

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

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**FORM 10-K**

Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2002

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number: 000-33001

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**NATUS MEDICAL INCORPORATED**

(Exact name of Registrant as specified in its charter)

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

**77-0154833**  
(I.R.S. Employer  
Identification Number)

**1501 Industrial Road, San Carlos, California 94070**  
(Address of principal executive offices, including zip code)

**(650) 802-0400**  
(Registrant's Telephone Number, including area code)

**Securities Registered Pursuant to Section 12(b) of the Act: None**

**Securities Registered Pursuant to Section 12(g) of the Act: Common Stock, \$0.001 par value**

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

As of June 30, 2002, the last business day of Registrant's most recently completed second fiscal quarter there were 16,079,894 shares of Registrant's common stock outstanding and the aggregate market value of such shares held by non-affiliates of Registrant (based upon the closing sale price of such shares on the Nasdaq National Market on June 28, 2002) was approximately \$48,429,496. Shares of Registrant's common stock held by each executive officer and director and by each entity that owns 5% or more of Registrant's outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

On March 19, 2003, 16,337,569 shares of Registrant's common stock, \$0.001 par value, were issued and outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

The Registrant has incorporated by reference into Part III of this Form 10-K portions of its Proxy Statement for the 2003 Annual Meeting of Stockholders.

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**ANNUAL REPORT ON FORM 10-K**  
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**PART I**

**ITEM 1. Business**

*This Annual Report on Form 10-K 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 1 include, but are not limited to, statements regarding the following: the effectiveness and advantages of our products, status, marketing and support of our CO-Stat® End-Tidal Breath Analyzer products and clinical studies related to the CO-Stat product, as a platform technology, the factors for acceptance of screening, incidence of newborn jaundice and hearing loss, bidding and selection processes, future results of clinical trials, our introduction of new disposable products for hearing screening, our marketing, technology enhancement and product development strategies, including additional applications for our CO-Stat product, our intention to enter into agreements with group purchasing organizations, future third party reimbursement for our products, factors relating to demand for and economic advantages of our products, the effect of Medicare reform legislation, implementation of newborn hearing screening and jaundice management, future manufacturing quality and cost, hiring of additional personnel, quality of materials from suppliers, future availability of components and materials and related production delays, the proprietary nature of our products, including infringement and enforcement of proprietary rights, future competition and our ability to compete, our compliance with regulatory requirements and laws, sufficiency of our facilities, resolution and effect of legal proceedings and our dividend policy.*

*You are cautioned not to place undue reliance on forward-looking statements. Forward-looking statements are not guarantees of future performance. The forward-looking statements are subject to substantial risks and uncertainties that could cause our future business, financial condition, or 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 “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and elsewhere in, or incorporated by reference into, this report. 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. These forward-looking statements are made in reliance upon the safe harbor provision of The Private Securities Litigation Reform Act of 1995.*

**Overview**

We are primarily focused on developing, manufacturing and marketing screening products for the identification, monitoring and treatment of common medical disorders that may occur during the time from conception to a baby’s first birthday. This period is critical to every child’s development. By allowing for early detection and treatment, we believe our products can improve clinical outcomes, may help reduce costs and may minimize the duration of treatment, unnecessary retesting or hospital readmission. We design our screening products to deliver accurate results in a rapid and reliable manner. In addition, our products address the policies and guidelines for standard medical practices adopted by the American Academy of Pediatrics.

We have three product lines the Food and Drug Administration, or FDA, has cleared for marketing: the ALGO® Newborn Hearing Screener, a product line for hearing screening, the CO-Stat analyzer, a product line for the detection of hemolysis that can be used for the management of newborn jaundice, and the neoBLUE™ LED Phototherapy device, a product for the treatment of newborn jaundice. The ALGO screener and CO-Stat analyzer product lines are comprised of hardware units and single use disposable components.

Our ALGO screening products use our clinically validated AABR® technology to enable simple, noninvasive and accurate screening for hearing impairment in newborns. The ALGO screener delivers sound

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stimuli to a newborn's ears and analyzes the resulting brain wave responses to produce a "Pass" or "Refer" result. The procedure can be performed within hours after birth. In addition, our ALGO screening products meet the American Academy of Pediatrics' guidelines without requiring a trained clinician to conduct the screening or interpret the results. We currently sell our ALGO screening products in over 20 countries worldwide, including the United States, Europe and Asia.

Our CO-Stat analyzer products enable physicians, within hours after birth, to assess the likelihood that serious newborn jaundice will not occur, thereby allowing physicians to keep newborns with higher risk of developing serious newborn jaundice in the hospital or under observation and to discharge those newborns with a lower risk. In the majority of cases, serious jaundice is the result of an abnormally high rate of hemolysis. Our CO-Stat analyzers accurately and non-invasively measure the rate of hemolysis by detecting the level of carbon monoxide in exhaled breath. The CO-Stat analyzer can be used on infants, children and adults and therefore may have applications, besides newborn jaundice, where assessing hemolysis is important. We are currently investigating the use of the CO-Stat analyzer for monitoring and assessing other clinical conditions, including pregnancy induced hypertension. We began commercially marketing our CO-Stat products in January 2001. To date, we have not achieved the level of sales of our CO-Stat products that we had anticipated, and in the third quarter of 2002, we began to reduce marketing and sales expenses associated with our CO-Stat products in order to more accurately reflect our expectations regarding near term revenues. We continue to believe that our CO-Stat technology represents a platform technology and are moving forward with clinical research for additional applications, most notably its use for the detection of medical conditions leading to pre-term delivery. While we intend to continue to support the user base now in place, we are currently evaluating the viability of marketing our CO-Stat products in the newborn jaundice market. We expect to continue to support clinical research in the field of newborn jaundice management and for additional clinical applications other than neonatal jaundice.

In October of 2002 we introduced our neoBLUE phototherapy device, for use in the treatment of newborn jaundice. Phototherapy is the standard of care treatment for newborn jaundice and consists of exposing the skin of a patient to a light source to accelerate the elimination of bilirubin from the body. Our neoBLUE phototherapy device is based on Light Emitting Diode technology and generates a narrow spectrum of light that is effective in converting bilirubin to a form that is easily excreted by the body. Compared to other available light sources, we believe the neoBLUE phototherapy device has the advantages of emitting less ultraviolet and infrared light, sustaining longer bulb life and generating less heat.

We were incorporated in California in May 1987 and reincorporated in the State of Delaware in August 2000. Our principal executive offices are located at 1501 Industrial Road, San Carlos, California 94070 and our telephone number at that location is (650) 802-0400. Our website is [www.natus.com](http://www.natus.com). The contents of our website are not incorporated by reference in this Annual Report on Form 10-K. We make our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, available on our website as soon as reasonably practicable after we electronically file them with the Securities and Exchange Commission.

## **Clinical Background**

### ***Hearing Impairment***

#### *Overview*

Approximately 4.0 million babies are born each year in the United States, and hearing impairment affects up to five per every 1,000 of those newborns. Until the introduction of universal newborn hearing screening programs, screening was generally performed only on those newborns who had risk factors for hearing impairment, including a family history of hearing impairment, infection prior to birth, low birth weight, skull or facial anomalies or bacterial meningitis. However, screening only those newborns with risk factors for hearing impairment overlooks approximately half of newborns with some level of hearing impairment.

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Early identification of hearing impairment and early intervention has been shown to improve language development significantly. Babies identified at birth as deaf or hearing impaired, who begin immediate therapy, can learn and progress at a rate comparable to children with normal hearing, regardless of the severity of hearing loss. However, undetected hearing impairment often results in the failure to learn, process spoken language and speak. A 1997 study conducted at the University of Colorado, Boulder evaluated the impact of hearing impairment on language and speech. All of the children evaluated in the study were born with a hearing impairment but differed by the age at which the hearing impairment was detected. The study concluded that those children whose hearing loss was detected and who received treatment early had significantly better language skills and vocabularies than those children whose hearing loss was detected later.

### *Newborn Hearing Screening*

Newborn hearing screening has been performed in the United States since 1964 but has been generally limited to babies with risk factors for hearing impairment. We believe the lack of accurate, low cost screening devices and the subjective nature of other currently used tests, has limited the willingness of governments and physicians to adopt hearing screening as a standard of care for all newborns. In recent years, the clinical evidence in support of early detection for hearing impairment combined with the introduction of new screening technology has increased support for universal newborn hearing screening programs. In 1993, the National Institutes of Health and, in 1994, the Joint Committee on Infant Hearing endorsed universal newborn hearing screening. The combined clinical benefit and cost savings encouraged additional highly populated states to adopt mandates for universal newborn hearing screening as early as 1997.

In the United States, 37 states and the District of Columbia have universal newborn hearing screening mandates in place. The majority of the mandates currently allow for implementation over a two to three-year period. An additional 5 states have voluntary programs in place. We define states that voluntarily comply to be states without mandated universal newborn screening but in which we estimate at least 50% of newborns are screened. In some states, the state health departments may purchase and distribute hearing screening equipment. We estimate that approximately 98% of births in the United States in 2002 occurred in states that currently have mandates or voluntary programs in place. Due in part to the implementation periods in states with mandates, only 69% of newborns born in the United States were screened for hearing loss as of May 2002.

Recognizing that only 50% of children with hearing impairment have a risk factor, the American Academy of Pediatrics stated that selectively screening babies at high risk was inadequate, and it has recommended that all babies be screened for hearing impairment. In 1999, the American Academy of Pediatrics' Task Force on Newborn and Infant Hearing published guidelines for universal newborn hearing screening programs. These guidelines are intended to establish the standard of care and provide that:

- at least 95% of all newborns should be screened;
- the screening method used must have the ability to detect all infants with a hearing impairment of at least 35 dBnHL, decibels normal hearing level, a common audiological unit to measure hearing, in the better ear;
- the screening method should not refer more than 4% of all children tested for further evaluation;
- no more than 3% of children with normal hearing who are screened should receive results that indicate they have a hearing impairment, a screening error known as a false positive result; and
- no child whose hearing is impaired should receive a normal result, a screening error known as a false negative result.

Because positive results are referred to an audiologist or physician for additional testing and evaluation, limiting the number of further evaluations stemming from false positive results reduces the cost of a newborn screening program. In addition, false positive results can cause unnecessary emotional trauma for parents.

In order to meet the standard of care guidelines set forth by the American Academy of Pediatrics, a hearing screening program needs to employ a screening method that focuses on two parameters: sensitivity and

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specificity. Sensitivity is the capacity to detect the disease or disorder in those infants with the disease or disorder. A sensitivity of 100% indicates that no newborns with a hearing impairment receive results indicating the absence of a hearing impairment. Specificity is the capacity to detect those infants without the disease or disorder. A specificity of 100% indicates that no newborn that actually has normal hearing receive results suggesting the presence of a hearing impairment.

### *Screening Techniques*

Traditional methods of screening for hearing impairment include subjective behavioral tests and more expensive objective diagnostic processes. We believe widespread acceptance of screening newborns for hearing impairment requires a relatively inexpensive screening method that produces sensitive, specific and reliable results. The two traditional technologies used to screen newborns for hearing impairment are auditory brainstem response and otoacoustic emissions.

*Auditory brainstem response.* Auditory brainstem response technology is the most accurate and comprehensive method for characterizing hearing impairment in adults and infants. Auditory brainstem response technology uses sensors placed on the head to measure the response of the brain and auditory nerves to sounds delivered through earphones. Hearing impairment is evaluated by monitoring the brain's response to varying the frequency and volume of sounds. Trained clinicians must operate the auditory brainstem response screening equipment, and the screening results must be interpreted by an audiologist or trained physician. Auditory brainstem response technology is primarily used to assess the degree of hearing impairment in adults and children and is not widely used for newborn screening due to the high cost, lengthy procedure time and unavailability of trained specialists in many neonatal nurseries. Enhanced auditory brainstem response devices automate portions of the screening process, such as providing pre-determined parameter menus, to make these devices easier to use or the results easier to interpret. The user has discretion to set some or all of the screening parameters and, as a result, many enhanced auditory brainstem response devices require substantial user training. A physician, audiologist or other trained specialist may also be required to review a pass or refer result because these products permit discretion in setting screening parameters.

*Otoacoustic emissions.* Otoacoustic emissions screening is a method of detecting hearing impairment in adults and children. Otoacoustic emissions are sounds created by the active biomechanical processes within the sensory cells of normal ears. Since otoacoustic emissions are present in normal ears, an absence of otoacoustic emissions is a sign of irregular function of these sensory cells, which could result in hearing impairment. Otoacoustic emissions screening uses a probe placed in the ear to deliver auditory stimulus and measures the response of the sensory cells with a sensitive microphone. Otoacoustic emissions screening does not evaluate the function of the entire hearing pathway because it does not assess the neural pathways. Therefore, otoacoustic emissions technology can fail to detect hearing disorders affecting the neural pathways, such as auditory neuropathy. An individual otoacoustic emissions screening is relatively inexpensive. However, a number of clinical studies have documented that otoacoustic emissions screening can result in an excessive number of false positive results, which require retesting. For example, a study conducted by researchers at the University of Michigan, reported in the December 2000 American Journal of Audiology, concluded that otoacoustic emissions screening of newborns had an 11% to 35% false referral rate, far in excess of the recommendations of the American Academy of Pediatrics. For otoacoustic emissions screening, these false positive results occur because in the first days after birth newborns commonly have fluid in their ears from the birth process, which can impair the ability to accurately assess hearing impairment with one screening.

*Natus AABR Technology.* In order to address the limitations of other screening techniques, our ALGO screening product family utilizes proprietary Natus AABR Technology to provide accurate and non-invasive hearing screening for newborns. The ALGO screener, like traditional and enhanced auditory brainstem response devices, utilizes a number of sensors placed on the newborn's head to measure the response of the brain and auditory nerves to sounds delivered through specially designed earphones. However, unlike traditional auditory brainstem response devices and most enhanced auditory brainstem response devices, our ALGO screener does

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not require a trained clinician to conduct the screening or an audiologist or physician to interpret the results. The ALGO screener uses our proprietary algorithms to perform the screening and draw a conclusion as to whether a baby needs to be referred to an audiologist for further evaluation.

### ***Hemolysis and Jaundice***

#### *Overview*

Babies are generally born with a quantity of red blood cells necessary for fetal life but in excess of their needs as newborns. These excess red blood cells are normally broken down by the body in a process known as hemolysis. The two products of hemolysis are a yellow pigment called bilirubin and a proportional amount of carbon monoxide. Abnormal rates of hemolysis cause abnormal levels of carbon monoxide and bilirubin. An abnormal rate of hemolysis may also be an indicator of a number of other disorders including anemia, infection and some genetic disorders.

High amounts of bilirubin in the body can cause a yellowing of the skin and eyes called jaundice. The high level of bilirubin can result either from too much bilirubin being produced by hemolysis or from the body's failure to excrete the bilirubin. Extremely high levels of bilirubin, or hyperbilirubinemia, are toxic and may cause irreversible brain damage and potentially result in death.

The American Academy of Pediatrics Committee on Fetus and Newborns estimates that each year 60% of the four million newborns in the United States become jaundiced. According to the Journal of the American Medical Association, neonatal jaundice is the single largest cause for hospital readmission of newborns in the United States and accounts for 50% of readmissions. A study of 391 readmitted newborns at nine New York hospitals, reported in the Journal of Perinatal Medicine in 1999, found that of the readmissions, 65% in the first week of life and 39% overall were due to hyperbilirubinemia. Hyperbilirubinemia occurs in approximately 6% to 10% of newborns. Because of the serious consequences of hyperbilirubinemia, the American Academy of Pediatrics recommends that all newborns be closely monitored for jaundice and has called for the physician to determine the presence or absence of an abnormal rate of hemolysis to establish the appropriate treatment for the newborn. In a 1996 study we commissioned, the Churchill Madison Group estimated that annual inpatient hospital charges for neonatal jaundice were approximately \$1.3 billion. By identifying those infants with high rates of hemolysis before they are discharged, fewer newborns would need to be readmitted and treatment could begin earlier.

Depending on its cause, jaundice can be treated by helping the newborn to excrete the bilirubin or to reduce bilirubin production. In the early stages, jaundice can be treated with blue light, known as phototherapy, hydration and frequent feedings. Dangerous or toxic levels of bilirubin are treated by blood exchange transfusion, which is a high-risk procedure for newborns. If a physician can assess the amount of bilirubin being produced and excreted by a newborn, the physician can better tailor the newborn's treatment appropriately, reduce the number of invasive tests required to monitor the levels of bilirubin, and determine the appropriate term of hospitalization. In full term infants, the level of bilirubin in their blood is highest at approximately 72 hours after birth. However, infants are being discharged from the hospital before 72 hours after birth due to cost considerations. The National Hospital Discharge Survey estimated that for 1998 approximately 73% of all newborns in the United States were discharged before 72 hours after birth. In addition, it estimated that 24% of all newborns in the United States were discharged before 48 hours after birth. Thus, some infants may develop a potentially dangerous elevation in bilirubin levels after discharge. An article in the February 22, 2001 New England Journal of Medicine reported that early discharge and a reluctance to treat jaundice aggressively has led to an increase in the reports of brain damage caused by severe hyperbilirubinemia. In April 2001, the Joint Commission on Accreditation of Healthcare Organizations, a healthcare accrediting body in the United States, issued a Sentinel Event Alert emphasizing the need for hospitals to review current policies and procedures relating to hyperbilirubinemia in newborns and suggesting steps to prevent its occurrence in the future. In June 2001, the Center for Disease Control's Morbidity and Mortality Weekly Report published four case studies of



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kernicterus. Kernicterus is a completely preventable condition that often results in permanent neurological damage brought on by the known toxic effects of excessively high levels of bilirubin.

The standard of care treatment for severe jaundice is phototherapy. During phototherapy the patient is exposed to a light source which converts the bilirubin to a form that is more easily excreted by the body. The optimal color of light to cause this conversion is in the blue range at a wavelength of approximately 450 nanometers. Most phototherapy lights use either fluorescent or halogen light sources. While these other light sources produce light that is effective in converting bilirubin they also produce light outside the optimal color range that may include harmful ultraviolet and/or infrared light. Ultraviolet light can cause skin damage similar to that which results from overexposure to the sun. Fluorescent and in particular, halogen light sources generate heat energy, which can result in dehydration.

Our neoBLUE phototherapy device is a phototherapy light that uses Light Emitting Diode or LED, technology to generate a narrow spectrum of light that, we believe, is optimal for the conversion of bilirubin, and produces a negligible amount of both ultraviolet and infrared light. These LEDs emit a high-intensity band of blue light, which is clinically proven to be most effective in the breakdown of bilirubin. Because the neoBLUE phototherapy device emits significantly less ultraviolet light and heat than conventional phototherapy devices, it may reduce the risk of skin damage and dehydration for infants undergoing treatment. Also, the utilization of this light may result in a more rapid reduction of bilirubin levels in newborns and potentially reduce the treatment time associated with phototherapy.

Our CO-Stat analyzer measures a baby's exhaled carbon monoxide to indicate the rate at which bilirubin is being produced and may assist the clinician in determining the cause of neonatal jaundice. If the rate of red blood cell break-down, or hemolysis, is normal or low, the baby is not producing excessive levels of bilirubin and may be a candidate for early discharge. If the rate of hemolysis is high, this may be an indication of potentially serious disorders and increases the likelihood of neonatal jaundice. If the baby is producing high levels of bilirubin and does not develop jaundice in the first few days, the baby is presumed to be eliminating bilirubin efficiently but the underlying cause of the hemolysis may require treatment. If the baby develops jaundice, monitoring the rate of hemolysis with our CO-Stat analyzer product can help determine if jaundice is caused by excessive bilirubin production or inadequate bilirubin excretion.

### *Screening Techniques*

Current means of identifying newborns with high or increasing bilirubin levels include visual observation, blood tests to assess bilirubin levels, antibody tests and the use of devices that measure the amount of yellow color in the skin.

*Total Serum Bilirubin Test.* The total serum bilirubin test is a blood test that measures the total amount of bilirubin in the blood but does not differentiate between increased bilirubin production or decreased bilirubin elimination. As a result, the test does not give the clinician the information necessary to determine the cause of the increased bilirubin level and the most appropriate treatment for the newborn.

*The Coombs Test.* The Coombs test is another frequently administered blood test that determines whether an antibody is affixed to the baby's red blood cells. Antibodies on red blood cells are often associated with a high rate of hemolysis in newborns. However, other conditions may result in the presence of the antibodies, and the antibodies' absence does not rule out a high rate of hemolysis or excessive levels of bilirubin. In addition, the Coombs test does not measure the rate of hemolysis. Even given these limitations, the Coombs test remains the most frequently used indicator of high levels of hemolysis and, in developed countries, it is currently administered to 50% to 60% of newborns prior to hospital discharge.



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*Skin Color Assessment.* In recent years, a number of devices have been introduced to monitor changes in bilirubin levels by measuring the amount of yellow color in the skin. They are convenient because they do not require a blood sample. However, the reliability of tests performed with these devices is complicated by the variations in skin pigmentation, the baby's age and birth weight. As with the blood sampling methods, measuring the amount of yellow color in the skin does not identify the factors contributing to the elevated bilirubin level.

*CO-Stat End-Tidal Breath Analyzer.* In order to address the limitations of other means of analyzing hemolysis, our CO-Stat analyzer measures a baby's exhaled carbon monoxide to assess the rate of hemolysis accurately. Hemolysis produces bilirubin and carbon monoxide in equal amounts, so that the rate of bilirubin production can be estimated by an analysis of the carbon monoxide in a newborn's exhaled breath, while correcting for the carbon monoxide existing in the screening environment. Our CO-Stat analyzer can be used by a clinician with minimal training to conduct hemolysis testing. The physician can use the results of our CO-Stat analyzer to assess the rate of hemolysis. An assessment of how rapidly a newborn is producing bilirubin can help to identify those newborns who are more likely to develop jaundice after discharge from the hospital. If a newborn develops jaundice, knowing how rapidly a newborn is producing bilirubin can also help physicians determine whether jaundice stems from excessive bilirubin production or failure to excrete bilirubin adequately, which may guide further evaluation and patient management.

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**Our Products**

Our products include the ALGO screener, MiniMuffs® Neonatal Noise Attenuators, CO-Stat analyzer and neoBLUE™ phototherapy device product lines. The ALGO screeners and related single use disposable supplies are designed to objectively test newborn hearing shortly after birth and prior to discharge. The CO-Stat analyzer and disposable supplies are designed to provide a measure of the rate of hemolysis in order to assess the cause of elevation in the level of bilirubin. MiniMuffs, single use protective ear covers, reduce the level of noise to which newborns are exposed. The neoBLUE phototherapy device is a phototherapy light, incorporating a blue LED light source for the treatment of newborn jaundice. The following table provides a list of our current products.

<i>Hearing Products</i>	<i>Description</i>	<i>Approved Markets</i>
ALGO 3™ screener	Newborn hearing screening station	United States, Europe, Australia, New Zealand and Canada
ALGO 2e Color™ screener	Newborn hearing screening station	United States, Europe, Japan, Australia, New Zealand and Canada
ALGO® Portable screener	Portable newborn hearing screener	United States, Europe, Japan, Australia, New Zealand and Canada
ALGO Disposable Kit(s): EarCouplers® Ear Phones or FlexiCouplers® Disposable Ear Phones Jelly Button® or Jelly Tab® Sensors	Single use disposables including ear phones and electrodes	United States, Europe, Japan, Australia, New Zealand and Canada
MiniMuffs®	Single use disposable ear cover to reduce noise	United States, Europe (no approval required), Australia and New Zealand
<i>Jaundice/Hemolysis Products</i>		
CO-Stat™ analyzer	Newborn screening station to analyze the rate of hemolysis	United States, Europe and Canada
CO-Stat Disposable Kit: Sample Tubing and Filters	Single use disposables including tubing and filter unit for patient sampling	United States, Europe and Canada
neoBLUE™ phototherapy device	Narrow band phototherapy device for treatment of jaundice	United States and Europe

***Hearing Products***

*ALGO Newborn Hearing Screening Product Family*

Our ALGO screening product family utilizes automated auditory brainstem response technology to provide accurate and non-invasive hearing screening for newborns. The ALGO screener delivers thousands of soft clicking sounds to the newborn’s ears through sound cables and disposable ear phones connected to the instrument. Each click elicits a series of identifiable brain waves, which are detected by disposable sensors placed on the baby’s forehead, shoulder, and at the nape of the neck. This methodology will detect hearing loss at 35 dBnHL or higher. The ALGO screener automatically extracts the infant’s brainwave responses from the background noise and noise caused by muscle activity. These brainwave responses are then compared to a template based on the brainwave responses of infants with normal hearing. The ALGO screener displays a “Pass” message when it collects sufficient data to establish that the baby’s responses are consistent with the responses of

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a normal hearing child to a 99.96% level of statistical confidence. If a determination cannot be reached after 15,000 clicks, the ALGO screener displays a “Refer” message, indicating that the infant should be referred for more detailed evaluation, including repeating the hearing screening by an audiologist or other specialist. Once the results of the second hearing screening are available, if the results still “Refer” the specialist will conduct additional tests to determine the type and severity of the hearing impairment. While the per test disposable costs of otoacoustic emissions screening may be lower than the per screening costs of our ALGO disposable supplies, published clinical studies have shown that ALGO-only screening programs are no more expensive than OAE-only programs or “two-step” (testing using OAE first, followed by ALGO screening for only the newborns that can not pass the OAE test) programs for hospitals with established screening programs, and that ALGO-only screening programs are lower in cost and achieve the lowest referral rates for hospitals just starting a newborn hearing screening program. We believe that by universally using automated auditory brainstem response technology our ALGO screening products have a number of advantages that include:

- **Accuracy.** Tests using automated auditory brainstem response have the highest documented specificity and sensitivity for newborn hearing screening of devices not requiring a specially trained audiologist, although the ALGO screener does not determine the cause of the hearing impairment.
- **Compliant with standard of care guidelines.** Our ALGO screener meets the requirements of the American Academy of Pediatrics for universal newborn hearing screening for low refer rates, minimizing parental anxiety and the cost of rescreening.
- **Immediate crib-side results.** Our screening tests can be conducted within hours after birth. Middle ear fluid and ear canal debris, which are often still present in the first 12 to 24 hours of after birth, do not significantly affect the results of our test.
- **Ease of use.** Our test does not require an audiologist or physician to conduct the screening or interpret the results.
- **Objective results.** Our test produces objective “Pass” or “Refer” results, which do not require interpretation by an audiologist or other trained clinician. The “Refer” result provides indications that the baby’s brainwave is not consistent with a normal hearing child but does not quantify the severity of the possible hearing impairment.
- **Rapid results.** ALGO hearing screenings can be performed and results can be obtained prior to discharge from the hospital.

The ALGO screener line was first introduced in 1985. We acquired the ALGO screener product line in 1987, and we have since introduced six new versions of the ALGO screener and currently market the ALGO 3 screener, the ALGO 2e Color screener and the ALGO Portable screener.

*ALGO 3 Newborn Hearing Screener.* In October 2001, we introduced the ALGO 3 screener. The ALGO 3 screener incorporates a laptop computer that interfaces our custom circuit boards and uses commercially available operating system software. This system uses our proprietary software to conduct simultaneous screening of both ears and conducts tests at 35 and 40 dBnHL. The ALGO 3 screener uses our software to store results from every test automatically, which facilitates prompt follow-up and tracking of patient results. Users can print daily, weekly or monthly reports, create backup files and integrate screening results into statewide databases. The ALGO 3 screener is also designed to allow for future software and hardware upgrades. The ALGO 3 screener uses an enhanced software program that makes it faster and easier to use. For example, the ALGO 3 screener lowered the initial refer rate of the already efficient ALGO 2e Color screener by an additional 50%.

*ALGO 2e Newborn Hearing Screener.* In December 1998, we introduced the ALGO 2e Color screener. The ALGO 2e Color screener is similar in configuration, but not in feature and functionality, to the ALGO 3 screener. This system uses its software to conduct simultaneous screening of both ears and conducts tests at 35 and 40 dBnHL. It uses software to store results from every test automatically, which facilitates prompt follow-up and tracking of patient results.

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*ALGO Portable Newborn Hearing Screener.* In June 1998, we introduced the ALGO Portable screener, which is compact and weighs less than five pounds. The ALGO Portable screener provides the flexibility to screen newborns in the newborn nursery, doctor's office, clinic or home. The ALGO Portable comes with an attachable printer and is sold primarily in Europe and in Japan and to low volume birthing centers and hospitals.

*ALGO Disposable Kit(s).* For infection control, accuracy, and ease of use, each hearing impairment test conducted with the ALGO screener is carried out with ALGO disposable kit(s) that include single use earphones, which we call Ear Couplers or FlexiCouplers, and electrodes, which we call Jelly Button or Jelly Tab Sensors. All of our screening supplies are alcohol and latex-free, and our adhesives are specially formulated for newborns.

Currently some hospitals use our ALGO screening products to screen only those newborns with risk factors for hearing loss while other hospitals use our ALGO screening products in their universal newborn screening programs.

### *MiniMuffs Neonatal Noise Attenuators*

In 1995, we introduced our MiniMuffs, which are disposable earmuffs designed to decrease noise exposure for babies in neonatal intensive care units. The MiniMuffs fit securely over a baby's ear and reduces sound levels by at least seven decibels, representing a reduction of sound pressure by more than 50%. Our MiniMuffs products are sold in the United States, Europe, Australia and New Zealand and meet health care infection control standards through a single use design. They adhere to the baby's head with a non-toxic adhesive and are designed for a single use on a single patient for one day.

### **Jaundice/Hemolysis Products**

#### *NeoBLUE LED Phototherapy device*

Our neoBLUE phototherapy device is a crib-side unit used for the treatment of jaundice. We believe that the neoBLUE phototherapy device is the only commercially available product that uses blue LED's as its light source, providing reduced ultraviolet light and reduced heat emissions compared to other currently available phototherapy devices. We received FDA clearance for use of our neoBLUE phototherapy device in October 2002. We began to commercially market our neoBLUE phototherapy device in October 2002.

#### *CO-Stat End-Tidal Breath Analyzer Product Family*

*CO-Stat End-Tidal Breath Analyzer.* Our CO-Stat analyzer is a point of care device used in well baby nurseries and newborn intensive care nurseries to measure a baby's exhaled carbon monoxide concentration to indicate the rate at which bilirubin is being produced and may assist the clinician in determining the cause of neonatal jaundice. In order to conduct a complete assessment of a newborn's risk of jaundice, the clinician would need to measure the rate at which bilirubin is being produced, the level of bilirubin in the blood and the rate at which the baby is excreting bilirubin. No currently available laboratory test or medical instrument is capable of assessing all of these clinical indicators. We received FDA clearance in March 1998 for use of our CO-Stat analyzer products to monitor hemolysis, or the rate at which red blood cell breakdown occurs and bilirubin is produced. We believe our CO-Stat analyzer is the only FDA-cleared device for this purpose. By measuring and subtracting the environmental level of carbon monoxide during the screening procedure, our CO-Stat analyzer identifies trace levels of carbon monoxide produced primarily through the breakdown of red blood cells. This information helps physicians distinguish between the jaundice stemming from bilirubin production and the body's failure to excrete bilirubin. The CO-Stat analyzer assists clinicians in assessing bilirubin production, but does not determine the level of bilirubin in the blood.

