failed to 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;

Table of Contents

Recall or seizure of our products;

Issuance of public notices or warnings;

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

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

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

Criminal prosecution.

We expect to introduce a new product that will potentially expose us to greater products liability exposure and FDA regulation

Olympic Medical is in the final stage of the FDA approval process for a product called the Cool-Cap, a product designed to lower the cerebral temperature of children born with a particular medical condition. This product is a minimally invasive medical device, and as such we may be subject to an increased product liability risk relative to our other, 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 development of the product could be delayed, or that sales of the product could be interrupted, due to the approval and oversight processes of the FDA and other regulatory bodies.

If we fail to obtain and maintain necessary foreign regulatory approvals in order to market and sell our products outside of the U.S., we may not be able to sell our products in other countries

Our products that are regulated domestically by the FDA are also regulated outside the U.S. by foreign governmental agencies similar to the FDA and are subject to regulatory requirements similar to those of the FDA. The time and cost required to obtain market authorization from other countries and the requirements for licensing a product in another country may differ significantly from FDA requirements. We may not be able to obtain these approvals without incurring significant expenses or at all, and we may not be able to maintain these approvals once they have been obtained.

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 can 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.

Governmental, environmental, health and safety regulations could adversely affect our operations

Our operations are subject to complex and stringent environmental, health, safety and other governmental laws and regulations. Existing laws and regulations may be revised or reinterpreted, or new laws and regulations may become applicable to us, that may have a negative effect on our business and results of operations.

We may not be successful in integrating the businesses that we acquire, or such businesses may not be accretive to earnings or perform as projected

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; we acquired Fischer-Zoth in 2004; and we acquired Bio-logic in early 2006. We expect to make additional acquisitions of products, technology assets or businesses in the future as part of our efforts to increase revenue and expand our product offerings. In addition to direct costs, acquisitions pose a number of risks, including:

Inability to effectively integrate acquired products into our business;

Loss of key personnel of the acquired company;

Failure to realize expected synergies;

Failure of acquired products to achieve projected sales;

Table of Contents

Failure to maintain customers of, or other relationships existing with respect to, the acquired business;

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

Assumption of unknown liabilities;

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

Write-off of goodwill and intangible assets related to such acquisitions.

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

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

At December 31, 2005, we had significant intangible assets, including goodwill and other acquired intangible assets. As a result of our acquisitions in 2006, these assets have increased significantly. The determination of related estimated useful lives and whether these assets are impaired involves significant judgments. Our ability to accurately predict future cash flows related to these intangible assets might be hindered by events over which we have no control. Due to the highly competitive nature of the medical device industry, new technologies could impair the value of our intangible assets if they create market conditions that adversely affect the competitiveness of our products. Any future determination that these assets are carried at greater than their fair value could result in additional charges, which could significantly impact our operating results.

Table of Contents

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

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

Our operating results would suffer if we were subject to a protracted infringement claim or a significant damage award

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 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 overlaps. Third parties such as individuals, educational institutions or other medical device companies may claim that we infringe their intellectual property rights. Any claims, with or without merit, could have any of the following negative consequences:

Result in costly litigation and damage awards;

Divert our management s attention and resources;

Cause product shipment delays or suspensions; or

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

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

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 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 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

Table of Contents

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.

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 pediatric audiology, neonatal jaundice management, and neonatal metabolic screening. We may be unable to attract and retain personnel necessary for the development of our business.

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

U.S. income tax law imposes limitations on the ability of corporations to use net operating loss carryforwards if the corporation experiences a more than 50% change in ownership during any three-year period. We may take actions, such as the issuance of additional stock, which would cause an ownership change to occur. Accordingly, we may be limited to the amount of our tax loss carryforwards we can use in any given year, so even if we have substantial net income, we may not be able to use our net operating loss carryforwards before they expire. In addition, the net operating loss 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.

During the second quarter of 2006 we completed a formal study to determine whether and the extent to which any of our tax loss and credit carryforwards will be limited. Based on the results of that study, we determined that approximately $650,000 of federal tax loss carryforwards existing as of December 31, 2005 will be limited.

As of December 31, 2005, we had total federal and state net operating loss carryforwards of approximately $19.7 million and $7.0 million, respectively, available to reduce future taxable income. These net operating loss carryforwards, if not utilized to offset taxable income in future periods, will expire in various amounts beginning in 2008 through 2025 for state and/or federal income tax purposes. If we have net tax losses in the future, we may not be able to utilize some or all of our net operating loss carryforwards before they expire.

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.

Our stockholder rights plan and anti-takeover provisions in our charter documents and under Delaware law may make it more difficult to acquire a large portion of our securities, to initiate a tender offer or a proxy contest, or to acquire us, even though such events may be beneficial to our stockholders

We maintain a stockholder rights plan that is designed to deter unsolicited takeover activity with respect to our Company. In addition, provisions of our restated certificate of incorporation, bylaws, and Delaware law, including provisions providing for a staggered board of directors, could make it more difficult for a third party to remove our management. Further, these provisions may make it more difficult to acquire a large portion of our securities to initiate a tender offer or a proxy contest or acquire us, even if doing so would benefit our stockholders.

Table of Contents

ITEM 5. Other Information

As more fully described in Note 15 - *Subsequent Events*, of Item 1, *Financial Statements*, in this Quarterly Report on Form 10-Q, on November 8, 2006 the Company entered into a $15 million Revolving Credit Facility with Wells Fargo Bank, which disclosure is incorporated herein by reference. The Revolving Credit Facility agreements are filed as Exhibits 10.1, 10.2, and 10.3 to this Quarterly Report.

ITEM 6. Exhibits

Exhibit No.	Exhibit
10.1	Credit Agreement dated as of November 8, 2006 by and between the Company and Wells Fargo Bank, National Association
10.2	Revolving Line of Credit Note dated November 8, 2006 in the principal amount of $15,000,000 in favor of Wells Fargo Bank National Association
10.3	Security Agreement dated as of November 8, 2006 by the Company in favor of Wells Fargo Bank National Association
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents

SIGNATURES

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

NATUS MEDICAL INCORPORATED

Dated: November 9, 2006 By: /s/ JAMES B. HAWKINS
James B. Hawkins

President and Chief Executive Officer

(Principal Executive Officer)

Dated: November 9, 2006 By: /s/ STEVEN J. MURPHY
Steven J. Murphy,

Vice President Finance and

Chief Financial Officer

(Principal Financial and

Accounting Officer)

Table of Contents

NATUS MEDICAL INCORPORATED

INDEX TO EXHIBITS

Exhibit No.	Exhibit
10.1	Credit Agreement dated as of November 8, 2006 by and between the Company and Wells Fargo Bank, National Association
10.2	Revolving Line of Credit Note dated November 8, 2006 in the principal amount of $15,000,000 in favor of Wells Fargo Bank National Association
10.3	Security Agreement dated as of November 8, 2006 by the Company in favor of Wells Fargo Bank National Association
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