*CO-Stat Disposables.* A small plastic tube containing filters attaches to the CO-Stat analyzer and is placed at the opening of the baby's nostril. To ensure proper infection control and accuracy of the test, the tube and

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filters used to sample the baby's breath and environmental carbon monoxide are disposed of after a single use. The sampling of environmental carbon monoxide alters the tube and filters so that they cannot be reused for another test.

### *CO-Stat Analyzer Product Status*

*CO-Stat Analyzer.* We began to commercially market our CO-Stat analyzer products in January 2001. To date, we have not achieved the level of sales of our CO-Stat products that we had anticipated, and in the third quarter of 2002, began to reduce marketing and sales expenses associated with our CO-Stat products in order to more accurately reflect our expectations regarding near term revenues. While we intend to continue to support the user base now in place, we are currently evaluating the viability of marketing our CO-Stat products in the newborn jaundice market.

We have supported clinical studies relating to the use of our CO-Stat product in the newborn jaundice market. For instance, we conducted a two-year study of the CO-Stat analyzer at ten sites with 1,300 newborns to evaluate the ability of the carbon monoxide analysis alone and in combination with blood-based bilirubin testing to identify newborns who are at risk for developing hyperbilirubinemia. Principal clinical investigators in the United States included researchers from Stanford University, University Hospital of Cleveland, Women & Infants' Hospital in Providence, Rhode Island, the University of Pennsylvania and William Beaumont Hospital in Royal Oak, Michigan. Investigators from hospitals in Israel, Hong Kong and Japan also participated. Based on the data gathered during the study, the investigators concluded that a high rate of hemolysis is an important contributing factor in the majority of cases of hyperbilirubinemia. In addition, the investigators concluded that the CO-Stat analyzer enables clinicians to rule out excessive rates of hemolysis and thereby identify those babies who potentially may be discharged early because they are not likely to develop hyperbilirubinemia. The study, which was published in *Pediatrics* in July 2001, also concluded that the preferred means of conducting pre-symptomatic jaundice monitoring is assessing bilirubin production and elimination concurrently. The CO-Stat analyzer assists clinicians to assess bilirubin production, but does not determine the level of bilirubin in the blood or bilirubin elimination.

In addition, the University of Chicago conducted a clinical study of approximately 660 babies to assess the cost-effectiveness and clinical reliability of the CO-Stat analyzer as compared to the Coombs test. The principal investigators presented the results of the study in March 2001 at the California Association of Neonatologists Annual Meeting and the study was published in the *Journal of Perinatology* in July 2002. The principal investigators concluded that the Coombs test is not as accurate as the CO-Stat analyzer for the identification of hemolysis in newborns. In addition, the principal investigators concluded that the cost of the Coombs test is approximately 1.5 times more per infant for identification and evaluation of hemolysis as compared to the CO-Stat analyzer.

We continue to support clinical research in the field of neonatal jaundice management. Additionally, we have initiated clinical trials with the CO-Stat analyzer designed to evaluate the rate of carbon monoxide production as an indicator for pre-eclampsia and pre-term labor. In addition, we commenced a separate small trial for use of the CO-Stat analyzer in the management of sickle cell disease. These trials are in their early phases and results are not expected until later in 2003, or beyond. We can not predict the results of these trials.

### **Customers**

Our customers include physicians, nurses, audiologists, hospitals and government agencies. We have sold approximately 4,355 ALGO screeners worldwide. We believe that there are approximately 4,000 birthing and children's hospitals in the United States. Our ALGO screening products have been installed in at least 2,000 of these facilities. We have sold a total of 14 neoBLUE phototherapy devices during the two months since the product was introduced. To date, our CO-Stat analyzer sales have not been significant.

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We sold disposable supplies to conduct approximately 2.1 million hearing screenings in 2002, 2.0 million hearing screenings in 2001 and approximately 1.7 million hearing screenings in 2000. While the majority of our sales have been to customers in the United States, we have also sold ALGO screeners in 22 countries, including, but not limited to, Austria, Australia, Belgium, Germany, Japan, New Zealand and the United Kingdom. From time to time we participate in bidding and other selection processes for country or statewide hearing screening programs. For example, we participated in the National Health Service's selection process in the United Kingdom for newborn hearing screening equipment vendors for England, Scotland and Wales. The selection process was finalized in 2002 and Natus shares the award as a vendor for newborn hearing screening equipment with five other vendors and to date, we have received the majority of the orders placed under that award. In September 2002, Natus also participated in the selection process for a province in Australia, sharing the award with one other vendor.

We began to commercially market our CO-Stat analyzer in January 2001 and our neoBLUE phototherapy device in October 2002. In 2002, 2001 and 2000, no single end customer comprised more than 10% of our revenues.

### **Marketing and Sales**

Our ALGO screening products have been commercially available since 1985, and we began selling our MiniMuffs products in 1995. We began marketing our CO-Stat analyzer products for commercial use in January 2001. To date, our CO-Stat product has not achieved the commercial success that we had anticipated; however, we continue to support clinical research in the field of newborn jaundice management and for additional clinical applications. We only recently began marketing our neoBLUE phototherapy device in October 2002. We are using methods to sell our MiniMuffs and neoBLUE phototherapy devices that are similar to the methods we currently use to sell our ALGO screening products. We are currently evaluating the methods and viability of marketing our CO-Stat products in the newborn jaundice markets. Any future successful marketing of our CO-Stat product will require our use of strategies to establish and grow a market for the product.

#### ***Marketing***

Our marketing strategy is to differentiate our products by their level of performance including sensitivity, specificity and reliability, ease of use and pre-discharge cost-impact testing advantages. We educate customers and potential customers about our products through:

- participation in physician group and health care agency conferences;
- efforts by our clinical educators and sales team;
- publications in peer reviewed, professional journals;
- our recently upgraded website;
- print and direct mail advertising;
- sponsorship of and participation in clinical education seminars; and
- electronic mail notification to customers about new products.

We believe that educational efforts directed at government agencies and other third party payors about the benefits of universal screening in terms of patient outcomes and long-term treatment costs are a key element of our marketing strategy.

#### ***Direct Sales***

In the United States, we sell our products to three groups of potential purchasers:

- *States.* To reduce the cost of special education and state funded rehabilitation programs, many states have mandated universal newborn hearing screening through legislation or provided funding for hearing

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screening at hospitals. Some of these states purchase hearing screening units directly from us and provide them to hospitals. Georgia, Mississippi, New Mexico, North Carolina, Oklahoma, South Carolina, Maine and Alaska have each purchased ALGO screening products for hospital placement. No states have mandated hemolysis testing for newborns or purchased equipment from us for this purpose.

- *Hospitals.* Hospitals often purchase products from us directly, either in response to a state mandate requiring universal newborn hearing screening or in conjunction with a voluntary screening program for newborn hearing or jaundice management.
- *Neonatologists, pediatricians and audiologists.* Our sales force often identifies these professionals as the advocate of universal hearing screening programs or newborn jaundice management within the hospital. We focus our sales efforts on these individuals who tend to be knowledgeable about the cost and treatment benefits of universal newborn hearing screening or pre-discharge hemolysis monitoring as the case may be.

Although we previously relied exclusively on distributors in Japan, we established a Japanese subsidiary in July 2000 and assumed the activities of our top-tier Japanese distributor in July 2001. We commenced sales to re-distributors in Japan in July 2001. We established a subsidiary in the United Kingdom in December 2000, which acquired our distributor in the United Kingdom in January 2001.

### ***Distributor Sales***

In addition to our direct sales force, outside the United States we have relied heavily on our distributor sales channel. Revenues from sales through distributors were approximately 13% of our revenues in 2002 and 14% of our revenues in 2001 and 2000, including sales to sub-distributors in Japan. Our distributors either assist our sales staff or are our sole sales and support representatives in their territories. We have established a network of distributors in Europe, Asia and Australia, numbering over 20 at the end of 2002. Our distributors typically perform marketing, sales and technical support functions in their country or region. Each one may distribute directly to the customer, via other distributors or resellers or both. We actively train our distributors in both product and sales methods.

### ***Group Purchasing Organizations***

In addition, approximately 90% of the hospitals in the United States are members of group purchasing organizations, which negotiate large volume purchase prices for member hospitals, group practices and other clinics. We have entered into agreements with several group purchasing organizations, and we intend to enter into similar agreements with other group purchasing organizations in the future. These group purchasing organizations are not required to continue to negotiate prices with us, and the members of these organizations are not required to purchase our products. For example, members of Novation, a group purchasing organization, receive specially negotiated prices, volume discounts and other preferential terms on their member's direct purchases from us. Our agreement with Novation requires Novation to promote our hearing screening products to its members and to inform its members about the special terms we have negotiated. We have agreed to pay Novation marketing fees for these efforts, which fees are based on a percentage of our net sales to Novation's members. Our agreement with Novation continues until January 31, 2004, but we or Novation may cancel it with notice or agree to extend it for up to two additional one-year terms. Direct purchases by members of Novation accounted for approximately 29% of our revenues in 2002, 25% of our revenues in 2001 and approximately 22% of our revenues in 2000. Novation's members purchase products directly from us under the terms negotiated in the group purchasing agreement, and Novation does not purchase and resell our products to its members. Direct purchases by members of group purchasing organizations accounted for approximately 47% of our revenues in 2002, 35% of our revenues in 2001 and approximately 23% of our revenues in 2000.

### ***Customer Service and Support***

Our ALGO screening products, CO-Stat analyzer and neoBLUE phototherapy device are sold with a one-year warranty. We also sell extended warranty agreements for all of our products. We provide service to our



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domestic customer base through our Redding, California service center. This facility is equipped to perform full service, repair, and calibration services to customers on a warranty and fee basis. Service for our international customers is provided either by TriVirix International, Inc., our European contract manufacturer, our Japanese subsidiary or our Redding facility. We have certified TriVirix to perform all levels of service and repair on ALGO screening products.

### **Third Party Reimbursement**

In the United States, health care providers that purchase products like ours generally rely on third party payors, including private health insurance plans, federal Medicare, state Medicaid and managed care organizations, to reimburse all or part of the cost of the procedure in which the product is used. Our ability to commercialize our products successfully in the United States will depend, in part, on the extent to which reimbursement is available for screenings, tests or treatments performed with the ALGO screener, CO-Stat analyzer or neoBLUE phototherapy device. Third party payors can affect the pricing or the relative attractiveness of our products by regulating the maximum amount of reimbursement these payors, such as insurance companies or health maintenance organizations, provide for testing services. In general, reimbursement for hearing impairment screening and jaundice assessment for newborns is included in the lump sum payment for the newborn's birth and hospitalization. For this reason, we are not able to measure a reimbursement success rate for our products.

The current cost reduction orientation of third party payors makes it difficult for new medical screening and testing devices and tests performed with them to be eligible for reimbursement. Often, it is necessary to convince these payors that the new devices or procedures will establish an overall cost savings compared to the cost of those that are currently reimbursed or long-term treatment for the condition if the screening does not occur early. While we believe that our products possess economic advantages that will be attractive, third party payors may not make reimbursement decisions based upon these advantages. Third party payors are increasingly scrutinizing and challenging the prices charged for medical products and services.

Effective October 1, 1991, the United States' The Centers for Medicare and Medicaid Services adopted regulations that provide for the inclusion of capital related costs in the prospective payment system for hospital inpatient services. Under this system most hospitals are reimbursed by Medicare on a per diagnosis basis at fixed rates unrelated to actual costs incurred in making the diagnosis. Under this system of reimbursement, equipment costs generally are not reimbursed separately, but rather are included in a single, fixed rate per patient reimbursement for screening based on approved current procedural terminology codes. Some states, such as California and Florida, reimburse clinicians for hearing screenings conducted with ALGO screening products as a separate reimbursement group from the birth and initial hospitalization reimbursement group. These regulations are being phased in over a ten-year period. Medicare reform legislation required The Centers for Medicare and Medicaid Services to implement a prospective payment system for outpatient hospital services. This system also provides for a per-patient fixed rate reimbursement for outpatient department capital costs. Although the full implications of these changes cannot be known, we believe that the regulations will place more pressure on hospitals' operating margins, causing them to limit capital expenditures and reduce operating budgets. These regulations could cause hospitals to decide to defer purchasing equipment like our products as a result of limitations on their capital expenditures. The recent Medicare legislation also requires The Centers for Medicare and Medicaid Services to adopt uniform coverage and administration policies for laboratory tests.

In addition to traditional third party reimbursement, universal newborn hearing screening may be either paid for directly by the state or through private insurance coverage required by state legislation. Thirty-seven states and the District of Columbia have passed legislation requiring newborns to be screened for hearing impairment prior to hospital discharge.

In the United States, we have found the state to be the most appropriate level of government to implement universal newborn hearing screening. At the state level, the cost of newborn hearing screening can most directly

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be weighed against the much higher cost to the state of education and treatment programs required for the hearing impaired. A key element of our reimbursement strategy for the ALGO screening products has been to promote the adoption of universal newborn hearing screening legislation and equipment purchases at the state level.

States typically implement universal newborn hearing screening in the following manners:

- **Voluntary.** Hospitals are not required to provide universal newborn hearing screening, but the majority of newborns are screened. In some cases, the state may also purchase the equipment and disposables directly and provide them to hospitals. As of December 31, 2002, the states with voluntary programs are Arizona, Delaware, Idaho, Iowa and Michigan.
- **Mandate with equipment purchase.** The state has mandated universal newborn hearing screening, and the state purchases or subsidizes equipment and disposables for birthing facilities. As of December 31, 2002, the states that have adopted this type of program are Georgia, Illinois, Kentucky, Mississippi, New Mexico, North Carolina, Oklahoma, South Carolina and Wyoming.
- **Mandate with state reimbursement.** The state has mandated universal newborn hearing screening and reimburses hospitals on a per-test basis for Medicaid patients. As of December 31, 2002, the states that have adopted this type of program are Arkansas, California, Florida, Maryland, Massachusetts, Missouri, Nebraska, Ohio and West Virginia.
- **Mandate without state reimbursement.** The state has mandated universal newborn hearing screening and requires third party reimbursement, usually as a part of the newborn birth process amount. As of December 31, 2002, the states that have adopted this type of requirement are Colorado, Connecticut, Hawaii, Indiana, Kansas, Louisiana, Maine, Montana, Nevada, New Hampshire, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Texas, Utah, Virginia and Wisconsin.

We have sold our ALGO screening products to customers in each of the 50 states. We help our customers understand the applicable regulations in their state and provide them with copies of published public policies. We also provide hospitals with local references so that customers may learn more about reimbursement in their states.

Reimbursement systems in international markets vary significantly by country and, within some countries, by region. Reimbursement approvals must be obtained on a country-by-country basis or a region-by-region basis. In addition, reimbursement systems in international markets may include both private and government sponsored insurance.

There are currently no states that have passed legislation related to universal newborn hemolysis monitoring.

### **Manufacturing**

A significant portion of the components of our products are manufactured for us by other companies. However, we perform final assembly, testing and packaging of the ALGO 3 screener, the ALGO 2e Color screener, neoBLUE phototherapy device and the CO-Stat analyzer ourselves to control quality and manufacturing efficiency. In order to reduce costs and to add additional capacity, in the future we may move some labor intensive operations to less costly manufacturing locations or outsourcing processes. For example, we entered into an agreement with TriVirix in December 1998 for the manufacture of our ALGO Portable screening product. We use contract vendors to manufacture our disposable products, and we perform regular quality audits of these vendors.

We purchase materials and components from qualified suppliers that are subject to our stringent quality specifications and inspections. We conduct quality audits of our key suppliers, several of which are experienced

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in the supply of components to manufacturers of finished medical devices or disposables for use with medical devices. Most of our purchased components are available from more than one supplier. For those components for which relatively few alternate supply sources exist, we are currently trying to locate additional suppliers that meet our quality standards as well as specific regulatory compliance standards.

Currently, only one Natus approved supply source exists for the adhesive used in our ALGO disposables and our MiniMuffs product. The adhesive, called hydrogel, is manufactured by a supplier that also sells the product to a variety of other medical device manufacturers. We are in the process of identifying other sources of hydrogel for ongoing supply, but, in the meantime, our disposables manufacturer has scheduled long term delivery of hydrogel for our products in an amount that we believe will be sufficient to allow us time to locate and qualify a new supplier should our current supplier fail to fulfill our needs. Other formulations of hydrogel exist. However, if a new adhesive is incorporated into our products, then those products may require new regulatory clearance by the FDA, as well as by similar regulatory agencies outside the United States. In addition, we have used a single source to obtain electrochemical sensors for our CO-Stat analyzer. Other sources of supply exist for this component, but we could experience a delay in production of our CO-Stat analyzers if we were unable to obtain a sufficient quantity from our current vendor.

Our manufacturing, service and repair facilities are subject to periodic inspection by United States, state and foreign regulatory authorities. Our quality assurance system is subject to regulation of both the FDA and the State of California. We are required to conduct our product design, testing, manufacturing and control activities in conformance with the FDA's quality system regulations and to maintain our documentation of these activities in a prescribed manner. Our manufacturing and service and repair facilities are registered and/or licensed by the FDA and the California Department of Health Services, Food and Drug Branch. We have passed all quality system regulations inspections of our facilities conducted by the FDA and the State of California. In addition, our facility has received ISO 9001/EN46001 certification. ISO 9001/EN46001 certification standards for quality operations have been developed to ensure that companies know the standards of quality on a worldwide basis. We have also received the EC Certificate pursuant to the European Union Medical Device Directive 93/42/EEC, which allowed us to place a CE mark on our products after assembling appropriate documentation.

We entered into a manufacturing agreement with TriVirix to serve as our European manufacturing, service and distribution center. We qualified TriVirix's Belfast, Northern Ireland facility to produce the ALGO Portable screener in April 1999. TriVirix is also a FDA registered manufacturing facility with a full quality system in place in accordance with the FDA's Quality System Regulation and ISO 9002. TriVirix currently supplies all of our ALGO Portable screening units and has begun to supply a portion of our preamplifier and printed circuit board needs.

## **Research and Development**

We believe that strong product development capabilities are essential to our strategy of enhancing our core technology and developing additional test applications for our current products.

Our CO-Stat analyzer has been cleared by the FDA for measuring exhaled carbon monoxide in pediatric and adult patients. Although the CO-Stat product has not achieved the commercial success that we had anticipated, we continue to support clinical research worldwide, in the fields of newborn jaundice management and other clinical applications. For example, we believe the CO-Stat analyzer may be used to detect pregnancy induced hypertension in its early stages. Exhaled carbon monoxide may be a clinical indicator for other disorders of newborns and adults such as pneumonia, asthma, infection, pre-eclampsia, pre-term labor and blood disorders. We have initiated clinical trials with the CO-Stat analyzer designed to evaluate the rate of carbon monoxide production as an indicator for pre-eclampsia and pre-term labor. We commenced a separate trial to test the use of the CO-Stat analyzer in the management of sickle cell disease. However, there are no current commercial uses for our CO-Stat analyzer in diagnosing or monitoring any of these conditions. We cannot be sure we will ever market a device to monitor or screen for these or any other disorders and cannot predict the results of clinical trials.

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Our research and development expenses were \$4.9 million in 2002, \$4.3 million in 2001 and \$3.5 million in 2000.

### **Proprietary Rights**

Our products rely on our internally developed intellectual property and other proprietary rights. We rely on a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and contractual provisions to protect our intellectual property and other proprietary rights. However, we believe that these measures afford only limited protection and do not provide significant barriers to competition. We have eighteen issued United States patents, which will expire at various times from 2007 to 2021, and eight patent applications pending before the United States Patent and Trademark Office. We have one patent granted in Canada and four patent applications pending in Canada. We have one patent issued with the European patent office, which we intend to register in ten countries and eleven patent applications pending with the European patent office. We have one patent granted in France and one patent application pending in France. We have three patent applications granted in Japan and twelve patent applications pending in Japan. We have two patents granted in Germany, one patent granted in Iceland, one patent granted in the Netherlands, one patent granted in Switzerland, and two patents granted in the United Kingdom. We have four patent applications pending in Australia, two patent applications pending in the Czech Republic, one patent application pending in Hong Kong, two patent applications pending in Hungary, one patent application pending in Italy and one patent application pending in Norway. Our patents and patent applications address various aspects of our current products and those in development including, but not limited to, the earphones used with our ALGO screeners, the method by which our CO-Stat analyzer measures end tidal carbon monoxide and the filters used with our CO-Stat analyzer. The original patent for an algorithm for analyzing auditory brainstem responses, which we licensed on a nonexclusive basis from a third party and upon which we developed our proprietary automated auditory brainstem response technology, expired in late 1999, and the subject matter of that patent is in the public domain. With respect to our neoBLUE phototherapy device, the basic concept of using blue lights for phototherapy is well established in the technical literature and is therefore not patentable. However, we have one patent pending that pertains to some of the features in our neoBLUE device, and the design and manufacturing methods we use are proprietary to us. Our ALGO screeners and CO-Stat analyzers use our proprietary software to produce their results, which we license under shrink wrap licenses that are included as part of the product packaging. Shrink wrap licenses are not negotiated with or signed by individual customers and purport to take effect upon the opening of the product package or use of the screening equipment. We also generally enter into confidentiality agreements with our employees and technical consultants. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or improperly obtain and use information that we regard as proprietary. Monitoring unauthorized use of our products is difficult and we are unable to determine the extent to which unauthorized use of our products exists. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. Our means of protecting our proprietary rights may be inadequate and enforcing our intellectual property rights could be costly and time consuming and may divert our management's attention and resources. Enforcing our intellectual property rights could also result in the loss of intellectual property rights.

We are not aware that our products employ technologies that infringe any valid proprietary rights of third parties and no assertions of infringement have been made by any third parties. However, the medical device industry is characterized by the existence of a large number of patents and frequent litigation based on allegations of patent infringement. As the number of entrants into our market increases, the possibility of an infringement claim against us grows. While we attempt to ensure that our products do not infringe other parties' patents and proprietary rights, our competitors may assert that our products and the methods we employ now or in the future may be covered by U.S. patents held by these competitors. In addition, our competitors may assert that the products and the methods we employ now or in the future infringe their other proprietary rights. Any infringement claims, with or without merit, could be time consuming to defend or result in costly litigation or damage awards. Any claim could divert management's attention and resources or cause a significant disruption in our revenues while we redesign products if we are found to infringe. A claim also could cause product

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shipment delays or cessation or require us to enter into royalty or licensing agreements. These royalty or licensing agreements may not be available on terms acceptable to us, if at all.

### **Competition**

We compete in intensely competitive and rapidly evolving markets. We face competition primarily from medical device companies that manufacture hearing screening products, testing products for determining bilirubin levels based on skin color, chemicals used to conduct the Coombs test or blood-based bilirubin tests and phototherapy products. We have experienced and expect to continue to experience increased competition from current and potential competitors, many of which have significantly greater financial, technical, marketing and other resources.

Companies offering competitive products vary in scope and breadth. With respect to our hearing impairment screening products, our competitors include:

- ETYMOTIC Research, Kedly, Inc., Nicolet Biomedical/Grason-Stadler, Inc., Madsen Electronics, Otodynamics, Ltd., Starkey Laboratories, Inc. and Welch Allyn, Inc., which sell otoacoustic emissions products;
- Intelligent Hearing Systems and Sonamed Corp., which sell enhanced auditory brainstem response and otoacoustic emissions products, which run a test on the basis of parameters set by the clinician performing the test and continue to conduct the test until parameters are satisfied and produce results that must be interpreted by a trained audiologist or other specialist;
- Bio-logic Systems, Madsen Electronics and Fischer-Zoth, which sells enhanced auditory brainstem response and otoacoustic emissions products; and
- SLE Ltd., which sells auditory brainstem response products.

With respect to our CO-Stat analyzer products, our competitors include:

- Johnson & Johnson and Roche, which sell laboratory equipment and chemicals used to conduct the Coombs test or to measure bilirubin levels in the blood; and
- Minolta and SpectRx, which sell equipment to measure the yellowness of the skin.

Our competitors for our neoBLUE phototherapy device include:

- Olympic Medical, Ohmeda Medical, Dräger Medical Inc. and Medela, which sell phototherapy devices.

We believe the principal factors that will draw clinicians and other buyers to a newborn testing product, including hearing testing and hemolysis monitoring products, include:

- the level of specificity, sensitivity and reliability of the product;
- the time required to run tests with the product;
- the relative ease of use of the product;
- the depth and breadth of the product's features;
- the quality of customer support for the product;
- the frequency of product updates;
- the extent to which third party reimbursement for the purchase of the product or the screening is available;
- the extent to which the products conform to standards of care guidelines; and
- the price of the product.

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We believe that we compete favorably on these factors. However, we expect competition in the newborn screening market to increase significantly as new companies enter the market and current competitors expand their product lines and services. For example, Bio-logic received FDA approval to sell its disposable products for use with versions of our ALGO screener other than the ALGO 3 screener. Many of these potential competitors are likely to enjoy substantial competitive advantages, including greater resources that can be devoted to the development, promotion and sale of their products. In addition, these potential competitors may have more established sales channels, greater product development experience or greater name recognition.

### **Government Regulation**

#### ***FDA's Premarket Clearance and Approval Requirements***

Unless an exemption applies, the FDA must either clear or approve in advance each medical device that we wish to market in the United States in one of two ways:

- clearance known as the 510(k) process; or
- premarket approval, a more rigorous process required 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 is much more costly, uncertain and may take from one to three years or even longer. We cannot be sure that 510(k) clearance or premarket approval will be obtained for products we propose to market.

The FDA decides whether a device must undergo either the 510(k) clearance or premarket approval process based upon statutory criteria. These criteria include the level of risk that the agency perceives to be associated with the device and a determination of whether the product is a type of device that is substantially equivalent to devices that are already legally marketed. The FDA places devices deemed to pose relatively less risk in either class I or class II, which requires the manufacturer to submit a premarket notification requesting 510(k) clearance, unless an exemption applies. The premarket notification must demonstrate that the proposed device is substantially equivalent in intended use and in safety and effectiveness to an existing legally marketed device that is a class I, class II, preamendment class III device or any of those for which the FDA has not yet called for submission of a premarket approval. The FDA has classified our ALGO screener, CO-Stat analyzer and neoBLUE phototherapy device as class II devices.

The FDA places devices deemed to pose the greatest risk, such as life-sustaining, life-supporting or implantable devices, or devices deemed to be not substantially equivalent to a predicate device, in class III. The FDA requires these devices to undergo the premarket approval process in which the manufacturer must prove the safety and effectiveness of the device. A premarket approval application must provide extensive preclinical and clinical trial data. To date, the FDA has not classified any of our products as class III devices.

The FDA may require results of clinical trials in support of a 510(k) submission and generally requires clinical trial results for a premarket approval application. In order to conduct a clinical trial on a significant risk device, the FDA requires manufacturers to apply for and obtain in advance an investigational device exemption. The investigational device exemption application must be supported by appropriate data, such as animal and laboratory testing results. If the FDA and the Institutional Review Boards at the clinical trial sites approve the investigational device exemption application for a significant risk device, the manufacturer may begin the clinical trial. An investigational device exemption approval provides for a specified clinical protocol, including the number of patients and study sites. If the manufacturer deems the product a nonsignificant risk device, the product will be eligible for more abbreviated investigational device exemption requirements. If the Institutional Review Boards at the clinical trial sites concur with the nonsignificant risk determination, the manufacturer may begin the clinical trial.

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The following chart shows the U.S. regulatory status of the products we currently sell and our regulatory status in Europe, Japan, Australia and New Zealand and Canada:

Natus Device	FDA 510(k)	CE Mark	Japan (Shonin)	Australia and New Zealand	Canada
ALGO 3 screener	October 2001	October 2001		January 2002	April 2002
ALGO 2e Color screener	December 1998	July 1999	September 1997	June 2000	December 2000
ALGO Portable screener	June 1998	July 1999	December 2000	January 2001	December 2000
MiniMuffs	February 1995	January 2001		June 2000	
CO-Stat analyzer	March 1998	July 1999			August 2002
neoBLUE phototherapy device	September 2002	November 2002			

### ***Pervasive and Continuing FDA Regulation***

Numerous FDA regulatory requirements apply to our marketed devices. These requirements include:

- the FDA's quality system regulation which requires manufacturers to create, implement and follow numerous elaborate design, testing, control, documentation and other quality assurance procedures;
- medical device reporting regulations, which require that manufacturers report to the FDA certain types of adverse and other events involving their products; and
- the FDA's general prohibition against promoting products for unapproved uses.

Class II devices may also be subject to special controls applied to them, such as performance standards, post-market surveillance, patient registries and FDA guidelines that may not apply to class I devices. Our products are currently subject to FDA guidelines for 510(k) cleared devices and are not subject to any other form of special controls, such as a requirement to conduct a screening in a laboratory within a medical facility. We believe we are in compliance with the applicable FDA guidelines, but we could be required to change our compliance activities or be subject to other special controls if the FDA changes its existing regulations or adopts new requirements.

We are subject to inspection and market surveillance by the FDA to determine compliance with regulatory requirements. If the FDA finds that we have failed to adequately comply, the agency can institute a wide variety of enforcement actions, ranging from a public warning letter to more severe sanctions such as:

- fines, injunctions and civil penalties;
- recall or seizure of our products;
- the issuance of public notices or warnings;
- the imposition of operating restrictions, partial suspension or total shutdown of production;
- the refusal of our requests for 510(k) clearance or premarket approval of new products;
- the withdrawal of 510(k) clearance or premarket approval already granted; and
- criminal prosecution.

The FDA also has the authority to require repair, replacement or refund of the cost of any medical device manufactured or distributed by us. Our failure to comply with applicable requirements could lead to an enforcement action that may have an adverse effect on our financial condition and results of operations.



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### ***Other United States Regulations***

We also must comply with numerous additional federal, state and local laws relating to matters such as safe working conditions, manufacturing practices, environmental protection, biohazards, fire hazard control and hazardous substance disposal. We believe we are currently in compliance with applicable safety and quality regulations and the environmental protection, biohazard and hazardous substance disposal regulations. We cannot be sure that we will not be required to incur significant costs to comply with these laws and regulations in the future or that these laws or regulations will not hurt our business and results of operations. Unanticipated changes in existing regulatory requirements or adoption of new requirements could hurt our business, results of operations and financial condition.

### ***Foreign Regulation***

In the foreign countries in which we sell or plan to sell our products, our products are also regulated as medical devices, and are subject to regulatory requirements by foreign governmental agencies similar to the FDA. Our manufacturing facility has been audited and certified to be ISO9001/EN46001 compliant, which allows us to sell our products in Europe. Our manufacturing facility is subject to CE Mark and ISO 9001 inspection by TÜV Rheinland. We plan to seek approval to sell our products in additional countries. 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.

### **Employees**

As of December 31, 2002, we had 127 full time employees worldwide. None of our employees is represented by a labor union. We have not experienced any work stoppages and consider our relations with our employees to be good.

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### Executive Officers

The following table lists our executive officers and their ages as of March 19, 2003:

<u>Name</u>	<u>Age</u>	<u>Position(s)</u>
Tim C. Johnson	45	Chief Executive Officer, President, Chief Operating Officer and Director
Glenn A. Bauer	45	Chief Financial Officer and Vice President, Finance
Bryan P. Flaherty, Ph.D.	39	Vice President, Research and Development
Mark E. Foster	54	Vice President, Legal, Human Resources and Regulatory & Quality Affairs, General Counsel and Secretary
Kenneth M. Traverso	42	Vice President, Worldwide Sales
William L. Mince	51	Vice President, Operations
George R. Ryan	53	Vice President, Business Development
D. Christopher Chung, M.D.	39	Vice President, Medical Affairs

*Tim C. Johnson* has served as our chief executive officer since July 1999, our president since March 1996, our chief operating officer since October 1995 and our secretary from April 1992 to March 2002. Mr. Johnson also was our controller from July 1990 to June 1991 and served as director of finance and administration from July 1991 to March 1992. In April 1992 Mr. Johnson was named vice president of finance and chief financial officer and served in that capacity until December 1997. Prior to joining our company, Mr. Johnson served in various capacities at Cray Research, Inc. and was previously an auditor with Coopers & Lybrand. Mr. Johnson holds a Bachelor of Science degree in Accounting from the University of Minnesota and a Masters of Business Administration degree from Stanford University.

*Glenn A. Bauer* has served as our chief financial officer since September 2002. From August 1999 to January 2002, Mr. Bauer served as chief financial officer and vice president of finance of AdvisorTech, a financial services application development company. From November 1993 to August 1999, Mr. Bauer served as controller of Avigen, a gene therapy company. Mr. Bauer holds a Bachelor of Science degree from Fresno State University and a Masters of Business Administration degree from Golden Gate University.

*Bryan P. Flaherty, Ph.D.* has served as our vice president of research and development since February 2000. Dr. Flaherty was our director of research and development from July 1998 to February 2000. Dr. Flaherty served as our manager of advanced product engineering from November 1996 to July 1998. From June 1994 to November 1996, Dr. Flaherty served as a senior development engineer of Vital Insite, Inc., a medical monitoring technology company. From September 1993 to June 1994, Dr. Flaherty served as a consultant at Failure Analysis Associates, an engineering consulting company. From September 1992 to September 1993, Dr. Flaherty served as a staff engineer at Rush Medical College, and from September 1989 to September 1992, he served as a staff engineer at Hines VA Rehabilitation Research and Development Center. Dr. Flaherty holds a Bachelor of Science degree in Mechanical Engineering from the University of California at Davis and Master of Science and Doctorate degrees in Bioengineering from the University of Illinois, Chicago.

*Mark E. Foster* has served as our vice president for legal, human resources and regulatory & quality affairs, general counsel and secretary since March 2002. From 1987 to March 2002, Mr. Foster practiced international corporate law as a principal with the Law Offices of Mark Foster. Mr. Foster served as the lawyer and lobbyist in Japan for the United States Electronics Industry Office, a joint effort of the Electronics Industries Association and the American Electronics Association, from 1986 to 1989. During part of the Reagan Administration, Mr. Foster served as special counsel to the United States Embassy in Tokyo, Japan, as a trade negotiator. Mr. Foster holds a Bachelor of Arts degree in Humanities from Alma College and a Doctor of Jurisprudence degree from the University of California Hastings College of Law.

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*Kenneth M. Traverso* has served as our vice president of worldwide sales since February 2003. From April 2002 to February 2003, he served as our vice president of marketing and sales. From September 2000 to April 2002, he served as our vice president of sales. From October 1999 to July 2000, Mr. Traverso served as president of DinnerNow.com Inc., an internet aggregator for the restaurant industry. From January 1998 to September 1999, Mr. Traverso served as vice president of sales, western region of Alere Medical, an outpatient chronic disease management company. From May 1995 to January 1998, Mr. Traverso served as vice president of marketing and sales of AbTox, Inc., a low temperature sterilization company. From August 1990 to May 1995, Mr. Traverso served in various capacities at our company, the most recent of which was vice president of sales. Mr. Traverso holds a Bachelor of Science degree in Administration & Marketing from San Francisco State University.

*William L. Mince* has served as our vice president of operations since October 2002. From November 2000 to September 2002, Mr. Mince served as president and founder of My Own Jukebox, an Internet retail company. From July 1998 to October 2000, Mr. Mince was a consultant with the majority of his time spent as senior vice president of network solutions for Premier Retail Network, a media broadcasting company. From July 1997 to June 1998, Mr. Mince served as president and chief operating officer of Ophthalmic Imaging Systems, a publicly held medical device company. From July 1994 to June 1997, Mr. Mince was vice president operations with Premier Retail Network. From May 1988 to June 1994, Mr. Mince was director of operations for Nellcor. Mr. Mince holds a Bachelors of Science degree in Business Administration from the University of Redlands and a Masters of Business Administration degree from National University.

*George R. Ryan* has served as our vice president business development since April 2002. From July 2000 to May 2002, Mr. Ryan served as president Japan and vice president, business development and international sales for Masimo Corp., a monitoring company. From April 1998 to July 2000, Mr. Ryan served as director of business development for Hill-Rom Corp., a medical device company. From May 1992 to April 1998, Mr. Ryan served as director of marketing and senior director of business development for Respironics, a medical device company. Mr. Ryan holds a Bachelor of Science degree in Electrical Engineering from the Milwaukee School of Engineering and a Masters degree in Finance and International Marketing from the University of Southern California.

*D. Christopher Chung, M.D.*, has served as our vice president, medical affairs since February 2003. Dr. Chung also served as our medical director from October 2000 to February 2003. From August 2000 to present, Dr. Chung has also served as a pediatric hospitalist at the California Pacific Medical Center in San Francisco. From June 1997 to June 2000, Dr. Chung trained as a pediatric resident at Boston Children's Hospital, Harvard University. From May 1986 to July 1993, Dr. Chung worked as an engineer at Nellcor, Incorporated, a medical device company. Dr. Chung holds a Bachelor of Arts degree in Computer Mathematics from the University of Pennsylvania and a Doctor of Medicine degree from the Medical College of Pennsylvania—Hahnemann University School of Medicine. He is board certified in Pediatrics and is a fellow of the American Academy of Pediatrics.

### **ITEM 2. Properties**

Our principal offices are located in a leased 30,000 square foot facility in San Carlos, California and house substantially all of our manufacturing, research and development and related customer support services employees, as well as all marketing, administration and finance employees. Our lease pertaining to 4,000 square feet on our San Carlos facility expires in December 2003. Our lease on 26,000 square feet of our San Carlos facility expires in December 2005. In addition, we lease a 1,000 square foot service and support center in Redding, California on a month-to-month basis, small facilities in Tokyo, Japan to support our sales efforts in Japan, the lease for which expires in June 2003 and a small office and warehouse facility outside London, England, the lease for which expires in September 2004. We expect that our current leased facilities will be sufficient for our needs over the next 12 months.

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**ITEM 3. Legal Proceedings**

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

**ITEM 4. Submission of Matters to a Vote of Security Holders**

No stockholder votes took place during the fourth quarter of the year ended December 31, 2002.

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**PART II**

**ITEM 5. Market for Common Equity and Related Stockholder Matters**

Our common stock has been traded on the Nasdaq National Market under the symbol “BABY” since our initial public offering in July 2001. The following table sets forth, for the periods indicated, the high and low closing sales price per share of our common stock, as reported on the Nasdaq National Market.

	<u>High</u>	<u>Low</u>
Fiscal Year Ended December 31, 2002:		
Fourth Quarter	\$4.03	\$3.15
Third Quarter	4.03	3.30
Second Quarter	4.95	3.91
First Quarter	6.00	4.20
Fiscal Year Ended December 31, 2001:		
Fourth Quarter	8.91	3.90
Third Quarter (from July 20, 2001)	15.50	7.10

As of March 19, 2003, there were 16,337,569 shares of our common stock issued and outstanding and held by approximately 151 stockholders of record. We estimate that there are approximately 1,200 beneficial owners of our common stock.

**Dividend Policy**

We have never declared or paid cash dividends on our capital stock. We currently expect to retain future earnings, if any, for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future.

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**ITEM 6. Selected Consolidated Financial Data**

Our selected consolidated financial data is presented below as of December 31, 2002, 2001, 2000, 1999 and 1998 and for each of the years in the five-year period ended December 31, 2002, and is derived from the consolidated financial statements of Natus Medical Incorporated and its subsidiaries. The consolidated financial statements as of December 31, 2002, 2001 and 2000 and for each of the years in the three-year period ended December 31, 2002 are included elsewhere in this report. The selected consolidated balance sheet data as of December 31, 2000, 1999 and 1998 and the consolidated statements of operations data for the years ended December 31, 1999 and 1998 are derived from our consolidated financial statements which are not included in this report. The selected consolidated financial data set forth below is qualified in its entirety by, and should be read in conjunction with, the Consolidated Financial Statements and Notes thereto and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included elsewhere in this report. Certain amounts in the 2001 and prior financial statements have been reclassified to conform to the current year presentation.

	Year ended December 31,				
	2002	2001	2000	1999	1998
	(in thousands, except per share data)				
<b>Consolidated Statement of Operations Data:</b>					
Revenues	\$27,013	\$27,401	\$ 24,633	\$ 19,783	\$ 15,884
Cost of revenues*	12,270	10,843	8,745	6,624	5,577
Gross profit	14,743	16,558	15,888	13,159	10,307
Operating expenses:					
Marketing and selling	13,632	12,476	8,984	7,684	6,275
Research and development	4,875	4,318	3,458	2,457	2,711
General and administrative	4,632	3,628	2,599	2,384	1,638
Amortization of deferred stock compensation*	390	958	611	—	—
Total operating expenses	23,529	21,380	15,652	12,525	10,624
Income (loss) from operations	(8,786)	(4,822)	236	634	(317)
Other income, net	1,296	942	32	20	118
Income (loss) before provision for income taxes	(7,490)	(3,880)	268	654	(199)
Income tax (benefit) provision	(38)	3	33	10	—
Net income (loss)	(7,452)	(3,883)	235	644	(199)
Accretion of redeemable convertible preferred stock	—	763	1,384	2,085	1,389
Net loss available to common stockholders	\$(7,452)	\$(4,646)	\$ (1,149)	\$ (1,441)	\$ (1,588)
Basic and diluted net loss per share	\$ (0.46)	\$ (0.62)	\$ (1.62)	\$ (2.56)	\$ (3.63)
Shares used in computing basic and diluted net loss per share	16,056	7,540	710	562	438
* Amortization of deferred stock compensation included in cost of revenues	\$ 79	\$ 139	\$ 184	\$ —	\$ —
* Amortization of deferred stock compensation attributable to operating expenses:					
Marketing and selling	\$ 216	\$ 507	\$ 157	\$ —	\$ —
Research and development	10	84	105	—	—
General and administrative	164	367	349	—	—
Total	\$ 390	\$ 958	\$ 611	\$ —	\$ —
	December 31,				
	2002	2001	2000	1999	1998
	(in thousands)				
<b>Balance Sheet Data:</b>					
Cash, cash equivalents and short-term investments	\$44,918	\$53,086	\$ 983	\$ 2,376	\$ 1,943
Working capital	50,883	58,642	4,065	3,814	3,206
Total assets	59,340	64,935	10,718	8,699	7,418
Long-term debt, net of current portion	—	—	—	—	150
Convertible preferred stock	—	—	25,226	23,842	21,154

Total stockholders' equity (deficit)	54,687	61,029	(18,283)	(18,226)	(16,851)
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### **ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*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. 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 7 include, but are not limited to, statements regarding the following: the future composition of our revenues and future revenues from international operations, our CO-Stat product strategy and alternative uses for our CO-Stat products, sales, marketing support for our CO-Stat product and clinical studies relating to the CO-Stat product, the CO-Stat as a platform technology, the impact of adoption of accounting standards, acceptance of our products and the products of our competitors, fluctuation of our operating results and gross margins, expansion in and opportunities relating to international markets, future marketing and selling expenses, future operating results, warranty allowances, impact of our application of resources, spending relating to our products, impact of and trends relating to trade-ins, sufficiency of future resources such as employees, future investments, investment in and development of new products and enhancement of existing products, future liquidity and capital requirements, our investment policy, sufficiency of cash and cash equivalents and availability of funds, effect of and exposure to foreign currency exchange rates, market risk exposure, increase in size and number of locations of our customer support organization, development of additional infrastructure and future hiring, cost-effectiveness of our products, third-party reimbursement, consolidation of our industry and consequences intellectual property disputes.*

*You are cautioned not to place undue reliance on forward-looking statements. Forward-looking statements are not guarantees of future performance. The forward-looking statements are subject to substantial risks and uncertainties that could cause our future business, financial condition, or 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," beginning on page 40 of this "Management's Discussion and Analysis of Financial Condition and Results of Operations," and elsewhere in or incorporated by reference into this report. The following discussion and analysis also should be read in conjunction with "Selected Consolidated Financial Data" and our Consolidated Financial Statements and Notes thereto included elsewhere in this report. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. These forward-looking statements are made in reliance upon the safe harbor provision of The Private Securities Litigation Reform Act of 1995.*

#### **Overview**

We develop, manufacture and market screening products for the detection, monitoring, and treatment of common medical disorders in infants. Currently, we sell our ALGO screening products for hearing screening, our CO-Stat products for the analysis of hemolysis and our neoBLUE phototherapy device for the treatment of jaundice.

Our revenues are from sales of equipment and disposable supplies. We currently derive substantially all of our revenues from sales of a limited number of products. Nearly all of our revenues were from sales of our ALGO screening products in 2002, 2001 and 2000. Although we commercially launched our CO-Stat analyzer product in January 2001 and our neoBLUE phototherapy device in October of 2002, we expect that a substantial majority of our revenues will continue to be generated from sales of our ALGO screening products for at least the next two years.

Historically we have sold our products directly through our sales force in the United States and indirectly through distributors internationally. Domestic sales were 83% of our revenues during 2002 and 2001, and 86% of our revenues during 2000. We plan to expand our international operations significantly because we believe

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international markets represent a significant growth opportunity. We acquired the distribution operations of our United Kingdom distributor in January 2001 and also began distribution operations in Japan in July 2001, when we acquired the business operations of our Japanese distributor. The results of our operations in the United Kingdom and Japan were immaterial and have been included in our consolidated results from those dates. We anticipate that international revenues will increase as a percent of revenues in the future. If international sales increase, we may not experience corresponding growth in operating income due to the higher cost of selling outside of the United States. Historically, our international sales have been indirect and through distributors and have been characterized by lower gross margins due to the discount the distributors receive from our list prices.

Our net income or loss can be markedly impacted by the decisions of management regarding the level of resources applied to our business. Management, and our board of directors, makes these decisions on the basis of sales forecasts, expected customer orders, economic conditions and other factors. These costs are primarily personnel and facilities costs that are relatively fixed in the short-term and directly impact net income.

In 2001 and the first half of 2002, we increased our level of spending on the marketing and sales of our CO-Stat products. We spent a considerable amount of time and resources on education of governments, hospitals and clinicians regarding the benefit of our CO-Stat products. Despite these expenditures, we have not achieved the level of sales of our CO-Stat products that we had anticipated. In the third quarter of 2002, we began to reduce marketing and sales expenses associated with our CO-Stat products, in order to adjust our expenses to more accurately reflect our expectations regarding near term revenues. In the fourth quarter of 2002, we also recorded a write-down of excess parts and materials we had purchased for our CO-Stat products. We continue to believe that our CO-Stat technology represents a platform technology and are moving forward with clinical research for additional applications, most notably its use for the detection of medical conditions leading to pre-term delivery. While we intend to continue to support the user base now in place, we are currently evaluating the viability of marketing our CO-Stat products in the newborn jaundice market. We do not expect to realize material revenue from our CO-Stat product in 2003, if ever.

We introduced our neoBLUE phototherapy device in October 2002 at the American Academy of Pediatrics National Conference and Exhibition in Boston, Massachusetts. Our neoBLUE product enhances the line of products and services that we provide to assist clinicians with the management of newborn jaundice. Our current sales and marketing force incorporates our neoBLUE device as part of our jaundice management product offering. Because we have not previously marketed the neoBLUE phototherapy device or devices for the treatment of newborn jaundice, we cannot be certain that it will be well-received by our clinician customers. We do not expect to recognize material revenue from our neoBLUE phototherapy device in 2003, if ever.

During the third quarter of 2002, we implemented an operating cost reduction plan that resulted in a reduction of 18 employees and the accrual of associated employee termination-related benefits. The employee reductions were from production, marketing and sales, research and development, and administrative.

Our net loss available to common stockholders includes accretion charges to increase the carrying amount of our redeemable convertible preferred stock to the amount we would have been required to pay if the preferred stock had been redeemed prior to the date of our initial public offering in July 2001. Our redeemable convertible preferred stock converted to common stock on a one-for-one basis upon the closing of our initial public offering in July 2001 and accretion ceased as of that time. We did not pay accrued dividends on the redeemable convertible preferred stock when it converted, and accrued but unpaid dividends became additional paid-in capital.

As of December 31, 2002, we had total federal and state net operating loss carry forwards of approximately \$13.1 million and \$4.2 million, respectively, available to reduce future taxable income. If not utilized to offset taxable income in future periods, these net operating loss carry forwards will expire in various amounts beginning in 2003 and continuing through 2021. If we continue to have net losses, we may not be able to utilize some or all of our net operating loss carry forwards before they expire. In addition United States income tax law

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imposes limitations on the amount of net operating loss carry forwards we can use in any given year and on the ability to use net operating loss carry forwards if we experience a more than 50% change in ownership during any three-year period.

### **Application of Critical Accounting Policies**

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

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

#### ***Revenue Recognition***

We recognize revenue, net of discounts, from product sales, including sales to distributors, when a purchase order has been received, when title transfers (generally upon shipment), when the selling price is fixed or determinable, and when collection of the resulting receivable is probable. We generally do not provide rights of return on our products. Revenue from extended warranty contracts is recognized ratably over the warranty period. Advance payments from customers are recorded as deferred revenue until shipment of the related product. We have established an allowance for estimated uncollectible accounts receivable.

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 as well as 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.

At December 31, 2002 our deferred revenues under extended warranty contracts were approximately \$325,000. Advance payments from customers were not material at December 31, 2002. Our allowance for estimated uncollectible accounts receivable was \$250,000 at December 31, 2002.

#### ***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.

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. 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.

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### ***Carrying value of intangible assets***

Under generally accepted accounting principles we are required to write down intangible assets if such assets are determined to be impaired. Under current accounting standards, an impairment of an intangible is considered to have occurred when the estimated undiscounted future cash flows related to the asset are less than the carrying value of the asset. Estimates of future cash flows involve consideration of many factors including the marketability of new products, product acceptance and lifecycle, competition, and operating margins. We amortize intangible assets with finite lives over their useful lives; any future changes that would limit their useful lives could result in additional charges to our research and development costs and decrease our operating results. We carry intangibles with indefinite lives at original cost; any future determination that these assets are carried at greater than their expected future undiscounted cash flows could result in additional charges to our research and development costs and decrease our operating results.

At December 31, 2002 we have intangible assets with a carrying value of approximately \$1.1 million.

### ***Liability for product warranties***

Our products are covered by standard one-year product warranty plans. A liability has been established for the expected cost of servicing our products during these warranty 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. 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 decreases to our operating margins and results of operations.

At December 31, 2002 our reserve for product warranties is approximately \$200,000.

### ***Valuation allowance for deferred tax assets***

We record a valuation allowance against our deferred tax assets, which result primarily from net operating loss and credit carryforwards that expire over time, and timing differences between book and tax results. In evaluating whether we would more likely than not recover these deferred tax assets, we have not assumed any future taxable income in the tax jurisdictions in which we operate. To the extent we establish a valuation allowance, or increase this allowance in a period, we include an offsetting expense within the tax provision in the consolidated statement of operations. Future income generation in these tax jurisdictions could lead to the reversal of these valuation allowances and additional income recognition.

At December 31, 2002, our net deferred tax assets were zero, net of an \$8.0 million valuation allowance.

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### Results of Operations

The following table sets forth for the periods indicated selected consolidated statement of operations data as a percentage of total revenues. Our historical operating results are not necessarily indicative of the results for any future period. Certain amounts in the 2001 and 2000 financial statements have been reclassified to conform to the current year presentation.

	Percent of Revenue		
	Years Ended December 31,		
	2002	2001	2000
Revenues	100.0%	100.0%	100.0%
Cost of revenues*	45.4	39.6	35.5
Gross profit	54.6	60.4	64.5
Operating expenses:			
Marketing and selling	50.5	45.5	36.5
Research and development	18.1	15.8	14.0
General and administrative	17.1	13.2	10.5
Amortization of deferred stock compensation*	1.4	3.5	2.5
Total operating expenses	87.1	78.0	63.5
Income (loss) from operations	(32.5)	(17.6)	1.0
Other income, net	4.8	3.4	0.1
Income (loss) before provision for income taxes	(27.7)	(14.2)	1.1
Income tax (benefit) provision	0.1	—	0.1
Net income (loss)	(27.6)	(14.2)	0.9
Accretion of redeemable convertible preferred stock	—	2.8	5.7
Net loss available to common stockholders	(27.6)%	(17.0)%	(4.7)%
* Amortization of deferred stock compensation included in cost of revenues	0.3 %	0.5 %	0.7 %
* Amortization of deferred stock compensation attributable to operating expenses:			
Marketing and selling	0.8 %	1.9 %	0.7 %
Research and development	—	0.3	0.4
General and administrative	0.6	1.3	1.4
Total	1.4 %	3.5 %	2.5 %

### Comparison of 2002 and 2001

Our revenues decreased \$388,000, or 1.4%, to \$27.0 million in 2002 from \$27.4 million in 2001. This decrease was primarily attributable to decreased quantities of ALGO screening hardware sold, partially offset by increased quantities of ALGO screening supplies sold. Revenue from ALGO screening hardware decreased \$1.5 million, or 17%, to \$7.4 million in 2002 from \$8.9 million in 2001. Revenues from ALGO screening disposable supplies increased \$0.7 million, or 4%, to \$18.4 million in 2002 from \$17.6 million in 2001. As a percent of revenues, revenues from sales of ALGO screening disposables increased to 68% in 2002 from 64% in 2001. No end customer accounted for more than 10% of our revenues in either 2002 or 2001.

Revenues from sales outside the United States were \$4.7 million for both 2002 and 2001. Revenue from Europe increased by \$0.7 million to \$1.9 million in 2002, revenue from Australia/New Zealand increased by \$266,000 to \$339,000 in 2002, while revenue from Asia decreased by \$1.0 million to \$2.4 million in 2002. International sales of ALGO screening hardware decreased by \$1.1 million to \$2.6 million, while international sales of ALGO screening supplies increased by \$0.9 million to \$1.9 million.

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Our cost of revenues increased \$1.4 million, or 13%, to \$12.3 million in 2002 from \$10.8 million in 2001. The increase in the cost of revenues was primarily due to the write-down of \$450,000 of excess inventory related to the CO-Stat analyzer, higher costs associated with producing the new ALGO Pak supply, and increases in manufacturing costs. Cost of revenues also includes an adjustment of \$230,000 to decrease the reserve for expected warranty costs to reflect recent improved warranty cost experience. Cost of revenues included amortization of \$79,000 of deferred stock compensation in 2002 and \$139,000 in 2001. As a percent of revenues, the cost of revenues increased to 45% in 2002 from 40% in 2001.

Gross profit decreased \$1.8 million, or 11%, to \$14.7 million in 2002 from \$16.6 million in 2001. Gross profit as a percentage of revenues decreased to 55% in 2002 from 60% in 2001. The increase in cost of revenues and the decrease in gross profit as a percentage of revenues was to attributable the write-down of inventory, higher costs associated with producing the new ALGO Pak supply, and increases in manufacturing costs.

Our marketing and selling expenses increased \$1.2 million, or 9%, to \$13.6 million in 2002 from \$12.5 million in 2001. The dollar increase in marketing and selling expenses was primarily attributable to the expansion of our international sales efforts, as well as business development efforts.

Our research and development expenses increased \$557,000, or 13%, to \$4.9 million in 2002 from \$4.3 million in 2001. This increase in research and development expenses was primarily attributable to the development of new products based on technology acquired from Pemstar/Pacific Consultants.

Our general and administrative expenses increased \$1.0 million, or 28%, to \$4.6 million in 2002 from \$3.6 million in 2001. The dollar increase in general and administrative expenses was primarily attributable to increased legal, accounting and other consulting fees, increases in insurance costs, and increases in reserves for estimated local tax expense. Many of the increased costs were costs associated with being a public company for the entire year.

In September 2002, we recorded a restructuring charge of approximately \$255,000 relating to an operating cost reduction plan which resulted in a reduction of 18 employees and the accrual of associated employee termination-related benefits. The employee reductions were from production, marketing and sales, research and development, and administrative. Accordingly, the related charges were recorded in cost of revenues, marketing and selling, research and development, and general and administrative expenses. As of December 31, 2002, we had paid approximately \$234,000 of costs related to the restructuring.

We recorded aggregate amortization of \$469,000 of deferred stock compensation in 2002, of which \$79,000 was included in cost of revenues, and \$1.1 million of deferred stock compensation in 2001, of which \$139,000 was included in cost of revenues.

Our other income (expense), net increased \$354,000 or 38%, to \$1.3 million in 2002 from \$942,000 in 2001. The increase was primarily due to foreign currency gains as well as interest earned on greater average cash and short-term investment balances in 2002 as a result of our initial public offering.

### ***Comparison of 2001 and 2000***

Our revenues increased \$2.8 million, or 11%, to \$27.4 million in 2001 from \$24.6 million in 2000. This increase was primarily attributable to increased quantities of disposable supplies sold. Revenues from disposable supplies increased \$2.6 million, or 18%, to \$17.6 million in 2001 from \$15.0 million in 2000. As a percent of revenues, revenues from sales of disposables increased to 64% in 2001 from 61% in 2000. No end customer accounted for more than 10% of our revenues in either 2001 or 2000. Sales to our Japanese distributor, Nippon Eurotec, accounted for 11% of our revenues in 2000.

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Revenues from sales outside the United States increased \$1.4 million, or 42%, to \$4.7 million in 2001 from \$3.3 million in 2000. This increase was due primarily to higher quantities of our products sold in Japan, the United Kingdom and other countries as well as increases in realized selling prices associated with our subsidiaries now acting as distributors in those countries. Japanese sales were \$3.4 million in 2001 and \$2.7 million in 2000.

Our cost of revenues increased \$2.1 million, or 24%, to \$10.8 million in 2001 from \$8.7 million in 2000. The increase in the cost of revenues in dollars was primarily due to the increased volume of screening equipment and disposable supplies sold during 2001 and increases in manufacturing costs. Cost of revenues included amortization of \$139,000 of deferred stock compensation in 2001 and \$184,000 in 2000. As a percent of revenues, the cost of revenues increased to 40% in 2001 from 36% in 2000.

Gross profit increased \$670,000, or 4%, to \$16.6 million in 2001 from \$15.9 million in 2000. Gross profit as a percentage of revenues decreased to 60% in 2001 from 65% in 2000. The increase in cost of revenues and the decrease in gross profit as a percentage of revenues was attributable to increased fixed costs related to the hiring of additional employees, increased consulting costs and increased manufacturing costs, particularly those associated with early production runs of our ALGO 3 screening disposable supplies. We experienced a reduction in the effective selling price of our ALGO 3 screening equipment due to an increase in the number of units sold in connection with trade-ins. Trade-ins reduced margins by up to \$5,000 per unit, and are typically more frequent at the commencement of a new model cycle.

Our marketing and selling expenses increased \$3.5 million, or 39%, to \$12.5 million in 2001 from \$9.0 million in 2000. The dollar increase in marketing and selling expenses was primarily attributable to the hiring of additional marketing and selling personnel, increases in commissions due to increased sales and the expansion of our sales efforts, particularly in connection with an increase in our domestic field staff and the acquisition of our distributors in Japan and the United Kingdom during 2001. We expect that marketing and selling expenses will continue to increase in the future.

Our research and development expenses increased \$860,000, or 25%, to \$4.3 million in 2001 from \$3.5 million in 2000. This increase in research and development expenses was primarily attributable to the hiring of additional engineers and consultants.

Our general and administrative expenses increased \$1.0 million, or 40%, to \$3.6 million in 2001 from \$2.6 million in 2000. The dollar increase in general and administrative expenses was primarily attributable to the hiring of additional personnel, as well as increased legal, accounting and other consulting fees and insurance costs. Payroll, consulting and manufacturing costs in 2001 increased 28% over 2000, a rate greater than our increase in revenue. Many of the increased costs were costs associated with being a public company.

We recorded aggregate amortization of \$795,000 of deferred stock compensation in 2000, of which \$184,000 was included in cost of revenues and \$1.1 million of deferred stock compensation in 2001, of which \$139,000 was included in cost of revenues.

Our other income (expense), net increased \$910,000 to \$942,000 in 2001 from \$32,000 in 2000. The increase was primarily due to higher interest earned on increased average cash and short-term investment balances in 2001 as a result of our initial public offering.

### **Liquidity and Capital Resources**

As of December 31, 2002, we had cash, cash equivalents and short-term investments of \$44.9 million, stockholders' equity of \$54.7 million and working capital of \$50.9 million. We completed an initial public offering of 5,000,000 shares of our common stock at \$11.00 per share in July 2001 and raised \$51.2 million after underwriting discounts and commissions, but before expenses payable by us. In August 2001, our managing



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underwriters exercised their right to purchase an additional 750,000 shares of our common stock at \$11.00 per share for net proceeds of \$7.7 million after underwriting discounts and commissions but before any expenses payable by us.

Net cash used in operating activities of \$6.1 million for 2002 compared to net cash used in operating activities of \$4.6 million for 2001, and net cash provided by operating activities of \$375,000 for 2000. Cash used in operating activities for 2002 resulted primarily from the net loss during the period and an increase in inventories, accounts receivable, and prepaid expenses, and a decrease in accrued expenses. These factors were partially offset in part by an increase in accounts payable and non-cash items such as depreciation and amortization of intangibles and deferred compensation. The increase in inventories was due primarily to having inventory at our Japanese and UK subsidiaries at December 31, 2002, whereas in 2001 these inventories were owned by our independent distributors. A portion of the increase in inventory was also additional domestic inventory associated with the ALGO 3 screener product line. Net cash used in operating activities for 2001 resulted primarily from the net loss during the period and an increase in inventories and a decrease in accrued liabilities, offset in part by non-cash items such as deferred stock compensation and depreciation and amortization. Increases in inventories and accounts receivable were primarily associated with the acquisition and expansion of our wholly owned foreign operations in the United Kingdom and Japan. Net cash provided by operating activities for 2000 resulted primarily from non-cash items such as deferred stock compensation and depreciation and amortization, plus an increase in accrued liabilities, reduced by an increase in accounts receivable and inventories.

Net cash used in investing activities was \$7.2 million for 2002, \$23.5 million for 2001, and \$762,000 for 2000. Net cash used in investing activities during 2002 was primarily the result of acquisition of property and equipment, including a major upgrade to the company's existing enterprise resource planning system, as well as increases in deposits and other assets, and purchases of short term investments, net of sale proceeds. Net cash used in investing activities during 2001 was primarily for investment of cash received as a result of our initial public offering and for the purchase of new computers, equipment and furniture as we expanded operations. Net cash used in investing activities for 2000 was primarily for the purchase of new computers, equipment and furniture as we expanded operations. Because of our investment policy, the types of investments we may make are limited. Primarily all of our short-term investments are available-for-sale securities with maturities of less than a year, and fluctuations between cash equivalents and short-term investments are often attributable to investment decisions. We had no material capital expenditure commitments as of December 31, 2002. We have a \$334,000 interest-bearing certificate of deposit that is classified as a held to maturity investment. This investment matures in April 2004 and was assigned to a bank in February 1999 to guarantee a loan on a primary residence of an officer totaling \$250,000 plus accrued interest. The guarantee is collateralized by 26,688 shares of our stock held by the officer.

Net cash provided by financing activities of \$664,000 for 2002 was primarily from the proceeds of purchases of stock by employees pursuant to our stock option and purchase plans. Net cash provided by financing activities of \$57.8 million for 2001 resulted primarily from the net proceeds received from our initial public offering offset by deferred offering costs. Net cash used in financing activities of \$1.0 million for 2000 resulted primarily from deferred offering costs and repayment of borrowings.

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

- the amount and timing of revenues;
- the extent to which our existing and new products gain market acceptance;
- the extent to which we make acquisitions;
- the cost and timing of product development efforts and the success of these development efforts;
- the cost and timing of marketing and selling activities; and
- available borrowings under line of credit arrangements and the availability of other means of financing.



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We have entered into noncancelable operating leases for its facilities located in the United States through December 2005. Noncancelable operating leases for facilities located in the United Kingdom expire in 2004, and in Japan in 2003. Minimum lease payments under noncancelable operating leases as of December 31, 2002 are as follows (in thousands):

	<b>Operating Leases</b>
Year Ending December 31,	
2003	\$ 470
2004	396
2005	473
2006	—
2007	—
<b>Total minimum lease payments</b>	<b>\$ 1,339</b>

We had various firm purchase commitments for inventory totaling approximately \$215,000 at December 31, 2002.

In March 2002, we entered into an agreement to acquire certain intellectual property and technology patents of a private company for \$1.0 million subject to certain conditions to closing and other obligations of the seller. We financed the acquisition with short-term notes payable that do not bear interest. Payments of \$500,000 each were made in April and July 2002, and the notes have been paid in full. We also entered into a product development agreement with respect to the acquired rights, which we expect will involve additional payments in the aggregate amount of \$500,000 between April 1, 2002 and September 30, 2003. As of December 31, 2002, we have paid \$250,000 of the costs associated with the product development agreement.

We believe that our current cash and cash equivalent balances and any cash generated from operations and from current or future debt financing will be sufficient to meet our operating and capital requirements for at least the next 18 months. However, it is possible that we may require additional financing within this period. We intend to continue to invest in the development of new products, and enhancements to our existing products, and in both existing and new product distribution domestically and overseas. The factors described above will affect our future capital requirements and the adequacy of our available funds. In addition, even if our current funds are sufficient to meet our anticipated cash needs during the next 18 months, we may need to raise additional funds beyond this time, particularly if we invest significant amounts in the acquisition of businesses and products. We may be required to raise those 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.

### **Quantitative and Qualitative Disclosures about Market Risk**

We develop products in the United States and sell those products primarily in the United States, Japan and Europe. 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. Prior to our acquisition of the distribution activities of our top-tier distributor in Japan and our acquisition of our distributor in the United Kingdom, our sales generally were denominated in United States dollars. Since that time, our expenses and revenues in these countries have increasingly been denominated in the applicable foreign currency. As our operations in Japan and the United Kingdom increase, we expect that our exposure to foreign currency fluctuations will increase. Changes in exchange rates also may affect the volume of our sales or our foreign currency sales prices compared to those of our foreign competitors and could make our products less competitive in those countries. If the United States dollar uniformly increased or decreased in strength by 10% relative to the currencies in which our sales were denominated, our net loss would have correspondingly increased or decreased by an estimated \$100,000 for

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the year ended December 31, 2002. For purposes of this calculation, we have assumed that the exchange rates would change in the same direction relative to the United States dollar.

Our interest income is sensitive to changes in the general level of interest rates in the United States, particularly since the majority of our investments are in short-term instruments. However, as substantially all of our short-term investments carry a fixed rate of interest, a hypothetical decrease of 10% in market interest rates would not result in a material decrease in interest income earned on investments held at December 31, 2002 through the date of maturity on those investments.

The fair value of our available-for-sale securities is also sensitive to changes in the general level of interest rates in the United States, 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 December 31, 2002, the fair value of our portfolio would decline by an immaterial amount.

All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of December 31, 2002. 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.

Our investment policy permits us to invest funds in excess of current operating requirements in:

- corporate securities including commercial paper, rated A1, P1 or better, and corporate debt instruments, including medium term notes and floating rate notes issued by foreign and domestic corporations, that pay in United States dollars and carry a rating of A or better;
- bank certificates of deposit and banker's acceptances that are rated at least A1 or P1;
- United States treasury bills, notes and bonds and United States AAA-rated agency securities that carry the direct or implied guarantee of the United States government, including notes, discount notes, medium term notes and floating rate notes;
- asset-backed securities rated A or better;
- repurchase agreements with major banks and dealers that are recognized as primary dealers by the Federal Reserve Bank of New York;
- money market mutual funds that offer daily purchase and redemption; and
- tax exempt/tax advantage investments in money market funds, variable rate demand notes, municipal notes or bonds and auction preferred municipal and corporate securities.

In July and August 2001, we received \$58.8 million in aggregate net proceeds in connection with our initial public offering after deducting underwriting discounts and commissions, but before deducting offering expenses payable by us. We are currently investing net offering proceeds from the offering pursuant to our investment policy.

### **Recent Accounting Pronouncements**

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that all business combinations initiated after September 30, 2001 be accounted for under the purchase method and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible

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assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will rather be tested at least annually for impairment. Under the provisions of SFAS No. 142, any impairment loss identified upon adoption of this standard is recognized as a cumulative effect of a change in accounting principle, which is charged directly to retained earnings. Any impairment loss incurred subsequent to initial adoption of SFAS No. 142 is recorded as a charge to current period earnings. We adopted SFAS No. 142 on January 1, 2002 and stopped amortizing immaterial amounts of goodwill that resulted from business combinations completed prior to September 30, 2001. The adoption of SFAS No. 141 and 142 did not have a material effect on our financial position or results of operations.

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs, including legal obligations. We are required to adopt SFAS No. 143 January 1, 2003. We currently believe the adoption of SFAS No. 143 will not have a material effect on our financial position or results of operations.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, effective for fiscal years beginning after December 31, 2001. Under the new rules, the criteria required for classifying an asset as held-for-sale have been significantly changed. Assets held-for-sale are stated at the lower of their fair values or carrying amounts, and depreciation is no longer recognized. In addition, the expected future operating losses from discontinued operations will be displayed in discontinued operations in the period in which the losses are incurred rather than as of the measurement date. More dispositions will qualify for discontinued operations treatment in the statement of operations under the new rules. We adopted SFAS No. 144 January 1, 2002. The adoption of SFAS No. 144 did not have any impact on our financial position, results of operations or cash flows.

In April 2002, the FASB issued SFAS No. 145, which, among other things, changed the presentation of gains and losses on the extinguishment of debt. Any gain or loss on extinguishment of debt that does not meet the criteria in APB Opinion 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions", shall be included in operating earnings and not presented separately as an extraordinary item. We will adopt SFAS No. 145 January 1, 2003.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue, or EITF, No. 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit on Activity (including Certain Costs Incurred in a Restructuring)*. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost was recognized at the date of the Company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amount recognized. We will adopt the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002.

In November 2002, the FASB issued Interpretation (FIN) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantee of Indebtedness of Others*. This interpretation addresses the disclosures to be made by guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. FIN No. 45 also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. In accordance with FIN No. 45, the Company adopted the disclosure requirements on December 31, 2002 and is required to adopt the recognition requirements effective on January 1, 2003. The Company is evaluating the impact on the recognition requirements of this interpretation and does not expect it to have a material impact on its financial position results of operations, EPS or cash flows.

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In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. This statement amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide companies with alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. Additionally, SFAS No. 148 amends certain disclosure requirements of SFAS No. 123. The Company adopted the annual disclosure requirements of SFAS No. 148 as of December 31, 2002. The transitional provisions of SFAS No. 148 did not have an impact on the Company's financial position, results of operations, EPS, or cash flows, as the fair value method has not been adopted.

### **Risk Factors**

#### **We have a history of losses and may experience losses in the future, which may result in the market price of our common stock declining**

Since our inception, we have incurred significant net losses and we may incur net losses in 2003.

We anticipate that our expenses may increase substantially in the foreseeable future as we:

- continue to invest in research and development to enhance our ALGO screening, neoBLUE phototherapy device and develop new products and technologies;
- develop additional applications for our current technology, such as the use of our CO-Stat analyzer for the detection of pre-term labor and pre-eclampsia;
- increase our marketing and selling activities, particularly outside the United States;
- continue to increase the size and number of locations of our customer support organization, particularly outside the United States; and
- develop additional infrastructure and hire required management and other employees to keep pace with our growth.

As a result of these possible increased expenses, we may need to generate significantly higher revenues to achieve profitability. We cannot be certain that we will achieve profitability in the future or, if we achieve profitability, sustain it. If we do not achieve and maintain profitability, the market price of our common stock is likely to decline, perhaps substantially.

#### **We have relied, and expect to continue to rely, on sales of our ALGO screening product family for substantially all of our revenues, and a decline in sales of these products could cause our revenues to fall**

Historically, we have derived substantially all of our revenues from sales of our ALGO screening products. We expect that the revenues from our ALGO screening product family will continue to account for a substantial majority of our revenues for at least the next two years. To date, our MiniMuffs product, which is a disposable ear cover for newborns, and our CO-Stat analyzer product, which is a jaundice management device for newborns, have accounted for only a small percentage of our revenues. We have not derived any significant revenues from sales of our CO-Stat analyzer products and have recently decreased sales and marketing resources devoted to these products. We are also currently evaluating the viability of marketing our CO-Stat products in the newborn jaundice market and may determine to cease these marketing efforts altogether. We introduced our neoBLUE phototherapy device in October 2002 and do not expect to recognize any material revenues from this product during 2003, if ever. Any factors adversely affecting the pricing of our ALGO screening equipment and related disposables or demand for our ALGO screening products, including physician acceptance or the selection of competing products, could cause our revenues to decline and our business to suffer.

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### **If more physicians do not adopt our ALGO screening products, CO-Stat analyzer products and neoBLUE phototherapy device, we will not achieve future sales growth**

We acquired the ALGO screening product technology in 1987, introduced our CO-Stat analyzer product in January 2001 and introduced our neoBLUE phototherapy device in October 2002. More neonatologists and pediatricians must adopt these products for our sales to increase. To date, we have not achieved the revenue levels we previously anticipated with respect to our CO-Stat products and have decreased the resources devoted to these products. We believe that physicians will not use our products unless they determine, based on published peer-reviewed journal articles, long-term clinical data and experience, that the products provide an accurate and cost-effective alternative to other means of testing for hearing impairment or jaundice management. There are currently alternative hearing screening and jaundice management products, which may be less expensive or may be quicker on a per test basis. Physicians are traditionally slow to adopt new products, testing practices and treatments, partly because of perceived liability risks and the uncertainty of third party reimbursement. If more neonatologists and pediatricians do not adopt our products, we may never have significant revenues or achieve and maintain profitability. Factors that may affect the medical community's acceptance of our products, some of which are beyond our control, include:

- the changing governmental and physician group guidelines for screening of newborns, particularly with respect to full term babies;
- the performance, quality, price and total cost of ownership of our screening and jaundice management products relative to other screening and jaundice management products for newborns;
- our ability to maintain and enhance our existing relationships and to form new relationships with leading physician organizations, hospitals and third party payors;
- changes in state and third party payor reimbursement policies for newborn screening equipment; and
- the adoption of state and foreign laws requiring universal newborn screening.

### **A continuation of the general economic downturn in the United States or abroad may reduce our revenue and harm our business**

The primary customers for our products are neonatologists, physicians, audiologists, hospitals and government agencies. Any significant downturn in domestic or global economic conditions which results in the reduction of the capital spending budgets of our customers or a delay in capital equipment purchases would likely result in a decline in demand for our products and could be detrimental to our business. Economic growth in the United States and other countries has slowed significantly and many commentators believe that the United States economy is experiencing a recession. Overall, customer spending is getting tighter and spending decisions are being more closely scrutinized. These conditions have negatively impacted our business and may continue to do so if they persist. Like other companies, we currently have very limited visibility with respect to our near term quarters and are having difficulty predicting our revenues and operating results during these periods.

### **A sluggish economy as a result of recent and future terrorist attacks and the uncertainty of war could have an adverse effect on our business**

The September 11, 2001 terrorist attacks in New York and Washington D.C. contributed to the slowdown in the United States economy and the economies of other countries. At the time of the attacks, capital investment by businesses, particularly capital investment in technology, had been experiencing substantial weakness. Continuing economic and political uncertainties, both domestically and abroad, resulting from these attacks and the uncertainty of war have resulted in declines in new technology investments by our customers, including investment in our products. We do not know what further effect future terrorist attacks, or resulting military actions by the United States and war, could have on our business, revenues or results of operations. If our customers or potential customers defer or cancel purchases of our products, our revenues will be adversely affected, which would harm our results of operations and financial condition.

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### **Our quarterly operating results may fluctuate, which could cause our stock price to fluctuate**

Our revenues 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 revenues, operating results and margins to fluctuate significantly from quarter to quarter:

- the budgeting cycle of our customers;
- the size and timing of specific sales, such as large purchases of screening equipment or disposables by government agencies or hospital systems;
- product and price competition;
- trade-in allowances or other concessions in connection with the introduction of new products or improvements to existing products;
- the timing and market acceptance of new product introductions and product enhancements by us and our competitors, such as the expected reduction in demand for and potential inventory obsolescence relating to our existing ALGO screener prior to or after the announced launch date of our next generation ALGO screener;
- the length of our sales cycle;
- the loss of key sales personnel or international distributors; and
- changes caused by the rapidly evolving market for newborn screening products.

In addition, if a majority of our customers were to implement enterprise-wide evaluation programs or purchase products for the entire organization at once, our sales cycle could lengthen and our revenues could be erratic from quarter to quarter.

We have limited historical experience selling our products other than our hearing screening products and cannot determine how the sales cycle for these products will affect our revenues. The sales cycle, however, could be protracted and could result in further unpredictability in our revenues from quarter to quarter.

Many of these factors are beyond our control, and 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. If our revenues vary significantly from quarter to quarter, our business could be difficult to manage and our quarterly results could be below expectations of investors and stock market analysts, which could cause our stock price to fluctuate.

### **Our operating results have been and may continue to be subject to seasonal fluctuations**

We experience seasonality in the sale of our screening equipment. For example, our sales typically decline from our fourth fiscal quarter to our first fiscal quarter. We anticipate that we will continue to experience relatively lower sales in 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. These seasonal factors may lead to fluctuations in our quarterly operating results. It is difficult for us to evaluate the degree to which the summer slow down and capital budgeting and customer purchasing cycle variations may make our revenues unpredictable in the future.

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

We intend to develop additional testing products for the diagnosis and monitoring of common medical conditions in infants and pregnant women. Developing new products and improving our existing products to meet the needs of neonatologists and pediatricians requires significant investments in research and development.

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If we fail to successfully develop and market new products and update our existing products, our operating results may decline as our existing products reach the end of their commercial life cycles.

### **Our future growth and profitability will depend, at least in part, on our ability to achieve volume sales of our CO-Stat analyzer and neoBLUE phototherapy products**

We introduced our CO-Stat analyzer product family for clinical research uses in July 1999 and began commercially marketing it in January 2001. We introduced our neoBLUE phototherapy device in October 2002. To date, CO-Stat analyzer products and neoBLUE phototherapy devices have accounted for only a limited portion of our revenues. We have experienced limited success in marketing and selling our CO-Stat analyzer products and have limited experience marketing and selling our neoBLUE phototherapy device. We are currently evaluating the viability of marketing our CO-Stat analyzer products in the newborn jaundice market, but continue to support clinical research and development relating to our CO-Stat analyzer products in this area and for other clinical applications. Our future growth and profitability will depend, in part, on our ability to commercially sell CO-Stat analyzer products and the neoBLUE phototherapy device in volume. We cannot be certain that our CO-Stat analyzer products or our neoBLUE phototherapy device will be successful, that a market for these products will develop at all or that physicians, governments or other third party vendors will accept and adopt these products.

### **Physicians may not adopt or continue to use our CO-Stat analyzer or neoBLUE phototherapy products if we cannot show that these products are cost-effective or if clinical data does not support our products, which would harm our operating results**

One clinical study has concluded that our CO-Stat analyzer product is more cost-effective than another test for detecting hemolysis in jaundiced newborns. Our safety, effectiveness, reliability, sensitivity and specificity data for the use of our CO-Stat analyzer products for purposes of newborn jaundice management is based in part on a study of over 1,300 newborns conducted in 1998. In addition, clinical research is ongoing with respect to additional applications for our CO-Stat analyzer, most notably the detection of medical conditions leading to pre-term delivery. With respect to our neoBLUE phototherapy device, initial data from clinical research suggests that the device may be more effective in treating hyperbilirubinemia than other currently marketed phototherapy products. We cannot be certain that clinical studies will produce results that are favorable to our products. If studies and clinical experience do not support our products or demonstrate their cost-effectiveness, our products may not gain commercial acceptance and may not be accepted by physicians and governments, which would harm our operating results. In addition, we could be subject to significant liability for any failure of our products to perform properly, and could have similar problems with any other product we offer in the future.

### **If the guidelines for recommended universal newborn screening do not continue to develop in the United States and foreign countries, and governments do not require testing of all newborns as we anticipate, our revenues may not grow because our products will not be needed for universal newborn screening**

The demand for our screening products depends, in part, upon state and foreign governments' adoption of universal screening requirements for the disorders for which our products screen. The guidelines for universal newborn screening for hearing impairment and jaundice monitoring have been adopted by some physician groups and governments only recently. We cannot predict the outcome or the impact that statutes and government regulations requiring universal newborn screening will have on our sales. The widespread adoption of these guidelines will depend on our ability to educate government agencies, neonatologists, pediatricians, third party payors and hospital administrators about the benefits of universal newborn hearing testing and the benefits of universal newborn hemolysis monitoring, as well as the use of our products to perform the screening and monitoring.



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### **Our revenues may not grow if densely populated states and foreign countries do not adopt guidelines requiring universal newborn hearing screening or if those guidelines have a long phase-in period**

If the governments in the most densely populated states and foreign countries do not require universal screening for the disorders for which our products test, our business would be harmed and our revenues may not grow. As of December 31, 2002, 37 states and the District of Columbia had mandated universal newborn hearing screening, but the phase-in of these guidelines varies widely from six months to four years. To date, there has been only limited adoption of newborn hearing screening prior to hospital discharge by foreign governments. Our revenues may not grow if hospitals are slow to comply with these guidelines or the applicable government provides for a lengthy phase-in period for compliance.

### **Our revenues may not grow if state and foreign governments do not mandate hemolysis monitoring as the standard of care for newborn jaundice screening, or if we are not able to successfully establish other uses for our CO-Stat analyzer products**

To date, physician groups and federal, state and local governments have not mandated the screening methodology to be used for newborn jaundice management or established monitoring of hemolysis as the best practice. If these mandates or practice recommendations are not issued, or we are unable to successfully establish other uses for our CO-Stat analyzer products, a market may not develop for our CO-Stat analyzer products.

### **Any failure in our efforts to educate clinicians, government and other third party payors could significantly reduce our product sales**

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 success of our products depends upon physician, government agency and other third party payor confidence in the benefits of our products as well as their comfort with the reliability, sensitivity and specificity of our products. The impact of our products will not be demonstrable unless highly sensitive and specific evaluations are performed on a substantial number of newborns, including those who do not have risk factors for hearing impairment or who do not display signs of jaundice. If we fail to demonstrate the effectiveness of our products and the potential long-term benefits to patients and third party payors of universal newborn screening, our products will not be adopted.

### **If health care providers are not adequately reimbursed for procedures conducted with our equipment or for our products, we may never achieve significant revenues**

Physicians, hospitals and state agencies are unlikely to purchase our products if clinicians are not adequately reimbursed for the procedures conducted with our equipment or the disposable products needed to conduct screenings. Unless a sufficient amount of positive, peer-reviewed clinical data about our products has been published, third party payors, including insurance companies and government agencies, may refuse to provide reimbursement for the cost of newborn hearing screening and jaundice management with our products. 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 be dependent upon the availability of adequate reimbursement or funding, as the case may be, within prevailing health care payment systems. Reimbursement, funding and health care payment systems vary significantly by country and include both government-sponsored health care and private insurance. Although we intend to seek international reimbursement or funding approvals, we may not obtain these approvals in a timely manner or at all.



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### **Even if third party payors provide adequate reimbursement for procedures conducted with our equipment, or for our products, 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. 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. We cannot assure you that in a managed care system the cost of our products will be incorporated into the overall payment for childbirth and newborn care or that there will be adequate reimbursement for our equipment and disposable products separate from reimbursement for the procedure. Unless the cost of screening is reimbursed as a standard component of the newborn's care, universal screening is unlikely to occur and the number of infants likely to be screened with our products will be substantially reduced.

### **We have very limited experience selling and marketing products other than our ALGO screening products, and our failure to develop and manage our sales force or to effectively market and distribute our CO-Stat analyzer, neoBLUE phototherapy device or other products will hurt our revenues and quarterly results**

Our sales force has achieved limited success selling our CO-Stat analyzer, and has limited experience selling our neoBLUE phototherapy device and related products, and we cannot predict how successful our sales force will be in selling them in the future. In order to successfully introduce and penetrate the market for our CO-Stat analyzer and neoBLUE phototherapy device products, we must sell our products to hospital administrators accustomed to the use of laboratory bench equipment rather than portable point of care screening devices for jaundice management.

We market almost all of our newborn hearing screening products in the United States through a direct sales force. There are significant risks involved in building and managing our sales force and marketing our products. We may be unable to hire a sufficient number of qualified sales people with the skills and training to sell our newborn hearing screening and jaundice management products effectively. Furthermore, we do not have any agreements with distributors for domestic sales of our products.

### **We may not be successful in generating revenues from our CO-Stat or neoBLUE products because we may encounter difficulties in manufacturing them in commercial quantities**

We do not have experience manufacturing our CO-Stat or neoBLUE products in commercial quantities, and we may encounter difficulties in the manufacturing of these products. We may also increase our manufacturing personnel or increase the volume of products we purchase from contract manufacturers that produce the CO-Stat or neoBLUE products for us. If we encounter any of these difficulties, we may not be successful in marketing our CO-Stat or neoBLUE products, and our revenues and financial condition may be harmed.

### **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. For certain of these materials and components, relatively few alternative sources of supply exist. In addition, the lead-time involved in the manufacturing of some of these components can be lengthy and unpredictable. During 2002, we experienced delays on the part of a supplier to provide us with volume production of our new ALGO 3 screening Flexicoupler supplies. If these suppliers become unwilling or unable to supply us with 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 revenues and operating results to suffer.

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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 cannot be assured that we would be able to obtain the necessary regulatory clearance or approval. This could create supply disruptions that would harm our product sales and operating results.

There is only one Natus approved supplier that provides hydrogel, the adhesive used in our disposable products. In addition, we have relied on a single supplier for the electrochemical sensors used in our CO-Stat analyzer and we have not qualified another vendor for this component. A disruption in the supply of the adhesive or electrochemical sensors could negatively affect our revenues. If we or our contract manufacturers were unable to locate another supplier, it could significantly impair our ability to sell our products. In addition, we may be required to make new or supplemental filings with applicable regulatory authorities prior to our marketing a product containing new materials or produced in a new facility. If we fail to obtain regulatory approval to use a new material, we may not be able to continue to sell the affected products and revenues and operating results could suffer.

### **Our sales efforts through group purchasing organizations and sales to high volume purchasers may reduce our average selling prices, which would reduce our revenues 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 off of our normal selling prices and other special pricing considerations, which could cause our revenues and profit margins to decline. In addition, we have entered into agreements to sell our products to members of group purchasing organizations, which negotiate volume purchase prices for medical devices and supplies for member hospitals, group practices and other clinics. While we make sales directly to group purchasing organization members, the members of these group purchasing organizations now receive volume discounts off our normal selling price and may receive other special pricing considerations from us from time to time. Sales to members of one group purchasing organization, Novation, LLC, accounted for approximately 29%, 25% and 22% of our total revenues in the twelve months ended December 31, 2002, 2001 and 2000 respectively. Sales to members of group purchasing organizations accounted for approximately 47%, 35% and 23% of our total revenues the twelve months ended December 31, 2002, 2001 and 2000 respectively. Other of our existing customers may be members of group purchasing organizations with which we do not have agreements. Our sales efforts through group purchasing organizations may conflict with our direct sales efforts to our existing customers. If we enter into agreements with new group purchasing organizations and some of our existing customers begin purchasing our products through those group purchasing organizations, our revenues and profit margins could decline.

### **We rely on sales to existing customers for a majority of our revenues, and if our existing customers do not continue to purchase products from us, our revenues may decline**

We rely on sales of additional screening products to our existing customers for a majority of our revenues. If we fail to sell additional screening products to our existing customers directly or indirectly, we would experience a material decline in revenues.

### **Because we rely on distributors or sub-distributors to sell our products in some markets outside of the United States, our revenues 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 United States. Some distributors also assist us with regulatory approvals and education of physicians and government agencies. We intend to continue our efforts to increase our sales in Europe, Japan and other countries with a relatively high level of health care spending on infants. If we fail to sell our products through our international distributors, we

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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 that 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 revenues 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.

If we terminate our relationships with distributors for poor performance, as we have done in the past, we may be subject to foreign laws governing our relationships with our distributors. These laws may require us to make payments to our distributors even if we terminate our relationship for cause. Some countries require termination payments under common law or legislation that may supercede our contractual relationship with the distributor. These payments could be equal to a year or more of gross margin on sales of our products that the distributor would have earned. Any required payments would adversely affect our operating results.

### **Our plan to expand in international markets will result in increased costs and may not be successful, which could harm our business**

We must expand the number of distributors who sell our products or increase our direct international sales presence to significantly penetrate international markets. We have only recently begun to develop a direct sales force outside the United States. For example, we acquired our United Kingdom distributor in January 2001. Effective in July 2001, we assumed our Japanese distributor's sales and support activities, allowing us direct access to redistributors of our products in Japan. As we continue to increase our direct international sales presence, we will incur higher personnel costs that may not result in additional revenues. A higher percentage of our sales to international distributors could also impair our revenues due to discounts available to these distributors. We may not realize corresponding growth in operating results from growth in international sales, due to the higher costs of sales outside of the United States. Even if we are able to successfully expand our direct and indirect international selling efforts, we cannot be certain that we will be able to create or increase demand for our products outside of the United States.

### **Our operating results may suffer because of foreign currency exchange rate fluctuations or strengthening of the United States dollar relative to local currencies**

Prior to January 2001, substantially all of our sales contracts provided for payment in United States dollars. However, our subsidiary in Japan assumed the activities of our top-tier distributor in Japan in July 2001 and our United Kingdom subsidiary acquired our distributor in the United Kingdom in January 2001. Since that time, our revenues and expenses in these countries have increasingly begun to be denominated in the applicable foreign currency. We also have begun to sell our products in other local currencies as we expand our direct international sales. To date, we have not undertaken any foreign currency hedging transactions, and as a result, our future revenues and expense levels from international operations may be unpredictable due to exchange rate fluctuations. Furthermore, a strengthening of the dollar could make our products less competitive in foreign markets, and fluctuations in currencies could result in foreign exchange gains and losses associated with the translation of assets denominated in foreign currencies.

### **We face other risks from foreign operations, which could reduce our operating results and harm our financial condition**

Our international operations are subject to other risks, which include:

- the impact of possible recessions in economies outside the United States;
- political and economic instability, including instability related to war and terrorist attacks in the United States and abroad;

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- contractual provisions governed by foreign law, such as common law rights to sales commissions by terminated distributors;
- the dependence of demand for our products on health care spending by foreign governments;
- 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; and
- difficulty in obtaining foreign regulatory approvals.

### **Our failure to obtain necessary FDA clearances or approvals or to comply with FDA regulations could hurt our ability to commercially distribute and market our products in the United States, and this would harm our business and financial condition**

Unless an exemption applies, each medical device that we wish to market in the United States must first receive one of the following types of FDA premarket review authorizations:

- 510(k) clearance via Section 510(k) of the federal 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 is much more costly, lengthy and uncertain. Premarket approval generally takes from one to three years, but can take even longer. We cannot assure you that the FDA will ever grant either 510(k) clearance or premarket approval for any product we propose to market. Furthermore, if the FDA concludes that these future products using our technology do not meet the requirements to obtain 510(k) clearance, we would have to seek premarket approval. We cannot assure you that the FDA will not 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.

### **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 may not promote or advertise the ALGO screener, MiniMuffs, neoBLUE phototherapy device or CO-Stat analyzer products, or any future cleared or approved devices, for uses not within the scope of our clearances or approvals or make 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 revenues 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;
- the recall or seizure of our products;

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- the issuance of public notices or warnings;
- the imposition of operating restrictions, partial suspension or total shutdown of production;
- the refusal of our requests for 510(k) clearance or premarket approval of new products;
- the withdrawal of 510(k) clearance or premarket approvals already granted; and
- criminal prosecution.

### **If we fail to obtain necessary foreign regulatory approvals in order to market and sell our products outside of the United States, we may not be able to sell our products in other countries**

Our products are regulated outside the United States as medical devices by foreign governmental agencies similar to the FDA and are subject to regulatory requirements similar to the FDA's. 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 the FDA requirements. We may not be able to obtain these approvals without incurring significant expenses or at all.

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

Every manufacturer of a finished medical device, including us 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. Although we have passed inspections in the past, we cannot assure you that we or our contract manufacturers will pass any 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 regulations inspection, the FDA could shut down our or our contract manufacturers' manufacturing operations and require us, among other things, to recall our products, either of which would harm our business.

### **We may experience intense competition from other medical device companies, and this competition could adversely affect our revenues and our business**

Our most significant current and potential competitors for our ALGO screening products include companies that market enhanced auditory brainstem response and otoacoustic hearing screening equipment products. For jaundice management products, our competition falls into the following categories: for blood-based antibody and bilirubin tests, we anticipate our competitors to be large medical diagnostics companies that market laboratory bench equipment; for noninvasive analysis of skin tones to estimate the level of "jaundice yellowing" present in the skin, medium to large in vitro diagnostics companies that market point of care, handheld monitoring devices. With respect to our neoBLUE product, our competitors are companies that market phototherapy devices.

We believe that Bio-logic Systems Corp., Intelligent Hearing Systems, GN Otometrics, including Madsen Electronics and Sonamed Corp., each of which is also currently marketing enhanced auditory brainstem response and otoacoustic hearing screening equipment products, could introduce new, lower priced hearing screening equipment that may not require an audiologist or physician to interpret its results or review its recommendations, similar to our products. Bio-logic announced that it received FDA approval to sell its disposable products for use with versions of our ALGO screeners other than the ALGO 3 screener. The sales of these products has adversely impacted our revenues from sales of our disposable products. We believe that Minolta Co., Ltd. and SpectRx, Inc., each of which is currently marketing skin color analysis products for bilirubin monitoring, or Johnson & Johnson and F. Hoffman-La Roche Ltd., each of which is currently marketing equipment for blood-based bilirubin or antibody tests, could also introduce new, lower priced options for the management of newborn

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jaundice. We expect that competitors to our neoBLUE product include these companies. Some of our competitors may have greater financial resources and name recognition or larger, more established distribution channels than we do.

We believe our future success depends on our ability to enhance existing products, develop and introduce new products, satisfy customer requirements and achieve market acceptance. We cannot be certain that we will successfully identify new product opportunities. We may not be able to develop and bring new products to market before our competitors or in a more cost-effective manner. Increased competition may negatively affect our business and future operating results by leading to price reductions, higher selling expenses or a reduction in our market share.

### **Our business could be harmed if our competitors establish cooperative relationships with large medical testing equipment vendors or rapidly acquire market share through industry consolidation or by bundling other products with their hearing screening or jaundice monitoring products**

Large medical testing equipment vendors, such as Johnson & Johnson or F. Hoffman-La Roche Ltd., may acquire or establish cooperative relationships with our current competitors. We expect that the medical testing equipment 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.

Other medical device companies may decide to bundle their products with other newborn hearing screening, hemolysis monitoring or jaundice management products and sell the bundle at lower prices. If this happens, our business and future operating results could suffer if we were no longer able to offer commercially viable or competitive products.

### **We may not be successful in integrating the businesses that we acquire, or the businesses may not perform as projected**

In March 2002, we acquired intellectual property assets and technology patents from Pemstar, and may have additional acquisitions of products, technology assets or acquisitions 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:

- integration of the acquired products into our business;
- the failure to realize expected synergies;
- the failure of acquired products to achieve projected sales;
- the failure of our development agreement with Pemstar or other contract developers to result in the desired product developments;
- assumption of unknown liabilities;
- failure to understand and compete effectively in markets in which we have limited previous experience; and
- write-offs of goodwill and associated technologies or costs associated with such failed new products or businesses.

While we make efforts to analyze potential acquisitions carefully and to value assets and their related future lives appropriately, we cannot be certain that any completed acquisitions will positively impact our business.

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### **We may not be able to preserve the value of our products' 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 hearing screening or jaundice management 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. We have eighteen issued United States patents and eight patent applications pending before the United States Patent and Trademark Office. We have one patent granted in Canada and four patent applications pending in Canada. We have one patent issued with the European patent office, which we intend to register in ten countries and eleven patent applications pending with the European patent office. We have one patent granted in France and one patent application pending in France. We have three patent applications granted in Japan and twelve patent applications pending in Japan. We have two patents granted in Germany, one patent granted in Iceland, one patent granted in the Netherlands, one patent granted in Switzerland, and two patents granted in the United Kingdom. We have four patent applications pending in Australia, two patent applications pending in the Czech Republic, one patent application pending in Hong Kong, two patent applications pending in Hungary, one patent application pending in Italy and one patent application pending in Norway. We attempt to protect our intellectual property rights by filing patent applications for new features and products we develop. We enter into confidentiality or license agreements with our employees, consultants and corporate partners and seek to control access to our intellectual property and the distribution of our hearing screening or jaundice management products, documentation and other proprietary information. However, we believe that these measures afford only limited protection. Others may develop technologies that are similar or superior to our technology or design around the patents, copyrights and trade secrets we own. The original patent for an algorithm for analyzing auditory brainstem responses, which we licensed on a nonexclusive basis from a third party and upon which we developed our automated auditory brainstem response technology, expired in late 1999, and that subject matter is in the public domain. With respect to our neoBLUE phototherapy device, the basic concept of using blue lights for phototherapy is well established in the technical literature and is therefore not patentable. However, we have one patent pending that pertains to some of the features in our neoBLUE device, and the design and manufacturing methods we use are proprietary to us. In addition, we cannot assure you that the patent applications we have filed to protect the features of our products that we have subsequently developed will be allowed, or will deter others from using the auditory brainstem response technology.

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, particularly in foreign countries where the laws may not protect our proprietary rights as fully. 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. Enforcing our intellectual property rights could also result in the loss of our intellectual property rights.

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

Substantial intellectual property litigation and threats of litigation exist in our industry. We expect that medical screening equipment 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;



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- cause product shipment delays or suspensions; or
- require us to seek to enter into royalty or licensing agreements, which may not be available on terms acceptable to us, if at all.

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 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 medical testing products could lead to the filing of a product liability claim if someone were to be injured using one of our devices or if one of our devices fails to perform properly or to detect a disorder for which it was being used to screen. 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. We cannot assure you that our product liability insurance would 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 may incur significant costs related to a class action lawsuit due to the likely volatility of the public market price of our stock**

Our stock price may fluctuate for a number of reasons including:

- quarterly fluctuations in our results of operations;
- our ability to successfully commercialize our products;
- announcements of technological or competitive developments by us or our competitors;
- announcements regarding patent litigation or the issuance of patents to us or our competitors;
- announcements regarding state screening mandates or third party payor reimbursement policies;
- regulatory developments regarding us or our competitors;
- acquisitions or strategic alliances by us or our competitors;
- changes in estimates of our financial performance or changes in recommendations by securities analysts; and
- general market conditions, particularly for companies with a relatively small number of shares available for sale in the public market.

Securities class action litigation is often brought against a company after a period of volatility of the market price of its stock. If our future quarterly operating results are below the expectations of securities analysts or investors, the price of our common stock would likely decline. Stock price fluctuations may be exaggerated if the trading volume of our common stock is low. Any securities litigation claims brought against us could result in substantial expense and damage awards and divert our management's attention from running our business.

### **Our executive officers, directors, principal stockholders and their affiliates hold a substantial portion of our stock and could exercise significant influence over matters requiring stockholder approval, regardless of the wishes of other stockholders**

Our executive officers, directors, principal stockholders and individuals or entities affiliated with them beneficially own in the aggregate approximately 63% of our outstanding common stock, as of March 19, 2003. If



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these stockholders act together, they could significantly influence all matters that our stockholders vote upon, including the election of directors and determination of significant corporate actions. This concentration of ownership could delay or prevent a change of control transaction that could otherwise be beneficial to our stockholders.

**Anti-takeover provisions in our charter documents and under Delaware law may affect the price of our common stock, and make it more difficult 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 to acquire us, even though such events may be beneficial to our stockholders.**

Provisions of our certificate of incorporation and bylaws may affect the price of our common stock, and 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. Among other things, these provisions:

- authorize the issuance of “blank check” preferred stock that could be issued by our Board of Directors to increase the number of outstanding shares and thwart a takeover attempt; and
- limit who may call a special meeting of stockholders.

On September 4, 2002, our Board of Directors adopted a preferred share purchase rights plan, commonly known as a “poison pill.” The provisions described above, our preferred share purchase rights plan and provisions of the Delaware General Corporation Law relating to business combinations with interested stockholders may discourage, delay or prevent a third party from removing our management. Further, they may discourage, delay or prevent a third party from acquiring a large portion of our securities, initiating a tender offer or proxy contest or acquiring us, even if our stockholders might receive a premium for their shares in the acquisition over then current market prices.

**We depend upon key employees in a competitive market for skilled personnel, and, without additional employees, we cannot grow or achieve and 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 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 and neonatal jaundice management. 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**

As of December 31, 2002, we had a total federal and state net operating loss carryforwards of approximately \$13.1 million and \$4.2 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 2003 through 2022. If we continue to have net losses, we may not be able to utilize some or all of our net operating loss carryforwards before they expire.

In addition, United States 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

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three-year period. We cannot assure you that we will not take actions, such as the issuance of additional stock, that would cause an ownership change to occur. Accordingly, we may be limited to the amount 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, or IRS, and are thus subject to adjustment or disallowance resulting from any such IRS examination.

If we have taxable income in the future, and we are unable to fully utilize our net operating loss carryforwards, our future tax payments could be higher and our financial results may suffer.

### **If earthquakes and other catastrophic events strike, our business may be negatively affected**

Our corporate headquarters, including a substantial portion of our research and development operations, are located in the Silicon Valley area of Northern California, a region known for seismic activity. A significant natural disaster such as an earthquake could have a material adverse impact on our business, operating results, and financial condition.

### **ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk**

The information required by this Item is set forth in the section entitled “Management’s Discussion and Analysis of Financial Conditions and Results of Operations.”

### **ITEM 8. Financial Statements and Supplementary Data**

The Consolidated Financial Statements and Supplementary Data required by this Item are set forth where indicated in Item 15 of this report.

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**Quarterly Results of Operations**

The following table presents our operating results for each of the eight quarters in the period ending December 31, 2002. The information for each of these quarters is unaudited and has been prepared on the same basis as our audited financial statements appearing elsewhere in this report. In the opinion of our management, all necessary adjustments, consisting only of normal recurring adjustments, have been included to present fairly the unaudited quarterly results when read in conjunction with our audited consolidated financial statements and the related notes appearing elsewhere in this report. Certain amounts in the attached table have been reclassified to conform to the current year presentation. These operating results are not necessarily indicative of the results of any future period.

	Quarters Ended							
	Dec. 31, 2002	Sept. 30, 2002	June 30, 2002	March 31, 2002	Dec. 31, 2001	Sept. 30, 2001	June 30, 2001	March 31, 2001
	(in thousands)							
Revenues	\$ 7,686	\$ 6,781	\$ 6,470	\$ 6,076	\$ 7,516	\$ 6,324	\$ 7,243	\$ 6,318
Cost of revenues	3,948	2,886	2,920	2,516	3,273	2,432	2,710	2,428
Gross profit	3,738	3,895	3,550	3,560	4,243	3,892	4,533	3,890
Gross profit percentage	48.6 %	57.4 %	54.9 %	58.6 %	56.5 %	61.5 %	62.6 %	61.6 %
Operating expenses:								
Marketing and selling	3,295	3,403	3,567	3,367	3,495	3,010	3,026	2,945
Research and development	1,200	1,344	1,275	1,056	1,105	1,184	1,018	1,011
General and administrative	1,434	1,151	1,029	1,018	1,037	855	954	782
Amortization of deferred stock compensation	49	61	136	144	148	238	284	288
Total operating expenses	5,978	5,959	6,007	5,585	5,785	5,287	5,282	5,026
Loss from operations	(2,240)	(2,064)	(2,457)	(2,025)	(1,542)	(1,395)	(749)	(1,136)
Other income (expense), net	132	463	463	238	250	702	(23)	13
Loss before provision for income taxes	(2,108)	(1,601)	(1,994)	(1,787)	(1,292)	(693)	(772)	(1,123)
Income tax (benefit) provision	(38)	—	—	—	2	—	—	1
Net loss	(2,070)	(1,601)	(1,994)	(1,787)	(1,294)	(693)	(772)	(1,124)
Accretion of redeemable convertible preferred stock	—	—	—	—	—	71	346	346
Net loss available to common stockholders	\$(2,070)	\$(1,601)	\$(1,994)	\$(1,787)	\$(1,294)	\$ (764)	\$(1,118)	\$(1,470)

**ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**PART III**

**ITEM 10. Directors and Executive Officers**

The information required by this item concerning our directors is incorporated by reference to the sections captioned “Election of Directors” and “Section 16(a) Beneficial Ownership Reporting Compliance” contained in our Proxy Statement related to the 2003 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission within 120 days of the end of our fiscal year pursuant to General Instruction G(3) of Form 10-K (the “Proxy Statement”). Certain information required by this item concerning executive officers is set forth in Part I of this Report in “Business—Executive Officers.”

**ITEM 11. Executive Compensation**

The information required by this item is incorporated by reference to the Proxy Statement.

**ITEM 12. Security Ownership of Certain Beneficial Owners and Management**

**Equity Compensation Plan Information**

The following table provides information as of December 31, 2002 about our common stock that may be issued upon the exercise of options, warrants and rights under all of our existing equity compensation plans, including the 1991 Stock Option Plan, 2000 Stock Option Plan, 2000 Supplemental Stock Option Plan, 2000 Director Option Plan and 2000 Employee Stock Purchase Plan, each as amended.

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance under Equity Compensation Plans (excluding securities reflected in the first column)
Equity compensation plans approved by security holders	2,368,819(1)	\$ 4.26	3,224,946(2)
Equity compensation plans not approved by security holders	—	—	—
<b>Total</b>	<b>2,368,819</b>	<b>\$ 4.26</b>	<b>3,224,946</b>

- (1) Of these shares of common stock, 693,374 shares related to outstanding options under our 1991 Stock Option Plan, 1,175,445 shares related to outstanding options under our 2000 Stock Option Plan, 350,000 shares related to outstanding options under our 2000 Supplemental Stock Option Plan, 150,000 shares related to outstanding options under our 2000 Director Option Plan.
- (2) Of these shares of common stock, 1,433,682 shares remained available for future issuance under our 2000 Stock Option Plan, 329,323 shares remained available for future issuance under our 2000 Director Option Plan and 1,461,941 shares remained available for future issuance under our 2000 Employee Stock Purchase Plan. The 1991 Stock Option Plan and 2000 Supplemental Stock Option Plan were terminated as to new grants in July 2001. The number of shares reserved for issuance pursuant to our 2000 Stock Option Plan is subject to an automatic increase on the first day of our fiscal year in an amount equal to the lesser of (i) 1,500,000 shares of common stock; (ii) 7% of our outstanding shares of common stock on the last day of the prior fiscal year; or (iii) an amount determined by our board of directors. The number of shares reserved for issuance pursuant to our 2000 Director Option Plan is subject to an automatic increase on the first day of our fiscal year in an amount equal to the lesser of (i) 100,000 shares of common stock; (ii) one-half of one percent of our outstanding shares of common stock on the last day of the prior fiscal year; or (iii) an amount determined by our board of directors. The number of shares reserved for issuance pursuant to our 2000 Employee Stock Purchase Plan is subject to an automatic increase on the first day of our fiscal year in an amount equal to the lesser of (i) 650,000 shares of common stock; (ii) 4% of our outstanding shares of

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common stock on the last day of the prior fiscal year; or (iii) an amount determined by our board of directors.

Additional information required by this item is incorporated by reference to the Proxy Statement.

**ITEM 13. Certain Relationships and Related Transactions**

The information required by this item is incorporated by reference to the Proxy Statement.

**ITEM 14. Controls and Procedures**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-14(c) promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), within 90 days of the filing date of this report. Based on their evaluation, our principal executive officer and principal accounting officer concluded that our disclosure controls and procedures are effective to ensure that material information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. It should be noted, however, that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

There have been no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referenced in paragraph above.

PART IV

ITEM 15. Exhibits, Financial Statement Schedules, and Reports On Form 8-K

(a)(1) Financial Statements

The following consolidated financial statements are filed as part of this Report:

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Independent Auditors' Report	F-2
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Consolidated Statements of Stockholders' Equity (Deficit) and Comprehensive Income (Loss)	F-5
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(a)(2) Financial Statement Schedules

**SCHEDULE II: VALUATION AND QUALIFYING ACCOUNTS**  
**For the years ended December 31, 2002, 2001 and 2000**  
**(in thousands)**

	<u>Balance at Beginning of Period</u>	<u>Additions Charged to Expense</u>	<u>Deductions</u>	<u>Balance at End of Period</u>
<b>Year ended December 31, 2002</b>				
Allowance for doubtful accounts	\$ 239	\$ 64	\$ (53)	\$ 250
Accrued warranty costs	\$ 542	\$ 38	\$ (380)	\$ 200
<b>Year ended December 31, 2001</b>				
Allowance for doubtful accounts	\$ 203	\$ 37	\$ (1)	\$ 239
Accrued warranty costs	\$ 548	\$ 172	\$ (178)	\$ 542
<b>Year ended December 31, 2000</b>				
Allowance for doubtful accounts	\$ 201	\$ 89	\$ (87)	\$ 203
Accrued warranty costs	\$ 487	\$ 233	\$ (172)	\$ 548

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### *(a)(3) Exhibits*

<u>Exhibit No.</u>		<u>Exhibit Title</u>
3.1.1	(b)	Certificate of Incorporation
3.1.2	(g)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of the Registrant
3.2	(b)	Bylaws of the Registrant
4.2	(h)	Preferred Stock Rights Agreement, dated as of October 8, 2002, between Registrant and Equiserve Trust Company, N.A., including the form of Rights Certificate and Summary of Rights attached thereto as Exhibits B and C, respectively
4.2.1	(i)	Amendment No. 1 to Preferred Stock Rights Agreement dated as of February 14, 2003 between the Registrant and Equiserve Trust Company, N.A.
4.3	(i)	Voting Agreement dated February 14, 2003 between the Registrant and Perry Corp.
10.1	(b)	Form of Indemnification Agreement between the Registrant and each of its directors and officers
10.2	(b)	Amended and Restated 1991 Stock Option Plan
10.2.1	(b)	Form of Option Agreement under the 1991 Stock Option Plan
10.3	(b)	2000 Stock Option Plan
10.3.1	(b)	Form of Option Agreement under the 2000 Stock Option Plan
10.4	(b)	2000 Director Option Plan
10.4.1	(b)	Form of Option Agreement under 2000 Director Option Plan
10.5	(b)	2000 Employee Stock Purchase Plan and form of subscription agreement thereunder
10.6		Reserved
10.6.1		Reserved
10.7†	(b)	Patent License Agreement dated June 30, 1998 between Registrant and The Leland Stanford Junior University
10.8	(b)	Lease Agreement dated August 24, 1998 between Registrant and San Carlos Co-Tenancy
10.8.1	(a)	Amendment to Lease Agreement dated August 24, 1998 between Registrant and San Carlos Co-Tenancy
10.9	(b)	Promissory Note dated March 24, 1999 between Scott Valley Bank and Tim C. Johnson
10.9.1	(b)	Assignment of Deposit Account dated March 24, 1999 between Registrant, Scott Valley Bank and Tim C. Johnson
10.9.2	(b)	Security Agreement dated March 26, 1999 between Registrant and Tim C. Johnson
10.10†	(b)	Capital Equipment Supplier Agreement dated June 25, 1999 between the Registrant and Novation, LLC
10.10.1†	(a)	Letter Amendment dated January 8, 2003 to Capital Equipment Supplier Agreement dated June 25, 1999 between the Registrant and Novation, LLC
10.11†	(b)	Manufacturing Agreement dated December 3, 1998 between Registrant and TriVirix International, Inc. (formerly CMA International, Inc.)

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<u>Exhibit No.</u>	<u>Exhibit Title</u>
10.12	Reserved
10.13	Reserved
10.14†	(b) Memorandum of Understanding dated December 7, 2000 between Registrant and the Ludlow Company LP
10.15	(b) 2000 Supplemental Stock Option Plan
10.15.1	(b) Form of Option Agreement for 2000 Supplemental Stock Option Plan
10.16	(b) Lease dated March 3, 2000 between W&G Properties Limited, Neonatal Perspectives Limited and Andrew Vincent for the premises located at Unit 9, Northmill, Buckinghamshire, United Kingdom
10.17	Reserved
10.17.1	Reserved
10.17.2	Reserved
10.17.3	Reserved
10.17.4	Reserved
10.18	(c) Leasing Agreement dated June 11, 2001 between Natus Japan and Sanwa Radiator Co. Ltd. (Japanese to English translation)
10.19	(d) Severance Agreement and Release between Registrant and Terese Baker dated March 8, 2002
10.20	(e) Transition and Release Agreement between Registrant and William H. Lawrenson dated April 26, 2002
10.21	(f) Severance Agreement and Release between Registrant and Lucille A. Ferus dated October 7, 2002
10.22	(f) Severance Agreement and Release between Registrant and Thomas M. Waugh dated September 19, 2002
10.23	(a) Employment Agreement dated as of November 18, 2002 between Registrant and Tim C. Johnson
10.24	(a) Form of Employment Agreement between the Registrant and each of its executive officers
14.1	(a) Code of Ethics for Financial Executives
21.1	(b) Subsidiaries
23.1	(a) Independent Auditors' Consent
24.1	(a) Power of Attorney (see page 62)
99.1	(a) Certifications Of Chief Executive Officer And Chief Financial Officer

† Portions of this agreement have been omitted pursuant to a request for confidential treatment and the omitted portions have been filed with the Securities and Exchange Commission.

(a) Filed herewith.

(b) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Registration Statement on Form S-1 (Registration Statement 333-39891), which the Securities and Exchange Commission declared effective on July 19, 2001.

(c) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001.



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- (d) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002.
- (e) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.
- (f) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002.
- (g) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Report on Form 8-A as declared effective by the Securities and Exchange Commission on February 25, 2003.
- (h) Incorporated by reference to the exhibit filed with the amendment to the Registrant's Registration Statement on Form 8-A on October 8, 2002.
- (i) Incorporated by reference to the exhibit filed with the Registrant's Report on Form 8-K as filed with the Securities and Exchange Commission on February 25, 2003.

### ***(b) Reports on Form 8-K***

The Company filed a current report on Form 8-K dated October 1, 2002 to report that the Company had undertaken a reduction in the Company's work force by approximately 14%.

### ***(c) Exhibits***

See Item 15(a)(3) above.

### ***(d) Financial Statement Schedules***

See Item 15(a)(2) above.



**CERTIFICATIONS**

I, Tim C. Johnson, certify that:

1. I have reviewed this annual report on Form 10-K of Natus Medical Incorporated;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - (c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 24, 2003

/s/ TIM C. JOHNSON

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Tim C. Johnson  
President and Chief Executive Officer

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I, Glenn A. Bauer, certify that:

1. I have reviewed this annual report on Form 10-K of Natus Medical Incorporated;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - (c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 24, 2003

/s/ GLENN A. BAUER

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Glenn A. Bauer  
Chief Financial Officer

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**INDEPENDENT AUDITORS' REPORT**

To the Board of Directors and Stockholders of Natus Medical Incorporated:

We have audited the accompanying consolidated balance sheets of Natus Medical Incorporated and subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations, stockholders' equity (deficit) and comprehensive income (loss), and of cash flows for each of the three years in the period ended December 31, 2002. Our audits also included the consolidated financial statement schedule included in Item 15(a)(2) in the Annual Report on Form 10-K of the Company. These consolidated financial statements and consolidated financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and consolidated financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Natus Medical Incorporated and subsidiaries as of December 31, 2002 and 2001 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such consolidated financial statement schedule referenced above, when considered in relation to the basic consolidated financial statements as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ Deloitte & Touche LLP

Deloitte & Touche LLP

San Jose, California

February 18, 2003

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**NATUS MEDICAL INCORPORATED**  
**CONSOLIDATED BALANCE SHEETS**  
(dollars in thousands)

	December 31,	
	2002	2001
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 17,768	\$ 30,351
Short-term investments	27,150	22,735
Accounts receivable, net of allowance for doubtful accounts of \$250 in 2002 and \$239 in 2001	5,395	5,209
Inventories	4,560	3,598
Prepaid expenses and other current assets	663	655
<b>Total current assets</b>	<b>55,536</b>	<b>62,548</b>
Property and equipment, net	2,247	1,757
Long-term investment	334	327
Deposits and other assets	1,223	303
<b>Total assets</b>	<b>\$ 59,340</b>	<b>\$ 64,935</b>
<b>LIABILITIES, CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY</b>		
Liabilities:		
Accounts payable	\$ 1,788	\$ 892
Accrued liabilities	2,460	2,702
Deferred revenues	405	312
<b>Total liabilities</b>	<b>4,653</b>	<b>3,906</b>
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred Stock, \$ .001 per share, 10,000,000 shares authorized, no shares issued and outstanding in 2002 and 2001, respectively	—	—
Common stock, \$0.001 par value; 120,000,000 shares authorized; shares issued and outstanding: 16,267,700 in 2002 and 15,864,670 in 2001	86,593	86,007
Deferred stock compensation	(219)	(767)
Accumulated deficit	(31,751)	(24,299)
Accumulated other comprehensive income	64	88
<b>Total stockholders' equity</b>	<b>54,687</b>	<b>61,029</b>
<b>Total liabilities, convertible preferred stock and stockholders' equity</b>	<b>\$ 59,340</b>	<b>\$ 64,935</b>

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

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**NATUS MEDICAL INCORPORATED**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(dollars in thousands)

	Years Ended December 31,		
	2002	2001	2000
Revenues	\$27,013	\$27,401	\$24,633
Cost of revenues*	12,270	10,843	8,745
<b>Gross profit</b>	<b>14,743</b>	<b>16,558</b>	<b>15,888</b>
Operating expenses:			
Marketing and selling	13,632	12,476	8,984
Research and development	4,875	4,318	3,458
General and administrative	4,632	3,628	2,586
Amortization of deferred stock compensation*	390	958	611
<b>Total operating expenses</b>	<b>23,529</b>	<b>21,380</b>	<b>15,639</b>
Income (loss) from operations	(8,786)	(4,822)	249
Interest income	902	812	29
Interest expense	(10)	(39)	(8)
Other income, net	404	169	11
<b>Income (loss) before provision for income taxes, net</b>	<b>(7,490)</b>	<b>(3,880)</b>	<b>281</b>
Income tax (benefit) provision	(38)	3	46
<b>Net income (loss)</b>	<b>(7,452)</b>	<b>(3,883)</b>	<b>235</b>
Accretion of redeemable convertible preferred stock	—	763	1,384
<b>Net loss available to common stockholders</b>	<b>\$(7,452)</b>	<b>\$(4,646)</b>	<b>\$(1,149)</b>
<b>Basic and diluted net (loss) per share</b>	<b>\$ (0.46)</b>	<b>\$ (0.62)</b>	<b>\$ (1.62)</b>
Common shares used in computing basic and diluted net loss per share	16,056	7,540	710
* Amortization of deferred stock compensation included in cost of revenues	\$ 79	\$ 139	\$ 184
* Amortization of deferred stock compensation attributable to operating expenses:			
Marketing and selling	\$ 216	\$ 507	\$ 157
Research and development	10	84	105
General and administrative	164	367	349
<b>Total</b>	<b>\$ 390</b>	<b>\$ 958</b>	<b>\$ 611</b>

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



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**NATUS MEDICAL INCORPORATED**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)**  
**AND COMPREHENSIVE INCOME (LOSS)**  
(dollars in thousands)

	Common Stock		Deferred Stock Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income	Stockholders' Equity (Deficit)	Comprehensive Income (Loss)
	Shares	Amount					
Balances, January 1, 2000	597,689	\$ 278	\$ —	\$ (18,504)	\$ —	\$ (18,226)	\$ —
Accretion to redemption value on Series B, C and D redeemable convertible preferred stock				(1,384)		(1,384)	
Deferred stock compensation		2,504	(2,327)			177	
Amortization of deferred stock compensation			795			795	
Exercise of stock options	270,345	120				120	
Net income				235		235	235
<b>Comprehensive income</b>							<b>\$ 235</b>
Balances, December 31, 2000	868,034	2,902	(1,532)	(19,653)	—	(18,283)	\$ —
Accretion to redemption value of Series B, C and D redeemable convertible preferred stock				(763)		(763)	
Initial public offering of common shares, net of issuance cost of \$6,799	5,750,000	56,451				56,451	
Conversion of preferred stock to common stock	8,931,534	25,989				25,989	
Deferred stock compensation		332	(332)			—	
Amortization of deferred stock compensation			1,097			1,097	
Exercise of stock options	268,357	134				134	
Employee stock purchase plan	46,745	199				199	
Unrealized gain on available- for-sale short term investments					76	76	76
Foreign currency translation adjustment					12	12	12
Net loss				(3,883)		(3,883)	(3,883)
<b>Comprehensive loss</b>							<b>\$ (3,795)</b>
Balances, December 31, 2001	15,864,670	86,007	(767)	(24,299)	88	61,029	\$ —
Exercise of stock options	277,129	486				486	
Employee stock purchase plan	125,901	178				178	
Accelerated vesting of options		23	48			71	
Amortization of deferred stock compensation			481			481	
Cancellation of deferred stock compensation		(101)	19			(82)	
Unrealized gain on available- for-sale short term investments					(58)	(58)	(58)
Foreign currency translation adjustment					34	34	34
Net loss				(7,452)		(7,452)	(7,452)
<b>Comprehensive loss</b>							<b>\$ (7,428)</b>
Balances, December 31, 2002	16,267,700	\$86,593	\$ (219)	\$ (31,751)	\$ 64	\$ 54,687	

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

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**NATUS MEDICAL INCORPORATED**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(dollars in thousands)

	Year Ended December 31,		
	2002	2001	2000
Operating activities:			
Net income (loss)	\$ (7,452)	\$ (3,883)	\$ 235
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,173	847	655
Loss on disposal of property and equipment	102	7	7
Amortization of deferred stock compensation	469	1,097	795
Non-cash marketing expense	—	—	177
Changes in operating assets and liabilities:			
Accounts receivable	(186)	(979)	(1,272)
Inventories	(962)	(1,392)	(941)
Prepaid expenses and other current assets	(8)	(400)	(123)
Accounts payable	896	142	(224)
Accrued liabilities and deferred revenues	(149)	(67)	1,066
Net cash provided by (used in) operating activities	(6,117)	(4,628)	375
Investing activities:			
Acquisition of property and equipment	(1,663)	(1,046)	(668)
Deposits and other assets	(1,021)	(72)	(55)
Purchase of convertible notes receivable	—	—	(20)
Purchases of short-term investments	(82,330)	(163,945)	(596)
Sales of short-term investments	77,857	141,589	583
Cash paid for acquisition of business	—	(9)	—
Purchase of long-term investment	(7)	(6)	(6)
Net cash used in investing activities	(7,164)	(23,489)	(762)
Financing activities:			
Issuance of common stock	664	59,156	120
Deferred offering costs	—	(1,383)	(989)
Borrowings on bank loans	—	2,000	—
Payments of borrowings	—	(2,000)	(150)
Net cash provided by (used in) financing activities	664	57,773	(1,019)
Exchange rate effect on cash and equivalents	34	14	—
Net increase (decrease) in cash and equivalents	(12,583)	29,670	(1,406)
Cash and cash equivalents, beginning of year	30,351	681	2,087
Cash and cash equivalents, end of year	\$ 17,768	\$ 30,351	\$ 681
Non-cash investing and financing activities:			
Accretion of redeemable convertible preferred stock	\$ —	\$ 763	\$ 1,384
Forgiveness of convertible notes receivable and accounts receivable for acquisition of business	\$ —	\$ 189	\$ —
Reversal of deferred stock compensation relating to cancellation of stock options	\$ (101)	\$ —	\$ —
Conversion of convertible preferred stock into common stock	\$ —	\$ 25,989	\$ —
Stock compensation relating to accelerated vesting of stock options	\$ 23	\$ —	\$ —
Supplemental disclosure of cash flow information:			
Cash paid for interest	\$ 10	\$ 39	\$ 8
Cash paid for income taxes	\$ 2	\$ 50	\$ 45

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

**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**Years Ended December 31, 2002, 2001 and 2000**

**1—ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES**

**Organization**

Natus Medical Incorporated (the “Company”) was incorporated in California in May 1987 and reincorporated in the State of Delaware in August 2000. The Company is primarily focused on developing, manufacturing and marketing products for the identification and monitoring of common medical disorders that may occur during the time from conception to a baby’s first birthday. The Company’s product lines are the ALGO screener, a product line for hearing screening, the CO-Stat analyzer, a product line for the evaluation of newborn jaundice and the neoBLUE phototherapy device, a product for the treatment of newborn jaundice. Both the ALGO screener and CO-Stat analyzer product lines are comprised of hardware units and single-use disposable components.

On July 28, 2000, the Company created and incorporated a wholly-owned subsidiary in Japan. On December 21, 2000, the Company created and incorporated a wholly owned subsidiary in the United Kingdom.

**Principles of Consolidation**

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

**Basis of Presentation**

All share and per share amounts in the accompanying consolidated financial statements have been restated to give effect to the two-for-five reverse stock split that occurred on August 15, 2000.

**Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities in the consolidated financial statements. Such estimates include allowances for potentially uncollectible accounts receivable, warranty costs, and a valuation allowance for deferred tax assets. Actual results could differ from those estimates.

**Revenue Recognition**

The Company recognizes revenues, net of discounts, from product sales, including sales to distributors, upon shipment when a purchase order has been received, when title transfers (generally upon shipment), when the selling price is fixed and determinable, and when collection of the resulting receivable is probable. Rights of return are generally not provided. Advance payments from customers are recorded as deferred revenues until shipment of the related product. The Company provides for trade-ins of its own or competitive equipment. Trade-ins are recorded as a reduction of revenue at the time of shipping the replacement equipment. 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. Revenues from extended warranty contracts are recognized ratably over the warranty period.

**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

**Cash and Cash Equivalents**

The Company considers all highly liquid debt instruments purchased with a remaining maturity of three months or less to be cash equivalents.

**Short-Term Investments**

The Company classifies its short-term investments as available-for-sale securities in accordance with the provision of the Statements of Financial Accounting Standard ("SFAS") No. 115, "*Accounting for Certain Investments in Debt and Equity Securities*." Securities classified as available-for-sale are reported at fair market value with the related unrealized gains and losses included, net of tax, in accumulated other comprehensive income. The cost of securities sold is based on the specific identification method. Realized gains and losses and declines in value of securities judged to be other than temporary are included in interest income or expense.

**Certain Significant Risks and Uncertainties**

Financial instruments that potentially subject the Company to credit risk consist principally of cash and cash equivalents, short-term investments and accounts receivable. Cash and cash equivalents and short-term investments consist of cash in bank accounts and investments in money market funds. To minimize its exposure to credit risk, the Company invests in highly liquid, high investment-grade financial instruments.

The Company sells its products primarily to hospitals and medical institutions. The Company generally does not require its customers to provide collateral or other security to support accounts receivable. The Company maintains allowances for estimated potential bad debt losses. No single customer accounted for more than 10% of accounts receivable at December 31, 2002 or 2001 and one customer accounted for 14% of accounts receivable at December 31, 2000.

The Company operates in a dynamic industry and, accordingly, can be affected by a variety of factors. For example, management believes that changes in any of the following areas could have a negative effect on the Company in terms of its future financial position, cash flows and results of operations: ability to obtain additional financing; changes in domestic and international economic and/or political conditions or regulations; currency exchange rate fluctuations; fundamental changes in the technology; market acceptance of the Company's products and products under development; changes in the overall demand for products offered by the Company; successful and timely completion of product development efforts; competitive pressures in the form of new product introductions by competitors or price reductions on current products; availability of necessary product components; inventory obsolescence; development of sales channels; litigation or other claims against or by the Company based on intellectual property, patent, product, regulatory or other factors; and the hiring, training and retention of key employees.

**Fair Value of Financial Instruments**

The Company's financial instruments include cash and cash equivalents, short-term and long-term investments, and accounts receivable. Cash and cash equivalents and short-term investments are reported at their respective fair values on the balance sheet dates. The recorded carrying amount of accounts receivable approximates their fair value due to their short-term maturities.

**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

**Inventories**

Inventories are stated at the lower of standard cost, which approximates actual cost on a first-in, first-out basis, or market.

**Property and Equipment**

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over estimated useful lives of three to five years. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life. The Company capitalizes the costs associated with acquiring and installing software to be used for internal purposes.

**Long-Lived Assets**

The Company reviews for the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying amount of that asset may not be recoverable. When the sum of the undiscounted future net cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount, an impairment loss would be measured based on the discounted cash flows compared to the carrying amount. No impairment charge has been recorded in any of the years presented.

**Long-Term Investment**

At December 31, 2002, the Company has a \$334,000 interest-bearing certificate of deposit with a bank that matures in April 2004. This investment has been assigned to a bank to guarantee a loan on the primary residence of an officer totaling \$250,000 plus accrued interest. The sole collateral for such guarantee is 27,088 shares of the Company's common stock that is owned by the officer. Due to this arrangement, the Company has classified the investment as held-to-maturity. The estimated fair value of the long-term investment, using discounted cash flows is approximately \$334,000 and \$313,000 at December 31, 2002 and 2001, respectively.

**Research and Development Costs**

Costs incurred in research and development are charged to operations as incurred. The Company's products include certain software applications that are integral to the operation of the product. The costs to develop such software have not been capitalized as the Company believes its current software development process is essentially completed concurrent with the establishment of technological feasibility of the software.

**Foreign Currency**

The functional currency for the Company's foreign subsidiaries is the local currency of the country where the subsidiary is located. Accordingly, translation adjustments for the Company's subsidiaries are included as a component of accumulated other comprehensive income (loss).

Gains and losses from transactions denominated in currencies other than the functional currencies of the Company and its subsidiaries are included in other income and expense. In 2002, net foreign currency transaction gains were approximately \$198,000. In 2001, net foreign currency transaction losses were approximately \$102,000. In 2000, net foreign currency gains and losses were not material.

**Comprehensive Income (Loss)**

In accordance with SFAS No. 130, *Reporting Comprehensive Income*, the Company is required to report by major components and as a single total, the change in its net assets during the period from non-owner sources.

**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

The consolidated statement of comprehensive loss has been included with the consolidated statement of stockholders' equity. Accumulated other comprehensive income at December 31, 2002 consisted of unrealized gains on available for sale securities and translation gains on foreign currency transactions.

**Net Loss per Common Share**

Basic net loss per common share excludes dilution and is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding during the respective period. Diluted loss per share reflects the potential dilution that could occur if stock options were exercised. As a result of net losses for all periods presented, there is no difference between basic and diluted net loss per share. Outstanding securities consist of the following: at December 31, 2002, options to purchase 2,368,819 shares of common stock; at December 31, 2001, options to purchase 1,920,929 shares of common stock; at December 31, 2000, 8,931,534 shares of convertible preferred stock and options to purchase 1,685,513 shares of common stock.

**Stock-Based Compensation**

The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board ("APB") No. 25, *Accounting for Stock Issued to Employees*, as interpreted by Financial Accounting Standards Board ("FASB") Interpretation No. 44, *Accounting for Transactions Involving Stock Compensation—an Interpretation of APB Opinion No. 25*. The Company accounts for stock-based awards to non-employees in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation* and Emerging Issues Task Force ("EITF") Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

The Company typically grants stock option awards at market value, consequently, no compensation expense is recorded. As more fully described in Note 7 to the financial statements, in 2001 a modification of existing stock options resulted in the recording of deferred stock compensation of \$2,659,000, based on the difference between the exercise price and the deemed fair value of the modified options. The difference was recorded as stock-based compensation in stockholders' equity and is being amortized on a straight-line basis over the vesting period of the related options.

Had compensation expense for the Company's stock option awards been determined based on the Black-Scholes fair value method at the grant dates for awards under those plans, consistent with the fair value method of SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company would have recorded additional compensation expense and its net income and earnings per share (EPS) would have been reduced to the pro forma amounts presented in the following table:

	Years Ended December 31,		
	2002	2001	2000
Net loss, as reported	\$(7,452)	\$(4,646)	\$(1,149)
Add back amortization of deferred stock compensation, net of related tax effects	469	1,097	—
Less compensation expense for stock options, net of related tax effects	(1,893)	(1,545)	(218)
Pro forma net loss	\$(8,876)	\$(5,094)	\$(1,367)
Basic and Diluted EPS:			
As reported	\$ (0.46)	\$ (0.62)	\$ (1.62)
Pro forma	\$ (0.55)	\$ (0.68)	\$ (1.93)

**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

As a result of net losses for all periods presented, there is no difference between basic and diluted net loss per share.

**Reclassifications**

Certain 2001 and 2000 amounts have been reclassified to conform to the current year presentation.

**Recently Issued Accounting Standards**

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that all business combinations initiated after September 30, 2001 be accounted for under the purchase method and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will rather be tested at least annually for impairment. Under the provisions of SFAS No. 142, any impairment loss identified upon adoption of this standard is recognized as a cumulative effect of a change in accounting principle, which is charged directly to retained earnings. Any impairment loss incurred subsequent to initial adoption of SFAS No. 142 is recorded as a charge to current period earnings. We adopted SFAS No. 142 on January 1, 2002 and stopped amortizing immaterial amounts of goodwill that resulted from business combinations completed prior to September 30, 2001. The adoption of SFAS No. 141 and 142 did not have a material effect on our financial position or results of operations.

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs, including legal obligations. We are required to adopt SFAS No. 143 January 1, 2003. We currently believe the adoption of SFAS No. 143 will not have a material effect on our financial position or results of operations.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, effective for fiscal years beginning after December 31, 2001. Under the new rules, the criteria required for classifying an asset as held-for-sale have been significantly changed. Assets held-for-sale are stated at the lower of their fair values or carrying amounts, and depreciation is no longer recognized. In addition, the expected future operating losses from discontinued operations will be displayed in discontinued operations in the period in which the losses are incurred rather than as of the measurement date. More dispositions will qualify for discontinued operations treatment in the statement of operations under the new rules. We adopted SFAS No. 144 January 1, 2002. The adoption of SFAS No. 144 did not have any impact on our financial position, results of operations or cash flows.

In April 2002, the FASB issued SFAS No. 145, which, among other things, changed the presentation of gains and losses on the extinguishment of debt. Any gain or loss on extinguishment of debt that does not meet the criteria in APB Opinion 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, shall be included in operating earnings and not presented separately as an extraordinary item. We will adopt SFAS No. 145 January 1, 2003.



**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue, or EITF, No. 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit on Activity (including Certain Costs Incurred in a Restructuring)*. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost was recognized at the date of the Company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amount recognized. The company will adopt the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002.

In November 2002, the FASB issued Interpretation (FIN) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantee of Indebtedness of Others*. This interpretation addresses the disclosures to be made by guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. FIN No. 45 also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. In accordance with FIN No. 45, the Company adopted the disclosure requirements on December 31, 2002 and is required to adopt the recognition requirements effective on January 1, 2003. The Company is evaluating the impact on the recognition requirements of this interpretation and does not expect it to have a material impact on its financial position results of operations, EPS or cash flows.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. This statement amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide companies with alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. Additionally, SFAS No. 148 amends certain disclosure requirements of SFAS No. 123. The Company adopted the annual disclosure requirements of SFAS No. 148 as of December 31, 2002. The transitional provisions of SFAS No. 148 did not have an impact on the Company's financial position, results of operations, EPS, or cash flows, as the fair value method has not been adopted.

## 2—SHORT-TERM INVESTMENTS

The following table summarizes the estimated fair value of the Company's short-term investments classified as available-for-sale securities at December 31, 2002 (in thousands):

	<u>Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Market Value</u>
<i>Balances at December 31, 2001</i>				
U.S. Government agency bonds	\$22,659	\$ 78	\$ (2)	\$ 22,735
<i>Balances at December 31, 2002</i>				
U.S. Government agency bonds	\$27,132	\$ 146	\$ (128)	\$ 27,150

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**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

**3—INVENTORIES**

Inventories consist of (in thousands):

	December 31,	
	2002	2001
Raw materials and subassemblies	\$ 2,831	\$ 2,497
Finished goods	1,729	1,101
<b>Total</b>	<b>\$ 4,560</b>	<b>\$ 3,598</b>

Balances at December 31, 2002 reflect a write-off of approximately \$450,000 primarily related to excess CO-Stat inventory.

**4—PROPERTY AND EQUIPMENT**

Property and equipment consist of (in thousands):

	December 31,	
	2002	2001
Office furniture and equipment	\$ 1,769	\$ 1,316
Computer software and hardware	2,155	1,451
Demonstration and loaned equipment	1,458	1,231
Leasehold improvements	298	369
	5,680	4,367
Accumulated depreciation and amortization	(3,433)	(2,610)
<b>Total</b>	<b>\$ 2,247</b>	<b>\$ 1,757</b>

**5—ACCRUED LIABILITIES**

Accrued liabilities consist of (in thousands):

	December 31,	
	2002	2001
Compensation and related benefits	\$ 1,134	\$ 1,315
Warranty reserve	200	542
Accrued professional fees	138	167
Other	988	678
<b>Total</b>	<b>\$ 2,460</b>	<b>\$ 2,702</b>

**6—RESERVE FOR PRODUCT WARRANTIES**

The company provides a one-year warranty on all products. The company also sells extended service agreements on all of its products. Service for domestic customers is provided by a company-owned service center that performs 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.

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**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

The company has accrued a warranty reserve for the expected future costs of servicing products during the initial one-year warranty period. Amounts are added to the reserve based on unit sales of various product lines. As warranty costs are incurred, they are relieved from the reserve. During the year ended December 31, 2002 the company recorded a reduction to the reserve of approximately \$230,000 to reflect recent improved warranty cost experience.

Activity in the warranty reserve during the years ended December 31, 2002 and 2001 are as follows:

	December 31,	
	2002	2001
Balance—Beginning of period	\$ 542	\$ 548
Aggregate changes in accruals related to new warranties	38	206
Aggregate reductions for repairs under warranty	(150)	(211)
Aggregate changes for accruals related to preexisting warranties	(230)	—
Balance—End of period	<u>\$ 200</u>	<u>\$ 542</u>

**7—CONVERTIBLE AND REDEEMABLE CONVERTIBLE PREFERRED STOCK**

Upon the closing of the Company's initial public offering in July 2001, each outstanding share of preferred stock was converted into common stock on one-for-one basis. In accordance with the preferred stock rights, all preferred stock outstanding automatically converted into the conversion price at the time of the initial public offering.

Prior to the conversion, the Company had outstanding 1,241,841, 3,967,120, 2,490,181 and 1,232,392 shares of Series A convertible preferred stock and Series B, C and D redeemable convertible preferred stock, respectively. Changes in each class of convertible preferred stock from January 1, 2000 to December 31, 2001 are as follows (in thousands):

	Series A	Series B	Series C	Series D	Warrants for Series C	Total
Balances, December 31, 1999	\$ 2,227	\$ 11,764	\$ 5,416	\$ 4,435	\$ —	\$ 23,842
Accretion to redemption value on Series B, C and D redeemable convertible preferred stock	—	714	448	222	—	1,384
Balances, December 31, 2000	2,227	12,478	5,864	4,657	—	25,226
Accretion to redemption value on Series B, C and D redeemable convertible preferred stock	—	394	247	122	—	763
Conversion of preferred stock to common stock on initial public offering	(2,227)	(12,872)	(6,111)	(4,779)	—	(25,989)
Balances, December 31, 2001	—	—	—	—	—	—
Activity, year ending December 31, 2002	—	—	—	—	—	—
Balances, December 31, 2002	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

**8—STOCKHOLDERS' EQUITY (DEFICIT)**

**Common Stock**

The Company has 120,000,000 shares of common stock authorized at a par value of \$0.001 per share. On July 19, 2001, the Company completed an initial public offering of its shares pursuant to which it issued 5,750,000 common shares for proceeds of approximately \$56,451,000, net of issuance costs.

**Preferred Stock**

The Company has 10,000,000 shares of preferred stock authorized at a par value of \$0.001 per share. In accordance with the terms of the certificate of incorporation, the Board of Directors is authorized to provide for the issuance of one or more series of preferred stock, including increases or decreases to the series. The Board of Directors has the authority to set the rights, preferences and terms of such shares. As of December 31, 2002, no shares of preferred stock were issued and outstanding.

**Stockholder Rights Plan**

The Company adopted a Stockholder Rights Plan in September 2002 (the "Rights Plan"), as amended in October 2002 and February 2003. 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.

**Stock Option Plans**

Effective August 2000, the Company adopted the 2000 Stock Option Plan (the "2000 Plan") and reserved 1,500,000 shares of common stock for issuance under the 2000 Plan. Each year beginning January 1, 2002, the aggregate number of shares reserved under the 2000 Plan will automatically increase by the lesser of (i) 1,500,000, (ii) 7% of the shares of common stock outstanding at the end of preceding year, or (iii) an amount determined by the Board of Directors. On January 1, 2003, the number of shares reserved under the 2000 Plan increased by 1,138,704 shares. The 2000 Plan provides for the granting of incentive stock options to employees and nonqualified stock options to employees, directors, and consultants.

Under the 2000 Plan, incentive and nonqualified stock options may be issued at not less than the fair market value of the stock at the close of business of the Nasdaq National Market on the date immediately prior to the date of grant, as determined by the Board of Directors. Options issued under the 2000 Plan become exercisable as determined by the Board of Directors and expire no more than ten 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 at the date of grant, and the options expire five years after the date of grant. At December 31, 2002, 1,433,682 shares were available for grant of future options under the 2000 Plan.

The Company also has 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 Supplemental Plan generally were governed by the same terms as those under the 2000 Plan. At the time of the

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**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

Company's initial public offering, the 1991 Plan and Supplemental Plan was terminated such that no new options may be granted under these plans. Outstanding options at the date of the initial public offering remain outstanding under their original terms.

In addition, effective August 2000, the Company adopted the 2000 Director Option Plan (the "Director Plan"). The Director Plan provides for an initial grant to new nonemployee directors options to purchase 30,000 shares of common stock. Subsequent to the initial grants, each nonemployee director will be granted an option 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. The Company reserved a total of 400,000 shares of common stock under the Director Plan, plus an annual increase to be added on the first day of the Company's fiscal year beginning 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. At December 31, 2002, 329,323 shares were available for grant of future options under the Director Plan. On January 1, 2003, the number of shares reserved under the Director Plan increased by 81,336 shares.

A summary of option activity under various option plans is as follows:

	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding, January 1, 2000 (668,006 shares exercisable at a weighted average exercise price of \$0.58 per share)	1,093,630	\$ 0.85
Granted (weighted average fair value of \$5.28 per share)	985,820	\$ 4.27
Exercised	(270,345)	\$ 0.44
Cancelled	(123,592)	\$ 3.13
Outstanding, December 31, 2000 (699,317 shares exercisable at a weighted average exercise price of \$0.87 per share)	1,685,513	\$ 2.73
Granted (weighted average fair value of \$6.57 per share)	547,500	\$ 6.82
Exercised	(268,357)	\$ 0.50
Cancelled	(43,727)	\$ 4.91
Outstanding, December 31, 2001 (793,027 shares exercisable at a weighted average exercise price of \$2.31 per share)	1,920,929	\$ 4.16
Granted (weighted average fair value of \$1.81 per share)	1,027,128	\$ 3.77
Exercised	(340,407)	\$ 1.46
Cancelled	(238,831)	\$ 5.17
Outstanding, December 31, 2002 (844,263 shares exercisable at a weighted average exercise price of \$3.41 per share)	2,368,819	\$ 4.26

**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

The following table summarizes information concerning outstanding and exercisable options outstanding at December 31, 2002:

Range of Exercise Price	Number Outstanding as of 12/31/02	Weighted Average Remaining Contractual Life (Years)	Number Exercisable as of 12/31/02
\$ 0.2500 – \$ 1.0000	168,160	4.21	168,160
\$ 1.5000 – \$ 1.5000	250,534	7.28	196,501
\$ 1.8750 – \$ 3.2610	180,095	7.57	101,417
\$ 3.4500 – \$ 3.4500	427,148	9.87	833
\$ 3.4600 – \$ 4.1490	364,880	9.55	32,604
\$ 4.5500 – \$ 4.9000	245,500	9.04	6,648
\$ 5.6900 – \$ 5.6900	114,917	8.81	69,588
\$ 6.2500 – \$ 6.2500	481,025	7.98	247,285
\$10.0000 – \$11.0000	128,560	8.02	21,227
\$14.3800 – \$14.3800	8,000	8.64	0
	<hr/>	<hr/>	<hr/>
\$ 0.2500 – \$14.3800	2,368,819	8.34	844,263

The Company continues to account for its stock-based awards to employees using the intrinsic value method in accordance with APB No. 25 as interpreted by FIN 44, which, among other things, clarifies the definition of an employee for purposes of applying APB 25, the criteria for determining whether a plan qualifies as a non-compensatory plan, and the accounting consequence of various modifications to the terms of a previously fixed stock option award. However, SFAS No. 123, as amended by SFAS No. 148, requires the disclosure of pro forma net loss as if the Company had adopted the fair value method. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of the option pricing models.

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**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

Fair values of the options granted under the stock option plans were estimated at grant dates using a Black-Scholes option pricing model. The Company used the multiple option award approach and the following assumptions:

	Years Ended December 31,		
	2002	2001	2000
Expected life in years—Stock options	5.5 years	5.5 years	5.5 years
Expected life in years—ESPP	0.5 years	0.5 years	—
Risk free interest rate—Stock options	3.0%	4.5%	6.0%
Risk free interest rate—ESPP	1.0%	1.0%	—
Expected volatility	39%	118%	88%
Dividend yield	None	None	None

- (1) As the Company was privately held until July 2001, volatility was not applicable until filing its initial Registration Statement on August 19, 2000 as the Company utilized the minimum value method.

**Employee Stock Purchase Plan**

In August 2000, the Board of Directors approved the adoption of the 2000 Employee Stock Purchase Plan (the “Purchase Plan”) and reserved 1,000,000 shares of the Company’s common stock for issuance under the Purchase Plan. Each year, beginning January 1, 2003, the aggregate number of shares reserved for issuance under the Purchase Plan will automatically increase by a number of shares equal to the lesser of (i) 650,000, (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. The Purchase Plan adoption became effective at the time of the initial public offering. Under the Purchase Plan, eligible employees are allowed to have salary withholdings of up to 15% of their base compensation to purchase shares of common stock at a price equal to 85% of the lower of the market value of the stock at the beginning or end of defined purchase periods. There were 125,901 shares issued under the Purchase Plan in 2002. At December 31, 2002, 1,461,941 shares were reserved for future issuance under the Purchase Plan. On January 1, 2003, the number of shares reserved under the Purchase Plan increased by 650,000 shares.

**Deferred Stock Compensation**

In connection with the grant of stock options to employees during the year ended December 31, 2001, the Company recorded deferred stock compensation of \$2.7 million for the aggregate differences between the exercise prices of options at their dates of grant and the deemed fair value for accounting purposes of the common shares subject to these options. Such amount was recorded as a reduction of stockholders’ equity and is being amortized on a graded vesting method over the option vesting periods, which are generally four years.

**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

**9—COMMITMENTS**

**Leases**

The Company has entered into noncancelable operating leases for its facilities located in the United States through December 2005. Noncancelable operating leases for facilities located in the United Kingdom expire in 2004, and in Japan in 2003. Minimum lease payments under noncancelable operating leases as of December 31, 2002 are as follows (in thousands):

	<u>Operating Leases</u>
Year Ending December 31,	
2003	\$ 470
2004	396
2005	473
2006	—
2007	—
	<hr/>
Total minimum lease payments	\$ 1,339

Rent expense totaled approximately \$827,000, \$745,000, and \$574,000 in 2002, 2001 and 2000, respectively.

**Purchase Commitments**

The Company had various firm purchase commitments for inventory totaling approximately \$215,000 at December 31, 2002.

**10—RESTRUCTURING**

In September 2002, the Company recorded a restructuring charge of approximately \$255,000 relating to an operating cost reduction plan which resulted in a reduction of 18 employees and the accrual of associated employee termination-related benefits. The employee reductions were from production, marketing and sales, research and development, and administrative. Accordingly, the related charges were recorded in cost of revenues, marketing and selling, research and development, and general and administrative expenses. As of December 31, 2002, the Company has paid approximately \$234,000 of costs related to the restructuring.



**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

**11—INCOME TAXES**

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities as of December 31, 2002 and 2001 are as follows (in thousands):

	December 31,	
	2002	2001
Deferred tax assets:		
Net operating loss carryforwards	\$ 5,553	\$ 3,395
Accruals deductible in different periods	945	716
Basis difference in fixed and intangible assets	580	350
Credit carryforwards	690	551
Employee benefits	279	274
	8,047	5,286
Valuation allowance	(8,047)	(5,286)
	\$ —	\$ —

The Company's amount of income tax recorded differs from the amount using the federal statutory rate as follows (in thousands):

	Years Ended December 31,		
	2002	2001	2000
Federal statutory tax expense (benefit)	\$ (2,621)	\$ (1,335)	\$ 98
State tax expense (benefit)	(430)	(219)	3
Valuation allowance	2,761	1,070	(41)
California net operating loss limitation	134	100	—
Stock compensation expense on incentive stock options	191	447	279
Other	(73)	(60)	(306)
	\$ (38)	\$ 3	\$ 33

At December 31, 2002, the Company had federal net operating loss carryforwards of approximately \$13.1 million and state net operating loss carryforwards of approximately \$4.2 million available to reduce future taxable income. The federal net operating loss carryforwards expire beginning in 2007 through 2022, and the state net operating loss carryforwards expire through 2010. At December 31, 2002, the Company had credit carryforwards available of approximately \$398,000 for federal tax purposes that expire through 2022 and \$253,000 for California tax purposes of which a portion will expire through 2008.

The extent to which the federal and California operating loss and tax credit carryforwards can be used to offset future taxable income may be limited, depending on the extent of ownership changes within any three-year period, as provided in the Tax Reform Act of 1986. Such a limitation could result in the expiration of carryforwards before they are utilized.

A valuation allowance is provided when it is more likely than not that some portion or all of the deferred tax assets will not be realized. Accordingly, valuation allowances of \$8,047,000 and \$5,286,000 were recorded during the years ended December 31, 2002 and 2001 respectively.

**NATUS MEDICAL INCORPORATED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**Years Ended December 31, 2002, 2001 and 2000**

**12—EMPLOYEE BENEFIT PLAN**

The Company has a 401(k) tax-deferred savings plan under which eligible employees may elect to have a portion of their salary deferred and contributed to the plan. Employer matching contributions are determined by the Board of Directors and are discretionary. There was no employer matching contributions in 2002 or 2001. For the year ending December 31, 2000, the Board of Directors approved a dollar-for-dollar employer match of up to \$500 per employee on employee contributions, which resulted in the aggregate employer contributions of \$46,000 in 2000. Employer contributions vest ratably over four years from date of employment.

**13—CUSTOMER AND GEOGRAPHIC INFORMATION**

The Company operates in one reportable segment and is engaged in the design, manufacture and, marketing of newborn screening products for the identification and monitoring of common medical disorders that may occur during the critical development period of infants. The nature of the Company's products and production processes as well as type of customers and distribution methods are consistent among all of the Company's devices.

Revenues from customers by geographic area are as follows (in thousands):

	Years Ended December 31,		
	2002	2001	2000
Revenues:			
United States	\$ 22,311	\$ 22,683	\$ 21,306
Asia	2,396	3,410	2,703
All other	2,306	1,308	624
	<u>\$ 27,013</u>	<u>\$ 27,401</u>	<u>\$ 24,633</u>

At December 31, 2002, the long-lived assets located outside the United States with the Company's foreign subsidiaries totaled approximately \$394,000, and the remainder was located within the United States. At December 31, 2001, the long-lived assets located outside the United States with the Company's foreign subsidiaries totaled approximately \$150,000, and the remainder was located within the United States. At December 31, 2000, all of the Company's long-lived assets were located within the United States.

In 2002 and 2001, no sales to a single customer accounted for greater than 10% of revenues. In 2000, sales to a distributor accounted for 11% of revenues.

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**EXHIBIT INDEX**

<u>Exhibit No.</u>		<u>Exhibit Title</u>
3.1.1	(b)	Certificate of Incorporation
3.1.2	(g)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of the Registrant
3.2	(b)	Bylaws of the Registrant
4.2	(h)	Preferred Stock Rights Agreement, dated as of October 8, 2002, between Registrant and Equiserve Trust Company, N.A., including the form of Rights Certificate and Summary of Rights attached thereto as Exhibits B and C, respectively
4.2.1	(i)	Amendment No. 1 to Preferred Stock Rights Agreement dated as of February 14, 2003 between the Registrant and Equiserve Trust Company, N.A.
4.3	(i)	Voting Agreement dated February 14, 2003 between the Registrant and Perry Corp.
10.1	(b)	Form of Indemnification Agreement between the Registrant and each of its directors and officers
10.2	(b)	Amended and Restated 1991 Stock Option Plan
10.2.1	(b)	Form of Option Agreement under the 1991 Stock Option Plan
10.3	(b)	2000 Stock Option Plan
10.3.1	(b)	Form of Option Agreement under the 2000 Stock Option Plan
10.4	(b)	2000 Director Option Plan
10.4.1	(b)	Form of Option Agreement under 2000 Director Option Plan
10.5	(b)	2000 Employee Stock Purchase Plan and form of subscription agreement thereunder
10.6		Reserved
10.6.1		Reserved
10.7†	(b)	Patent License Agreement dated June 30, 1998 between Registrant and The Leland Stanford Junior University
10.8	(b)	Lease Agreement dated August 24, 1998 between Registrant and San Carlos Co-Tenancy
10.8.1	(a)	Amendment to Lease Agreement dated August 24, 1998 between Registrant and San Carlos Co-Tenancy
10.9	(b)	Promissory Note dated March 24, 1999 between Scott Valley Bank and Tim C. Johnson
10.9.1	(b)	Assignment of Deposit Account dated March 24, 1999 between Registrant, Scott Valley Bank and Tim C. Johnson
10.9.2	(b)	Security Agreement dated March 26, 1999 between Registrant and Tim C. Johnson
10.10†	(b)	Capital Equipment Supplier Agreement dated June 25, 1999 between the Registrant and Novation, LLC
10.10.1†	(a)	Letter Amendment dated January 8, 2003 to Capital Equipment Supplier Agreement dated June 25, 1999 between the Registrant and Novation, LLC
10.11†	(b)	Manufacturing Agreement dated December 3, 1998 between Registrant and TriVirix International, Inc. (formerly CMA International, Inc.)
10.12		Reserved
10.13		Reserved
10.14†	(b)	Memorandum of Understanding dated December 7, 2000 between Registrant and the Ludlow Company LP
10.15	(b)	2000 Supplemental Stock Option Plan

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<u>Exhibit No.</u>	<u>Exhibit Title</u>
10.15.1	(b) Form of Option Agreement for 2000 Supplemental Stock Option Plan
10.16	(b) Lease dated March 3, 2000 between W&G Properties Limited, Neonatal Perspectives Limited and Andrew Vincent for the premises located at Unit 9, Northmill, Buckinghamshire, United Kingdom
10.17	Reserved
10.17.1	Reserved
10.17.2	Reserved
10.17.3	Reserved
10.17.4	Reserved
10.18	(c) Leasing Agreement dated June 11, 2001 between Natus Japan and Sanwa Radiator Co. Ltd. (Japanese to English translation)
10.19	(d) Severance Agreement and Release between Registrant and Terese Baker dated March 8, 2002
10.20	(e) Transition and Release Agreement between Registrant and William H. Lawrenson dated April 26, 2002
10.21	(f) Severance Agreement and Release between Registrant and Lucille A. Ferus dated October 7, 2002
10.22	(f) Severance Agreement and Release between Registrant and Thomas M. Waugh dated September 19, 2002
10.23	(a) Employment Agreement dated as of November 18, 2002 between Registrant and Tim C. Johnson
10.24	(a) Form of Employment Agreement between the Registrant and each of its executive officers
14.1	(a) Code of Ethics for Financial Executives
21.1	(b) Subsidiaries
23.1	(a) Independent Auditors' Consent
24.1	(a) Power of Attorney (see page 62)
99.1	(a) Certifications Of Chief Executive Officer And Chief Financial Officer

† Portions of this agreement have been omitted pursuant to a request for confidential treatment and the omitted portions have been filed with the Securities and Exchange Commission.

- (a) Filed herewith.
- (b) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Registration Statement on Form S-1 (Registration Statement 333-39891), which the Securities and Exchange Commission declared effective on July 19, 2001.
- (c) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001.
- (d) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002.
- (e) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.
- (f) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002.
- (g) Incorporated by reference to the exhibit bearing the same number filed with the Registrant's Report on Form 8-A as declared effective by the Securities and Exchange Commission on February 25, 2003.
- (h) Incorporated by reference to the exhibit filed with the Amendment to the Registrant's Registration Statement on Form 8-A on October 8, 2002.
- (i) Incorporated by reference to the exhibit filed with the Registrant's Report on Form 8-K as filed with the Securities and Exchange Commission on February 25, 2003.

**THIRD AMENDMENT TO LEASE**

THIS THIRD AMENDMENT TO LEASE (this "Amendment") is executed as of December 12, 2002, between SAN CARLOS CO-TENANCY, a tenancy in common ("Landlord"), and NATUS MEDICAL, INC., a Delaware corporation ("Tenant").

**Recitals**

A. Pursuant to the terms of the written Lease Agreement between Tenant, as tenant, and Landlord, as landlord, dated August 24, 1998 (the "Original Lease"), as amended by that certain Lease Termination Agreement (the "Termination Agreement") dated January 28, 1999 (which terminated the Lease as to a 3,825 square foot portion of the Premises), as amended by that certain First Amendment to Lease dated September 23, 1999 (the "First Amendment"), and as further amended by that certain Second Amendment to Lease dated May 1, 2002 (the "Second Amendment"), Tenant leases from Landlord those certain Premises containing approximately 30,369 rentable square feet of space in portions of the Buildings (as defined in the Original Lease). The Premises are located at the following addresses: 1501, 1541, 1547, 1549, and 1555 Industrial Road, San Carlos, California. The Original Lease as amended by the Termination Agreement, the First Amendment and the Second Amendment is herein referred to as the "Existing Lease." As amended by this Amendment, the Existing Lease is herein referred to as the "Lease." Capitalized terms not otherwise defined in this Amendment shall have the meanings given them in the Existing Lease.

B. The Term of the Existing Lease is scheduled to expire on December 31, 2003 (the "Existing Expiration Date").

C. Landlord and Tenant desire to amend the Existing Lease to (i) extend the Term of the Existing Lease with respect to only a portion of the Premises identified as the Renewal Premises (as hereinafter defined), (ii) modify the existing Base Rent (for only the Renewal Premises) for a portion of the Term remaining prior to the Existing Expiration Date, (iii) establish the Base Rent for the Extended Term (as hereinafter defined), (iv) provide Tenant an option to renew the Term of the Lease in accordance with the provisions contained herein, (v) provide Tenant a right of first offer for a particular space in the Project, and (vi) for other purposes, all as set forth below. As herein defined, the term "Renewal Premises" means that portion of the original Premises containing approximately 26,299 square feet of space located at the following addresses: 1501, 1541, 1547 and 1549 Industrial Road, San Carlos, California. The Renewal Premises does not include approximately 4,070 square feet of space located at 1555 Industrial Road, San Carlos, California (identified in the Second Amendment as the "Additional Premises"). The Renewal Premises are identified on Exhibit A attached hereto and made a part hereof.

D. Except as otherwise expressly provided herein to the contrary, all capitalized terms used in this Amendment shall have the same meanings given such terms in the Existing Lease.

NOW, THEREFORE, in consideration of the foregoing recitals and the mutual covenants contained herein, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as that the Lease is amended as follows:

1. **Extended Term.** The Term of the Existing Lease for the Renewal Premises is hereby extended by two (2) years to expire on December 31, 2005 (the "New Expiration Date"), subject to Tenant's option to extend the Term of the Lease for a period of five (5) years in accordance with the provisions set forth in Paragraph 3 below.

2. **Monthly Base Rent.** Base Rent for the period of January 1, 2003 through the Existing Expiration Date is hereby amended for only the Renewal Premises in accordance with the following schedule. In addition, Tenant shall pay Base Rent during the Extended Term in accordance with the following schedule. Commencing on January 1, 2003 and continuing through the remainder of the Term (as extended through the New Expiration Date) Tenant shall pay to Landlord the following monthly Base Rent for the Renewal Premises:

January 1, 2003 – December 31, 2003:	\$26,299.00 per month (\$1.00/s.f./mo.)
January 1, 2004 – December 31, 2004:	\$32,873.75 per month (\$1.25/s.f./mo.)
January 1, 2005 – December 31, 2005:	\$39,488.50 per month (\$1.50/s.f./mo.)

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In addition to the Base Rent payable by Tenant for the Renewal Premises (as modified above) for the period of January 1, 2003 through December 31, 2005, Tenant shall continue to pay Base Rent for the Additional Premises at the rate contained in the Existing Lease, which for the period from January 1, 2003 through December 31, 2003 is as follows:

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January 1, 2003 – December 31, 2003:

\$6,105.00 per month (\$1.50/s.f./mo.)

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Tenant shall continue to pay Operating Costs and Taxes, and any other applicable costs and expenses, during the Term of the Lease (including the Extended Term) in accordance with the provisions of the Existing Lease.

3. Option to Extend the Term of the Lease. The Extension Option contained in Section 37 of the Original Lease is hereby deleted and replaced with the following:

“Subject to the provisions hereinafter set forth, Landlord hereby grants to Tenant one (1) option to extend the Term of this Lease (this “Extension Option”) for a period of five (5) years on the same terms, conditions and provisions as contained in this Lease, modified as provided herein, except that Tenant shall have no additional option to extend the Term of the Lease beyond the one (1) Extension Option herein contained. If Tenant effectively exercises this Extension Option in accordance with the provisions contained below, the extension period (the “Extension Option Term”) shall commence on January 1, 2006 and shall expire on December 31, 2010.

(a) The Extension Option must be exercised, if at all, by written notice from Tenant to Landlord, given not more than 12 months and not less than 9 months prior to the New Expiration Date, time being of the essence. Notwithstanding the foregoing, at Landlord’s election, this Extension Option shall be null and void and Tenant shall have no right to renew this Lease if (i) as of the New Expiration Date Tenant is not in occupancy of the entire Premises then demised hereunder or Tenant does not intend to continue to occupy the Premises (but intends to assign this Lease or sublet the space in whole or in part), or (ii) on the date Tenant exercises the Extension Option or on the New Expiration Date, Tenant is either (x) in default under any of Tenant’s monetary obligations under the Lease beyond any applicable grace or notice period, or (y) in material default under any of Tenant’s non-monetary obligations under the Lease beyond any applicable grace or notice period. If Tenant fails to timely give notice of its exercise of the Extension Option, the Extension Option shall thereupon terminate and become void without any requirement of notice from Landlord to Tenant.

(b) If Tenant effectively exercises this Extension Option, then during the Extension Option Term all of the terms and conditions set forth in this Lease as applicable to the Premises during the previously existing Term shall apply, except that (i) Tenant shall have no further right to extend the Term of this Lease, (ii) Tenant shall take the Premises in their then existing “as-is” state and condition, and (iii) the Base Rent payable by Tenant for the Premises shall be established as provided below. The Base Rent payable during the Extension Option Term shall be equal to ninety-five percent (95%) of the “Fair Market Rental Value” of the Premises (as hereinafter defined), but in no event shall the Base Rent be less than the Base Rent payable for the Premises immediately prior to the commencement of the Extension Option Term.

(c) “Fair Market Rental Value” shall be determined as of the date that is six (6) months prior to the commencement of the Extension Option Term, and shall include the periodic rental increases, if any, that would be included for space leased for the period of the Extension Option Term, and shall mean the rental rate as of said date for comparable space under primary lease (and not sublease) to renewal tenants in other buildings similar to the Buildings located in the general vicinity of the Premises, taking into consideration (1) the creditworthiness of such other tenant or tenants, (2) the size, configuration and location of the leased premises (including rights to expand or contract), (3) the presence or absence of parking, (4) the term of the letting (including options to extend or shorten the term), and (5) the condition of the leased premises.

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(d) Landlord shall, in response to and within thirty (30) days of Landlord's receipt of Tenant's notice exercising the Extension Option, give Tenant written notice of the Fair Market Rental Value, as reasonably determined in good faith by Landlord. Not later than fifteen (15) days after Landlord's notice to Tenant of Landlord's determination of the Fair Market Rental Value, Tenant shall timely notify Landlord of whether Tenant accepts or rejects Landlord's determination of the Fair Market Rental Value. If Tenant does not accept (or Tenant rejects) Landlord's determination, then Tenant shall give Landlord written notice of Tenant's then opinion of Fair Market Rental Value. If, within fifteen (15) days after Tenant receives Landlord's written determination of Fair Market Rental Value, Tenant fails to give Landlord written notice of Tenant's opinion of Fair Market Rental Value, then Tenant shall be deemed to have accepted Landlord's determination of Fair Market Rental Value, as contained in Landlord's written notice to Tenant. Upon Landlord's receipt of Tenant's opinion of the Fair Market Rental Value, if Tenant's written opinion of Fair Market Rental Value is given within the fifteen (15) day period contained above, then Landlord and Tenant shall meet to attempt to agree upon the Fair Market Rental Value. If Landlord and Tenant are unable to agree about Fair Market Rental Value within twenty (20) days after Landlord's receipt of Tenant's opinion of Fair Market Rental Value, then Fair Market Rental Value shall be determined by appraisal as provided below.

(e) If pursuant to the foregoing provisions the Fair Market Rental Value is to be determined by appraisal, the following procedures shall be implemented:

(i) Within fifteen (15) days after the expiration of the twenty (20) day period set forth above for the mutual agreement of Landlord and Tenant as to the Fair Market Rental Value, Landlord and Tenant shall each, at its cost, engage a real estate appraiser to act on its behalf in determining the Fair Market Rental Value. Each appraiser so selected shall be certified as an MAI appraiser and shall have had at least 5 years recent experience as a real estate appraiser working in the vicinity of the Premises, with working knowledge of current rental rates and practices for similar type buildings and projects as contained in, and located at, the Buildings. If a party does not appoint an appraiser within such fifteen (15)-day period but an appraiser is appointed by the other party, the single appraiser appointed shall be the sole appraiser and shall set the Fair Market Rental Value. If two appraisers are appointed by the parties, each shall promptly appraise the Fair Market Rental Value and they shall thereupon deliver to Landlord and Tenant their respective written appraisals of Fair Market Rental Value. If the appraisers are in agreement, their appraisals shall establish the Fair Market Rental Value. If they are not in agreement, then the arbitration provisions contained in Subsection (ii) below shall be used to determine Fair Market Rental Value.

(ii) If the Fair Market Rental Value is not determined through the foregoing procedure, then the two appraisers shall promptly select a third appraiser (the "Arbitrator") meeting the qualifications stated above. Landlord and Tenant shall each bear one-half (1/2) of the Arbitrator's fee. The Arbitrator shall not be told of the appraisal determinations of the other two appraisers and shall promptly conduct its own appraisal of the Fair Market Rental Value. When the Arbitrator has made its determination of Fair Market Rental Value, it shall give written notice thereof to the appraisers appointed by Landlord and Tenant. Within five (5) business days following receipt of the Arbitrator's determination, the appraisers selected by Landlord and Tenant shall submit their estimates of Fair Market Rental Value to the Arbitrator. The Arbitrator shall select only one (1) of the two (2) determinations of Fair Market Rental Value submitted to the Arbitrator by the appraisers selected by Landlord and Tenant, and such determination shall be binding upon Landlord and Tenant. The Arbitrator shall not average appraisals or otherwise select any other determination of Fair Market Rental Value, except one (1) of the two (2) submitted by the appraisers selected by Landlord and Tenant. If Tenant's determination of Fair Market Rental Value is selected by the Arbitrator, then Landlord shall bear all of the costs and fees of the Arbitrator. If Landlord's determination of Fair Market Rental Value is selected by the Arbitrator, then Tenant shall bear all of the costs and fees of the Arbitrator."

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4. Right of First Offer. The Right of First Offer contained in Section 36 of the Original Lease is hereby terminated and replaced with the following Right of First Offer:

“36. RIGHT OF FIRST OFFER.

(a) Provided that Natus Medical, Inc. has not assigned this Lease or sublet any or all of the Premises other than to an Affiliate (it being intended that all rights pursuant to this provision are and shall be personal to the original Tenant under this Lease, and any Affiliate of Tenant, and shall not be transferable or exercisable for the benefit of any Transferee, except for an Affiliate), and provided Tenant is either (x) not in default under any of Tenant’s monetary obligations under the Lease beyond any applicable grace or notice period, or (y) not in material default under any of Tenant’s non-monetary obligations under the Lease beyond any applicable grace or notice period at the time of the exercise of any such right or at any time thereafter until delivery of possession of the space to Tenant, subject to any and all rights granted by Landlord or asserted by others with respect to such space (including renewal and extension rights and rights of first offer, first negotiation, first refusal or other expansion rights), and subject to Landlord’s right to extend or renew any then existing lease of the space, Tenant shall have a one-time right of first offer to lease the following space in the Project: 4,100 square feet at the following address: 1585 Industrial Road, San Carlos, California (the “ROFO Space”). The ROFO space is shown on Exhibit A attached hereto and made a part hereof.

(b) Such right of first offer (i) may only be exercised with respect to the ROFO Space if and when the ROFO Space becomes vacant during the Term following expiration or other termination of the previous lease for the ROFO Space, and (ii) may only be exercised with respect to all of the space being offered by Landlord. If the ROFO Space becomes available, Landlord shall offer to lease such space to Tenant at the same rent and on the same terms that Landlord intends to offer to other prospective tenants. Tenant shall have seven (7) Business Days following receipt of Landlord’s offer with respect to the ROFO Space within which to notify Landlord in writing of its intention to lease such space, and such notice, if given by Tenant, shall constitute an acceptance of Landlord’s terms for the lease of such ROFO Space. If Tenant exercises such right of first offer, the ROFO Space shall be leased to Tenant on the same terms and conditions as are contained in this Lease except for the economic and other terms specifically set forth in Landlord’s notice, and the parties shall execute an amendment to this Lease to include such space in the Premises and otherwise to provide for the leasing of such ROFO Space on such terms. If Tenant fails so to exercise Tenant’s right of first offer within such seven (7) Business Day period, Landlord may thereafter lease such ROFO Space to other prospective tenants; provided, however, that if Landlord proposes to lease such space at an effective rent that is less than ninety percent (90%) of the effective rent proposed to Tenant, or upon other terms which are substantially more favorable to the prospective tenant, Landlord shall first re-offer such ROFO Space to Tenant at such lower rent and/or more favorable terms in accordance with the provisions of this paragraph.

(c) If Tenant does not lease the ROFO Space from Landlord when it is first offered to Tenant by Landlord or when it is re-offered to Tenant because the economic terms first offered to Tenant have materially changed, as described in the last sentence of paragraph (b) above, then this right of first offer shall terminate and Tenant shall have no further rights to lease any of the ROFO Space.”

5. Broker. Landlord agrees to pay a commission to CB Richard Ellis (the “Broker”) pursuant to a separate agreement between Landlord and Broker. Tenant represents and represents to Landlord that in negotiating or making of this Amendment neither Tenant nor anyone acting on Tenant’s behalf has contractually engaged any real estate broker or finder who might be entitled to a fee or commission for this Amendment. Tenant shall indemnify and hold harmless Landlord against any claim or claims, including expenses and attorneys’ fees incurred by Landlord directly in connection with defending any such claim(s), asserted by any real estate broker (other than Broker) for a fee or commission based upon any dealings with or statements made by Tenant or Tenant’s Representatives in connection with this transaction.

6. Full Force and Effect; No Other Amendment. Except as amended by this Amendment, the Existing Lease has not been amended or modified; and all of the terms and provisions of the Existing Lease, as modified by this Amendment, remain unmodified and in full force and effect. Landlord and Tenant hereby ratify the Existing Lease, as amended herein. The Lease contains the entire agreement between Landlord and Tenant regarding the subject matters contained herein, and supercedes all prior of contemporaneous agreements, understandings, proposals and other representations by or between Landlord and Tenant, whether written or oral, all of which are merged herein. This Amendment shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns. This Amendment is hereby executed and delivered in multiple counterparts, each of which shall have the force and effect of an original.



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IN WITNESS WHEREOF, Landlord and Tenant have executed this Amendment as of the day and year first above written.

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**LANDLORD:**

San Carlos Co-Tenancy, a tenancy in common

By: /s/ R. BRUCE MOSBACHER \_\_\_\_\_

Name: R. Bruce Mosbacher \_\_\_\_\_

Title: \_\_\_\_\_

By: /s/ JOHN HAMILTON \_\_\_\_\_

Name: John Hamilton \_\_\_\_\_

Title: Member \_\_\_\_\_

**TENANT:**

Natus Medical, Inc., a Delaware corporation

By: /s/ TIM C. JOHNSON \_\_\_\_\_

Name: Tim C. Johnson \_\_\_\_\_

Title: President and CEO \_\_\_\_\_

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

---

January 8, 2003

\*\*\*  
\*\*\*

Natus Medical Inc.  
1501 Industrial Road  
San Carlos, CA 94070-4111

RE: Extension of Agreement #CE90270

Dear \*\*\*:

Natus Medical Inc. and Novation, LLC agree to extend the above-referenced Agreement through January 31, 2004. In addition Natus and Novation agree to make the following changes to the Supplier Agreement:

**1a. Purchasing and Leasing Opportunities for Members.** In the 5<sup>th</sup> sentence delete "a Member" for purposes of this Agreement and replace with "eligible Member to participate in this Agreement". Also, in the 5<sup>th</sup> sentence delete the second "a Member" and replace with "eligible Member." Definition of "eligible Member" is found in Section 2a below.

**2a. Letter of Award.** Delete the first sentence and replace with the following: "By executing and delivery the Letter of Award attached hereto as Exhibit D ("Award Letter") to Supplier, Novation will have accepted the Bid, and Novation and Supplier therefore agree that Supplier will make Products available for purchase and/or lease by the Members that have completed a Letter of Participation (attached hereto in Exhibit A), at the Award Prices in accordance with the terms of this Agreement and the forms of purchase, lease, financing or servicing agreements, if any, attached hereto in Exhibit E (collectively, "Forms"); provided, however, that Novation's award of this Agreement to Supplier will not constitute a commitment by any person to purchase or lease any of the products. All subsequent reference in this Agreement to "Members" shall refer to those having completed the Letter of Participation."

**9a. Marketing Fees Calculation.** In the fifth line: after "revenues" change to less \*\*\* and \*\*\*, and then add "to the participating Members, directly or indirectly from Supplier (now add) "during the Term of this Agreement" and strike remaining part of this sentence.

**Exhibit A.** The current Exhibit A is replaced with the attached Exhibit A effective February 1, 2003. The revised Letter of Participation reflecting these changes is also attached.

**Exhibits B and D.** Delete references to Super Committed Participation Level.

All other terms and conditions of the current Agreement will remain in full force and effect.

Please indicate your acceptance of this extension as amended by signing in the space provided below, and returning one signed original to \*\*\* at your earliest convenience. A copy is provided for your records.

Sincerely,

/s/ Larry Dooley

Larry Dooley  
Vice President  
Contract and Program Services

\*\*\*Confidential treatment requested pursuant to a request for confidential treatment filed with the Securities and Exchange Commission. Omitted portions have been filed separately with the Commission.

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AGREED TO AND ACCEPTED this 30<sup>th</sup> day of January, 2003.

Natus Medical Inc.

By:           /s/ KENNETH M. TRAVERSO          

Printed Name:           Kenneth M. Traverso          

Title:           Vice President of Marketing & Sales          

\*\*\*Confidential treatment requested pursuant to a request for confidential treatment filed with the Securities and Exchange Commission. Omitted portions have been filed separately with the Commission.



NOVATION  
LETTER OF PARTICIPATION

2/1/03

Natus Infant Hearing Screening Equipment Contract (CE90270)

Hospital: \_\_\_\_\_ Address: \_\_\_\_\_

City, State, Zip: \_\_\_\_\_ Phone: \_\_\_\_\_

Annual Birth Rate: \_\_\_\_\_

**Freight—FOB Origin, Prepaid and Added to Invoice**

**1. ALGO® SCREENER PRICING:**

Model	P/N	List Price	Novation Price
ALGO®3	010038	\$18,500	***
ALGO 2eColor	010050	\$17,500	***
ALGO Portable	010049	\$10,900	***

**2. Colorado-Pak (P/N 040112 & 040170) and ALGO PAK (P/N 040546) List Price \$\*\*\*  
Single Purchaser—SINGLE ORDER OR 12 MONTH STANDING ORDER PRICING**

Screens	Boxes	Discount	Box Price	Screen Price	Indicate *** Standing Order
***	***	***	***	***	
***	***	***	***	***	
***	***	***	***	***	
***	***	***	***	***	
***	***	***	***	***	

- A. Natus Medical Inc. will apply Novation contract supply pricing to customers with \*\*\* on the \*\*\* of the month \*\*\* of this form at Natus.
- B. Natus Medical will provide assistance in determining appropriate Standing Order quantities and delivery periods. Standing Order shipments will be audited every \*\*\* to \*\*\*.

As a representative of the hospital, I verify that the hospital wishes to participate in the Natus contract CE90270.

Name \_\_\_\_\_ Signature \_\_\_\_\_

Title \_\_\_\_\_ Date \_\_\_\_\_

As a representative of Natus Medical, I verify that \*\*\*

Name \_\_\_\_\_ Signature \_\_\_\_\_

Title \_\_\_\_\_ Date \_\_\_\_\_

**PLEASE RETURN COMPLETED FORM TO:**

**NATUS MEDICAL INC.**, Attn: Customer Service, 1501 Industrial Road, San Carlos, CA 94070-4111  
Phone: 800-255-3901 Fax: 650-802-6620

\*\*\*Confidential treatment requested pursuant to a request for confidential treatment filed with the Securities and Exchange Commission. Omitted portions have been filed separately with the Commission.

**NATUS MEDICAL, INC.**  
**TIM C. JOHNSON EMPLOYMENT AGREEMENT**

This Agreement is entered into as of November 18, 2002, (the "Effective Date") by and between Natus Medical, Inc. (the "Company"), and Tim C. Johnson ("Executive").

1. Duties and Scope of Employment.

(a) Positions and Duties. As of the Effective Date, Executive will serve as President and Chief Executive Officer of the Company. Executive will render such business and professional services in the performance of his duties, consistent with Executive's position within the Company, as shall reasonably be assigned to him by the Company's Chief Executive Officer ("CEO"). The period of Executive's employment under this Agreement is referred to herein as the "Employment Term."

(b) Obligations. During the Employment Term, Executive will perform his duties faithfully and to the best of his ability and will devote his full business efforts and time to the Company. For the duration of the Employment Term, Executive agrees not to actively engage in any other employment, occupation or consulting activity for any direct or indirect remuneration without the prior approval of the Board.

2. At-Will Employment. The parties agree that Executive's employment with the Company will be "at-will" employment and may be terminated at any time with or without cause or notice. Executive understands and agrees that neither his job performance nor promotions, commendations, bonuses or the like from the Company give rise to or in any way serve as the basis for modification, amendment, or extension, by implication or otherwise, of his employment with the Company.

3. Compensation.

(a) Base Salary. During the Employment Term, the Company will pay Executive an annual salary of \$280,000.00 as compensation for his services (the "Base Salary"). The Base Salary will be paid periodically in accordance with the Company's normal payroll practices and be subject to the usual, required withholding. Executive's salary will be subject to review and adjustments will be made based upon the Company's normal performance review practices.

4. Employee Benefits. During the Employment Term, Executive will be entitled to participate in the employee benefit plans currently and hereafter maintained by the Company of general applicability to other senior executives of the Company, including, without limitation, the Company's group medical, dental, vision, disability, life insurance, and flexible-spending account plans. The Company reserves the right to cancel or change the benefit plans and programs it offers to its employees at any time.

5. Paid Time Off ("PTO"). Executive is entitled to receive PTO pursuant to Natus' standard benefit policy currently and hereafter maintained by the Company, and as may be cancelled or changed from time to time.

6. Expenses. The Company will reimburse Executive for reasonable travel, entertainment or other expenses incurred by Executive in the furtherance of or in connection with the performance of Executive's duties hereunder, in accordance with the Company's expense reimbursement policy as in effect from time to time.

7. Severance.

(a) Involuntary Termination. If Executive's employment with the Company terminates other than for "Cause" (as defined herein), death or disability, and Executive signs and does not revoke a standard release of claims with the Company, then, subject to Section 11, Executive shall be entitled to (i) receive continuing payments of severance pay (less applicable withholding taxes) at a rate equal to his Base Salary rate, as then in effect, for a period eighteen (18) months from the date of such termination, to be paid periodically in accordance with the Company's

normal payroll policies; (ii) the immediate vesting and exercisability of 100% of the shares subject to all of Executive's stock options to purchase Company Common Stock (whether currently outstanding or granted in following the Effective Date) outstanding on the date of such termination (the "Stock Options") and (iii) continued payment by the Company of the group health continuation coverage premiums for Executive and Executive's eligible dependents under Title X of the Consolidated Budget Reconciliation Act of 1985, as amended ("COBRA") as in effect through the lesser of (x) eighteen (18) months from the effective date of such termination, (y) the date upon which Executive and Executive's eligible dependents become covered under similar plans, or (z) the date Executive no longer constitutes a "Qualified Beneficiary" (as such term is defined in Section 4980B(g) of the Internal Revenue Code of 1986, as amended (the "Code")); provided, however, that Executive will be solely responsible for electing such coverage within the required time periods.

(b) Voluntary Termination; Termination for Cause. If Executive's employment with the Company terminates voluntarily by Executive (other than as described in subsection (c) below) or for Cause by the Company or due to Executive's death or disability, then (i) all vesting of Stock Options will immediately cease, (ii) all payments of compensation by the Company to Executive hereunder will terminate immediately (except as to amounts already earned), and (iii) Executive will only be eligible for severance benefits, if any, in accordance with the Company's established policies as then in effect.

(c) Change of Control Benefits. If within twelve (12) months following a "Change of Control" (as defined below) (i) Executive terminates Executive's employment with the Company for Good Reason, or (ii) the Company or the successor corporation terminates Executive's employment with the Company for other than Cause, death or disability, then Executive shall be entitled to the benefits provided for in subsection (a). Executive shall only be permitted to receive the benefits provided for in subsection (a) once and shall not be permitted to claim such benefits under both subsection (a) and (c) such that Executive would receive the benefits pursuant to subsection (a) twice.

8. Limitation on Payments. In the event that the severance and other benefits provided for in this Agreement or otherwise payable to the Executive (i) constitute "parachute payments" within the meaning of Section 280G of the Code and (ii) but for this Section 8, would be subject to the excise tax imposed by Section 4999 of the Code, then the Executive's severance benefits under Section 4(a)(i) shall be either:

- delivered in full, or
- delivered as to such lesser extent which would result in no portion of such severance benefits being subject to excise tax under Section 4999 of the Code,
- whichever of the foregoing amounts, taking into account the applicable federal, state and local income taxes and the excise tax imposed by Section 4999, results in the receipt by Executive on an after-tax basis, of the greatest amount of severance benefits, notwithstanding that all or some portion of such severance benefits may be taxable under Section 4999 of the Code. Unless the Company and Executive otherwise agree in writing, any determination required under this Section 8 shall be made in writing by the Company's independent public accountants immediately prior to Change of Control (the "Accountants"), whose determination shall be conclusive and binding upon Executive and the Company for all purposes. For purposes of making the calculations required by this Section 8, the Accountants may make reasonable assumptions and approximations concerning applicable taxes and may rely on reasonable, good faith interpretations concerning the application of Sections 280G and 4999 of the Code. The Company and Executive shall furnish to the Accountants such information and documents as the Accountants may reasonably request in order to make a determination under this Section. The Company shall bear all costs the Accountants may reasonably incur in connection with any calculations contemplated by this Section 8.

9. Definitions.

(a) Cause. For purposes of this Agreement, "Cause" shall mean (i) any act of personal dishonesty taken by Executive in connection with his responsibilities as an employee and intended to result in substantial personal enrichment of Executive, (ii) Executive's conviction of a felony, (iii) a willful act by Executive which constitutes gross misconduct and which is injurious to the Company, or (iv) continued substantial violations by Executive of Executive's employment duties which are demonstrably willful and deliberate on Executive's part after there has been delivered to Executive a written demand for performance from the Company which specifically sets forth the factual basis for the Company's belief that Executive has not substantially performed Executive's duties.

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(b) Change of Control. For purposes of this Agreement, “Change of Control” of the Company is defined as:

(i) any “person” (as such term is used in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934, as amended) is or becomes the “beneficial owner” (as defined in Rule 13d-3 under said Act), directly or indirectly, of securities of the Company representing 50% or more of the total voting power represented by the Company’s then outstanding voting securities; or

(ii) a change in the composition of the Board occurring within a two-year period, as a result of which fewer than a majority of the directors are Incumbent Directors. “Incumbent Directors” will mean directors who either (A) are directors of the Company as of the date hereof, or (B) are elected, or nominated for election, to the Board with the affirmative votes of at least a majority of the Incumbent Directors at the time of such election or nomination (but will not include an individual whose election or nomination is in connection with an actual or threatened proxy contest relating to the election of directors to the Company); or

(iii) the date of the consummation of a merger or consolidation of the Company with any other corporation that has been approved by the stockholders of the Company, other than a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity) more than forty percent (40%) of the total voting power represented by the voting securities of the Company or such surviving entity outstanding immediately after such merger or consolidation, or the stockholders of the Company approve a plan of complete liquidation of the Company; or

(iv) the date of the consummation of the sale or disposition by the Company of all or substantially all the Company’s assets;

or

(v) the termination of the CEO (in place on the Effective Date) for other than Cause, death or disability.

(c) Good Reason. For purposes of this Agreement, “Good Reason” shall mean without the Executive’s express written consent shall mean (i) the significant reduction of the Executive’s duties or responsibilities relative to Executive’s duties or responsibilities in effect immediately prior to such reduction; provided, however, that a reduction in duties or responsibilities solely by virtue of the Company being acquired and made part of a larger entity (as, for example, when the Chief Financial Officer of Natus Medical Incorporated remains as such following a Change of Control and is not made the Chief Financial Officer of the acquiring corporation) shall not constitute “Good Reason;” (ii) a reduction by the Company in Executive’s annual Base Salary as in effect immediately prior to such reduction; (iii) a material reduction by the Company in the kind or level of employee benefits to which Executive is entitled immediately prior to such reduction with the result that Executive’s overall benefits package is significantly reduced; (iv) the relocation of Executive to a facility or a location more than 35 miles from Executive’s then present location, without Executive’s express written consent; or (v) the failure of the Company to obtain the assumption of this Agreement by any successors contemplated in Section 12.

10. Confidential Information. Executive agrees to enter into the Company’s standard Confidential Information and Invention Assignment Agreement (the “Confidential Information Agreement”) upon commencing employment hereunder.

11. Conditional Nature of Severance Payments.

(a) Noncompete. Executive acknowledges that the nature of the Company’s business is such that if Executive were to become employed by, or substantially involved in, the business of a competitor of the Company following the termination of Executive’s employment with the Company, it would be very difficult for Executive not to rely on or use the Company’s trade secrets and confidential information. Thus, to avoid the inevitable disclosure of the Company’s trade secrets and confidential information, Executive agrees and acknowledges that Executive’s right to receive the severance payments set forth in Section 7 (to the extent Executive is otherwise entitled to such payments)



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shall be conditioned upon Executive not directly or indirectly engaging in (whether as an employee, consultant, agent, proprietor, principal, partner, stockholder, corporate officer, director or otherwise), nor having any ownership interest in or participating in the financing, operation, management or control of, any person, firm, corporation or business that competes with Company or is a customer of the Company. Upon any breach of this section, all severance payments pursuant to this Agreement shall immediately cease.

(b) Non-Solicitation. Until the date eighteen (18) months after the termination of Executive's employment with the Company for any reason, Executive agrees not, either directly or indirectly, to solicit, induce, attempt to hire, recruit, encourage, take away, hire any employee of the Company or cause an employee to leave his or her employment either for Executive or for any other entity or person. Additionally, Executive acknowledges that Executive's right to receive the severance payments set forth in Section 7 (to the extent Executive is otherwise entitled to such payments) are contingent upon Executive complying with this Section 10(b) and upon any breach of this section all severance payments pursuant to this Agreement shall immediately cease.

(c) Understanding of Covenants. Executive represents that Executive (i) is familiar with the foregoing covenants not to compete and not to solicit, and (ii) is fully aware of Executive's obligations hereunder, including, without limitation, the reasonableness of the length of time, scope and geographic coverage of these covenants.

12. Assignment. This Agreement will be binding upon and inure to the benefit of (a) the heirs, executors and legal representatives of Executive upon Executive's death and (b) any successor of the Company. Any such successor of the Company will be deemed substituted for the Company under the terms of this Agreement for all purposes. For this purpose, "successor" means any person, firm, corporation or other business entity which at any time, whether by purchase, merger or otherwise, directly or indirectly acquires all or substantially all of the assets or business of the Company. None of the rights of Executive to receive any form of compensation payable pursuant to this Agreement may be assigned or transferred except by will or the laws of descent and distribution. Any other attempted assignment, transfer, conveyance or other disposition of Executive's right to compensation or other benefits will be null and void.

13. Notices. All notices, requests, demands and other communications called for hereunder shall be in writing and shall be deemed given (i) on the date of delivery if delivered personally, (ii) one (1) day after being sent by a well established commercial overnight service, or (iii) four (4) days after being mailed by registered or certified mail, return receipt requested, prepaid and addressed to the parties or their successors at the following addresses, or at such other addresses as the parties may later designate in writing:

If to the Company:

Natus Medical, Inc.  
1501 Industrial Road  
San Carlos, CA 94070  
Attn: Mark Foster, General Counsel

If to Executive:

at the last residential address known by the Company.

14. Severability. In the event that any provision hereof becomes or is declared by a court of competent jurisdiction to be illegal, unenforceable or void, this Agreement will continue in full force and effect without said provision.

15. Arbitration.

(a) General. In consideration of Executive's service to the Company, its promise to arbitrate all employment related disputes and Executive's receipt of the compensation, pay raises and other benefits paid to Executive by the Company, at present and in the future, Executive agrees that any and all controversies, claims, or disputes with anyone (including the Company and any employee, officer, director, shareholder or benefit plan of the Company in their capacity as such or otherwise) arising out of, relating to, or resulting from Executive's service to the Company under this Agreement or otherwise or the termination of Executive's service with the Company, including any breach of this Agreement, shall be subject to binding arbitration under the Arbitration Rules set forth in California Code of Civil Procedure Section 1280 through 1294.2, including Section 1283.05 (the "Rules") and pursuant to California law.

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Disputes which Executive agrees to arbitrate, and thereby agrees to waive any right to a trial by jury, include any statutory claims under state or federal law, including, but not limited to, claims under Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act of 1990, the Age Discrimination in Employment Act of 1967, the Older Workers Benefit Protection Act, the California Fair Employment and Housing Act, the California Labor Code, claims of harassment, discrimination or wrongful termination and any statutory claims. Executive further understands that this Agreement to arbitrate also applies to any disputes that the Company may have with Executive.

(b) Procedure. Executive agrees that any arbitration will be administered by the American Arbitration Association (“AAA”) and that a neutral arbitrator will be selected in a manner consistent with its National Rules for the Resolution of Employment Disputes. The arbitration proceedings will allow for discovery according to the rules set forth in the *National Rules for the Resolution of Employment Disputes* or *California Code of Civil Procedure*. Executive agrees that the arbitrator shall have the power to decide any motions brought by any party to the arbitration, including motions for summary judgment and/or adjudication and motions to dismiss and demurrers, prior to any arbitration hearing. Executive agrees that the arbitrator shall issue a written decision on the merits. Executive also agrees that the arbitrator shall have the power to award any remedies, including attorneys’ fees and costs, available under applicable law. Executive understands the Company will pay for any administrative or hearing fees charged by the arbitrator or AAA except that Executive shall pay the first \$200.00 of any filing fees associated with any arbitration Executive initiates. Executive agrees that the arbitrator shall administer and conduct any arbitration in a manner consistent with the Rules and that to the extent that the AAA’s National Rules for the Resolution of Employment Disputes conflict with the Rules, the Rules shall take precedence.

(c) Remedy. Except as provided by the Rules, arbitration shall be the sole, exclusive and final remedy for any dispute between Executive and the Company. Accordingly, except as provided for by the Rules, neither Executive nor the Company will be permitted to pursue court action regarding claims that are subject to arbitration. Notwithstanding, the arbitrator will not have the authority to disregard or refuse to enforce any lawful Company policy, and the arbitrator shall not order or require the Company to adopt a policy not otherwise required by law that the Company has not adopted.

(d) Availability of Injunctive Relief. In addition to the right under the Rules to petition the court for provisional relief, Executive agrees that any party may also petition the court for injunctive relief where either party alleges or claims a violation of this Agreement or the Confidentiality Agreement or any other agreement regarding trade secrets, confidential information, nonsolicitation or Labor Code §2870. In the event either party seeks injunctive relief, the prevailing party shall be entitled to recover reasonable costs and attorneys’ fees.

(e) Administrative Relief. Executive understands that this Agreement does not prohibit Executive from pursuing an administrative claim with a local, state or federal administrative body such as the Department of Fair Employment and Housing, the Equal Employment Opportunity Commission or the workers’ compensation board. This Agreement does, however, preclude Executive from pursuing court action regarding any such claim.

(f) Voluntary Nature of Agreement. Executive acknowledges and agrees that Executive is executing this Agreement voluntarily and without any duress or undue influence by the Company or anyone else. Executive further acknowledges and agrees that Executive has carefully read this Agreement and that Executive has asked any questions needed for Executive to understand the terms, consequences and binding effect of this Agreement and fully understand it, including that Executive is waiving Executive’s right to a jury trial. Finally, Executive agrees that Executive has been provided an opportunity to seek the advice of an attorney of Executive’s choice before signing this Agreement.

16. Integration. This Agreement, together with the Option Plan, Option Agreement and the Confidential Information Agreement represents the entire agreement and understanding between the parties as to the subject matter herein and supersedes all prior or contemporaneous agreements whether written or oral. No waiver, alteration, or modification of any of the provisions of this Agreement will be binding unless it is in writing and specifically mentions this Section 16 and it is signed by duly authorized representatives of the parties hereto.

17. Waiver of Breach. The waiver of a breach of any term or provision of this Agreement, which must be in writing, shall not operate as or be construed to be a waiver of any other previous or subsequent breach of this Agreement.

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18. Headings. All captions and section headings used in this Agreement are for convenient reference only and do not form a part of this Agreement.
19. Tax Withholding. All payments made pursuant to this Agreement will be subject to withholding of applicable taxes.
20. Governing Law. This Agreement will be governed by the laws of the State of California (with the exception of its conflict of laws provisions).
21. Acknowledgment. Executive acknowledges that he has had the opportunity to discuss this matter with and obtain advice from his private attorney, has had sufficient time to, and has carefully read and fully understands all the provisions of this Agreement, and is knowingly and voluntarily entering into this Agreement.
22. Counterparts. This Agreement may be executed in counterparts, and each counterpart shall have the same force and effect as an original and shall constitute an effective, binding agreement on the part of each of the undersigned.

*[Remainder of Page Intentionally Left Blank]*



## NATUS MEDICAL, INC.

## EMPLOYMENT AGREEMENT

This Agreement is entered into as of \_\_\_\_\_, (the "Effective Date") by and between Natus Medical, Inc. (the "Company"), and \_\_\_\_\_ ("Executive").

1. Duties and Scope of Employment

(a) Positions and Duties. As of the Effective Date, Executive will serve as \_\_\_\_\_ of the Company. Executive will render such business and professional services in the performance of his duties, consistent with Executive's position within the Company, as shall reasonably be assigned to him by the Company's Chief Executive Officer ("CEO"). The period of Executive's employment under this Agreement is referred to herein as the "Employment Term."

(b) Obligations. During the Employment Term, Executive will perform his duties faithfully and to the best of his ability and will devote his full business efforts and time to the Company. For the duration of the Employment Term, Executive agrees not to actively engage in any other employment, occupation or consulting activity for any direct or indirect remuneration without the prior approval of the Board.

2. At-Will Employment. The parties agree that Executive's employment with the Company will be "at-will" employment and may be terminated at any time with or without cause or notice. Executive understands and agrees that neither his job performance nor promotions, commendations, bonuses or the like from the Company give rise to or in any way serve as the basis for modification, amendment, or extension, by implication or otherwise, of his employment with the Company.

3. Compensation

(a) Base Salary. During the Employment Term, the Company will pay Executive an annual salary of \$\_\_\_\_\_ as compensation for his services (the "Base Salary"). The Base Salary will be paid periodically in accordance with the Company's normal payroll practices and be subject to the usual, required withholding. Executive's salary will be subject to review and adjustments will be made based upon the Company's normal performance review practices.

4. Employee Benefits. During the Employment Term, Executive will be entitled to participate in the employee benefit plans currently and hereafter maintained by the Company of general applicability to other senior executives of the Company, including, without limitation, the Company's group medical, dental, vision, disability, life insurance, and flexible-spending account plans. The Company reserves the right to cancel or change the benefit plans and programs it offers to its employees at any time.

5. Paid Time Off ("PTO"). Executive is entitled to receive PTO pursuant to Natus' standard benefit policy currently and hereafter maintained by the Company, and as may be cancelled or changed from time to time.

6. Expenses. The Company will reimburse Executive for reasonable travel, entertainment or other expenses incurred by Executive in the furtherance of or in connection with the performance of Executive's duties hereunder, in accordance with the Company's expense reimbursement policy as in effect from time to time.

7. Severance

(a) Involuntary Termination. If Executive's employment with the Company terminates other than for "Cause" (as defined herein), death or disability, and Executive signs and does not revoke a standard release of claims with the Company, then, subject to Section 11, Executive shall be entitled to (i) receive continuing payments of severance pay (less applicable withholding taxes) at a rate equal to his Base Salary rate, as then in effect, for a period equal to \_\_\_ months, plus \_\_\_ month for each \_\_\_ months of employment, up to a maximum of \_\_\_ year

from the date of such termination, to be paid periodically in accordance with the Company's normal payroll policies; (ii) the immediate vesting and exercisability of \_\_\_% of the shares subject to all of Executive's stock options to purchase Company Common Stock (whether currently outstanding or granted in following the Effective Date) outstanding on the date of such termination (the "Stock Options") and (iii) continued payment by the Company of the group health continuation coverage premiums for Executive and Executive's eligible dependents under Title X of the Consolidated Budget Reconciliation Act of 1985, as amended ("COBRA") as in effect through the lesser of (x) \_\_\_ months from the effective date of such termination, (y) the date upon which Executive and Executive's eligible dependents become covered under similar plans, or (z) the date Executive no longer constitutes a "Qualified Beneficiary" (as such term is defined in Section 4980B(g) of the Internal Revenue Code of 1986, as amended (the "Code")); provided, however, that Executive will be solely responsible for electing such coverage within the required time periods.

(b) Voluntary Termination: Termination for Cause. If Executive's employment with the Company terminates voluntarily by Executive (other than as described in subsection (c) below) or for Cause by the Company or due to Executive's death or disability, then (i) all vesting of Stock Options will immediately cease, (ii) all payments of compensation by the Company to Executive hereunder will terminate immediately (except as to amounts already earned), and (iii) Executive will only be eligible for severance benefits, if any, in accordance with the Company's established policies as then in effect.

(c) Change of Control Benefits. If within twelve (12) months following a "Change of Control" (as defined below) (i) Executive terminates Executive's employment with the Company for Good Reason, or (ii) the Company or the successor corporation terminates Executive's employment with the Company for other than Cause, death or disability, then Executive shall be entitled to the benefits provided for in subsection (a). Executive shall only be permitted to receive the benefits provided for in subsection (a) once and shall not be permitted to claim such benefits under both subsection (a) and (c) such that Executive would receive the benefits pursuant to subsection (a) twice.

8. Limitation on Payments. In the event that the severance and other benefits provided for in this Agreement or otherwise payable to the Executive (i) constitute "parachute payments" within the meaning of Section 280G of the Code and (ii) but for this Section 8, would be subject to the excise tax imposed by Section 4999 of the Code, then the Executive's severance benefits under Section 4(a)(i) shall be either:

- delivered in full, or
- delivered as to such lesser extent which would result in no portion of such severance benefits being subject to excise tax under Section 4999 of the Code,
- whichever of the foregoing amounts, taking into account the applicable federal, state and local income taxes and the excise tax imposed by Section 4999, results in the receipt by Executive on an after-tax basis, of the greatest amount of severance benefits, notwithstanding that all or some portion of such severance benefits may be taxable under Section 4999 of the Code. Unless the Company and Executive otherwise agree in writing, any determination required under this Section 8 shall be made in writing by the Company's independent public accountants immediately prior to Change of Control (the "Accountants"), whose determination shall be conclusive and binding upon Executive and the Company for all purposes. For purposes of making the calculations required by this Section 8, the Accountants may make reasonable assumptions and approximations concerning applicable taxes and may rely on reasonable, good faith interpretations concerning the application of Sections 280G and 4999 of the Code. The Company and Executive shall furnish to the Accountants such information and documents as the Accountants may reasonably request in order to make a determination under this Section. The Company shall bear all costs the Accountants may reasonably incur in connection with any calculations contemplated by this Section 8.

9. Definitions.

(a) Cause. For purposes of this Agreement, "Cause" shall mean (i) any act of personal dishonesty taken by Executive in connection with his responsibilities as an employee and intended to result in substantial personal enrichment of Executive, (ii) Executive's conviction of a felony, (iii) a willful act by Executive which constitutes gross misconduct and which is injurious to the Company, or (iv) continued substantial violations by Executive of Executive's employment duties which are demonstrably willful and deliberate on Executive's part after there has been delivered to Executive a written demand for performance from the Company which specifically sets forth the factual basis for the Company's belief that Executive has not substantially performed Executive's duties.

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(b) Change of Control. For purposes of this Agreement, “Change of Control” of the Company is defined as:

(i) any “person” (as such term is used in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934, as amended) is or becomes the “beneficial owner” (as defined in Rule 13d-3 under said Act), directly or indirectly, of securities of the Company representing 50% or more of the total voting power represented by the Company’s then outstanding voting securities; or

(ii) a change in the composition of the Board occurring within a two-year period, as a result of which fewer than a majority of the directors are Incumbent Directors. “Incumbent Directors” will mean directors who either (A) are directors of the Company as of the date hereof, or (B) are elected, or nominated for election, to the Board with the affirmative votes of at least a majority of the Incumbent Directors at the time of such election or nomination (but will not include an individual whose election or nomination is in connection with an actual or threatened proxy contest relating to the election of directors to the Company); or

(iii) the date of the consummation of a merger or consolidation of the Company with any other corporation that has been approved by the stockholders of the Company, other than a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity) more than forty percent (40%) of the total voting power represented by the voting securities of the Company or such surviving entity outstanding immediately after such merger or consolidation, or the stockholders of the Company approve a plan of complete liquidation of the Company; or

(iv) the date of the consummation of the sale or disposition by the Company of all or substantially all the Company’s assets;

or

(v) the termination of the CEO (in place on the Effective Date) for other than Cause, death or disability.

(c) Good Reason. For purposes of this Agreement, “Good Reason” shall mean without the Executive’s express written consent shall mean (i) the significant reduction of the Executive’s duties or responsibilities relative to Executive’s duties or responsibilities in effect immediately prior to such reduction; provided, however, that a reduction in duties or responsibilities solely by virtue of the Company being acquired and made part of a larger entity (as, for example, when the Chief Financial Officer of Natus Medical Incorporated remains as such following a Change of Control and is not made the Chief Financial Officer of the acquiring corporation) shall not constitute “Good Reason;” (ii) a reduction by the Company in Executive’s annual Base Salary as in effect immediately prior to such reduction; (iii) a material reduction by the Company in the kind or level of employee benefits to which Executive is entitled immediately prior to such reduction with the result that Executive’s overall benefits package is significantly reduced; (iv) the relocation of Executive to a facility or a location more than 35 miles from Executive’s then present location, without Executive’s express written consent; or (v) the failure of the Company to obtain the assumption of this Agreement by any successors contemplated in Section 12.

10. Confidential Information. Executive agrees to enter into the Company’s standard Confidential Information and Invention Assignment Agreement (the “Confidential Information Agreement”) upon commencing employment hereunder.

11. Conditional Nature of Severance Payments.

(a) Noncompete. Executive acknowledges that the nature of the Company’s business is such that if Executive were to become employed by, or substantially involved in, the business of a competitor of the Company following the termination of Executive’s employment with the Company, it would be very difficult for Executive not to rely on or use the Company’s trade secrets and confidential information. Thus, to avoid the inevitable disclosure of the Company’s trade secrets and confidential information, Executive agrees and acknowledges that Executive’s right to receive the severance payments set forth in Section 7 (to the extent Executive is otherwise entitled to such payments)

shall be conditioned upon Executive not directly or indirectly engaging in (whether as an employee, consultant, agent, proprietor, principal, partner, stockholder, corporate officer, director or otherwise), nor having any ownership interest in or participating in the financing, operation, management or control of, any person, firm, corporation or business that competes with Company or is a customer of the Company. Upon any breach of this section, all severance payments pursuant to this Agreement shall immediately cease.

(b) Non-Solicitation. Until the date eighteen (18) months after the termination of Executive's employment with the Company for any reason, Executive agrees not, either directly or indirectly, to solicit, induce, attempt to hire, recruit, encourage, take away, hire any employee of the Company or cause an employee to leave his or her employment either for Executive or for any other entity or person. Additionally, Executive acknowledges that Executive's right to receive the severance payments set forth in Section 7 (to the extent Executive is otherwise entitled to such payments) are contingent upon Executive complying with this Section 10(b) and upon any breach of this section all severance payments pursuant to this Agreement shall immediately cease.

(c) Understanding of Covenants. Executive represents that Executive (i) is familiar with the foregoing covenants not to compete and not to solicit, and (ii) is fully aware of Executive's obligations hereunder, including, without limitation, the reasonableness of the length of time, scope and geographic coverage of these covenants.

12. Assignment. This Agreement will be binding upon and inure to the benefit of (a) the heirs, executors and legal representatives of Executive upon Executive's death and (b) any successor of the Company. Any such successor of the Company will be deemed substituted for the Company under the terms of this Agreement for all purposes. For this purpose, "successor" means any person, firm, corporation or other business entity which at any time, whether by purchase, merger or otherwise, directly or indirectly acquires all or substantially all of the assets or business of the Company. None of the rights of Executive to receive any form of compensation payable pursuant to this Agreement may be assigned or transferred except by will or the laws of descent and distribution. Any other attempted assignment, transfer, conveyance or other disposition of Executive's right to compensation or other benefits will be null and void.

13. Notices. All notices, requests, demands and other communications called for hereunder shall be in writing and shall be deemed given (i) on the date of delivery if delivered personally, (ii) one (1) day after being sent by a well established commercial overnight service, or (iii) four (4) days after being mailed by registered or certified mail, return receipt requested, prepaid and addressed to the parties or their successors at the following addresses, or at such other addresses as the parties may later designate in writing:

If to the Company:

Natus Medical, Inc.  
1501 Industrial Road  
San Carlos, CA 94070  
Attn: Mark Foster, General Counsel

If to Executive:

at the last residential address known by the Company.

14. Severability. In the event that any provision hereof becomes or is declared by a court of competent jurisdiction to be illegal, unenforceable or void, this Agreement will continue in full force and effect without said provision.

15. Arbitration.

(a) General. In consideration of Executive's service to the Company, its promise to arbitrate all employment related disputes and Executive's receipt of the compensation, pay raises and other benefits paid to Executive by the Company, at present and in the future, Executive agrees that any and all controversies, claims, or disputes with anyone (including the Company and any employee, officer, director, shareholder or benefit plan of the Company in their capacity as such or otherwise) arising out of, relating to, or resulting from Executive's service to the Company under this Agreement or otherwise or the termination of Executive's service with the Company, including any breach of this Agreement, shall be subject to binding arbitration under the Arbitration Rules set forth in California Code of Civil Procedure Section 1280 through 1294.2, including Section 1283.05 (the "Rules") and pursuant to California law.



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Disputes which Executive agrees to arbitrate, and thereby agrees to waive any right to a trial by jury, include any statutory claims under state or federal law, including, but not limited to, claims under Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act of 1990, the Age Discrimination in Employment Act of 1967, the Older Workers Benefit Protection Act, the California Fair Employment and Housing Act, the California Labor Code, claims of harassment, discrimination or wrongful termination and any statutory claims. Executive further understands that this Agreement to arbitrate also applies to any disputes that the Company may have with Executive.

(b) Procedure. Executive agrees that any arbitration will be administered by the American Arbitration Association (“AAA”) and that a neutral arbitrator will be selected in a manner consistent with its National Rules for the Resolution of Employment Disputes. The arbitration proceedings will allow for discovery according to the rules set forth in the *National Rules for the Resolution of Employment Disputes* or *California Code of Civil Procedure*. Executive agrees that the arbitrator shall have the power to decide any motions brought by any party to the arbitration, including motions for summary judgment and/or adjudication and motions to dismiss and demurrers, prior to any arbitration hearing. Executive agrees that the arbitrator shall issue a written decision on the merits. Executive also agrees that the arbitrator shall have the power to award any remedies, including attorneys’ fees and costs, available under applicable law. Executive understands the Company will pay for any administrative or hearing fees charged by the arbitrator or AAA except that Executive shall pay the first \$200.00 of any filing fees associated with any arbitration Executive initiates. Executive agrees that the arbitrator shall administer and conduct any arbitration in a manner consistent with the Rules and that to the extent that the AAA’s National Rules for the Resolution of Employment Disputes conflict with the Rules, the Rules shall take precedence.

(c) Remedy. Except as provided by the Rules, arbitration shall be the sole, exclusive and final remedy for any dispute between Executive and the Company. Accordingly, except as provided for by the Rules, neither Executive nor the Company will be permitted to pursue court action regarding claims that are subject to arbitration. Notwithstanding, the arbitrator will not have the authority to disregard or refuse to enforce any lawful Company policy, and the arbitrator shall not order or require the Company to adopt a policy not otherwise required by law that the Company has not adopted.

(d) Availability of Injunctive Relief. In addition to the right under the Rules to petition the court for provisional relief, Executive agrees that any party may also petition the court for injunctive relief where either party alleges or claims a violation of this Agreement or the Confidentiality Agreement or any other agreement regarding trade secrets, confidential information, nonsolicitation or Labor Code §2870. In the event either party seeks injunctive relief, the prevailing party shall be entitled to recover reasonable costs and attorneys’ fees.

(e) Administrative Relief. Executive understands that this Agreement does not prohibit Executive from pursuing an administrative claim with a local, state or federal administrative body such as the Department of Fair Employment and Housing, the Equal Employment Opportunity Commission or the workers’ compensation board. This Agreement does, however, preclude Executive from pursuing court action regarding any such claim.

(f) Voluntary Nature of Agreement. Executive acknowledges and agrees that Executive is executing this Agreement voluntarily and without any duress or undue influence by the Company or anyone else. Executive further acknowledges and agrees that Executive has carefully read this Agreement and that Executive has asked any questions needed for Executive to understand the terms, consequences and binding effect of this Agreement and fully understand it, including that Executive is waiving Executive’s right to a jury trial. Finally, Executive agrees that Executive has been provided an opportunity to seek the advice of an attorney of Executive’s choice before signing this Agreement.

16. Integration. This Agreement, together with the Option Plan, Option Agreement and the Confidential Information Agreement represents the entire agreement and understanding between the parties as to the subject matter herein and supersedes all prior or contemporaneous agreements whether written or oral. No waiver, alteration, or modification of any of the provisions of this Agreement will be binding unless it is in writing and specifically mentions this Section 16 and it is signed by duly authorized representatives of the parties hereto.

17. Waiver of Breach. The waiver of a breach of any term or provision of this Agreement, which must be in writing, shall not operate as or be construed to be a waiver of any other previous or subsequent breach of this Agreement.

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18. Headings. All captions and section headings used in this Agreement are for convenient reference only and do not form a part of this Agreement.
19. Tax Withholding. All payments made pursuant to this Agreement will be subject to withholding of applicable taxes.
20. Governing Law. This Agreement will be governed by the laws of the State of California (with the exception of its conflict of laws provisions).
21. Acknowledgment. Executive acknowledges that he has had the opportunity to discuss this matter with and obtain advice from his private attorney, has had sufficient time to, and has carefully read and fully understands all the provisions of this Agreement, and is knowingly and voluntarily entering into this Agreement.
22. Counterparts. This Agreement may be executed in counterparts, and each counterpart shall have the same force and effect as an original and shall constitute an effective, binding agreement on the part of each of the undersigned.

*[Remainder of Page Intentionally Left Blank]*

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IN WITNESS WHEREOF, each of the parties has executed this Agreement, in the case of the Company by their duly authorized officers, as of the day and year first above written.

**COMPANY:**  
NATUS MEDICAL, INC.

By: \_\_\_\_\_ Date: \_\_\_\_\_

\_\_\_\_\_

Title: \_\_\_\_\_

**EXECUTIVE:**

\_\_\_\_\_ Date: \_\_\_\_\_

\_\_\_\_\_

## Code of Ethics for Financial Executives

In my role as a finance executive of Natus Medical Incorporated, I certify to you that I adhere to and advocate the following principles and responsibilities governing my professional and ethical conduct.

To the best of my knowledge and ability:

1. I act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.
2. I provide constituents with information that is accurate, complete, objective, relevant, timely and understandable.
3. I comply with rules and regulations of federal, state, provincial and local governments, and other appropriate private and public regulatory agencies.
4. I act in good faith, responsibly, with due care, competence and diligence, without misrepresenting material facts or allowing my independent judgment to be subordinated.
5. I respect the confidentiality of information acquired in the course of my work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of my work is not used for personal advantage.
6. I share knowledge and maintain skills important and relevant to my constituents' needs.
7. I proactively promote ethical behavior as a responsible partner among peers in my work environment.
8. I achieve responsible use of and control over all assets and resources employed or entrusted to me.

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[Signature]

Copied to the company's CFO and/or Audit Committee as a best practice.

**INDEPENDENT AUDITORS' CONSENT**

We consent to the incorporation by reference in Registration Statement No. 333-65584 of Natus Medical Incorporated and subsidiaries on Form S-8 of our report dated February 18, 2003 appearing in this report on Form 10-K of Natus Medical Incorporated and subsidiaries for the year ended December 31, 2002.

/s/ Deloitte & Touche LLP

San Jose, California  
March 27, 2003

CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER  
PURSUANT TO TITLE 18, UNITED STATES CODE, SECTION 1350, AS ADOPTED  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Natus Medical Incorporated (the "Company") on Form 10-K for the year ended December 31, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Tim C. Johnson, President and Chief Executive Officer of the Company, certify, pursuant to Title 18, United States Code, Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ TIM C. JOHNSON

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Print Name:	Tim C. Johnson
Title:	President and Chief Executive Officer
Date:	March 24, 2003

In connection with the Annual Report of Natus Medical Incorporated (the "Company") on Form 10-K for the year ended December 31, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Glenn A. Bauer, Chief Financial Officer of the Company, certify, pursuant to Title 18, United States Code, Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ GLENN A. BAUER

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Print Name:	Glenn A. Bauer
Title:	Chief Financial Officer
Date:	March 24, 2003