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

FORM 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2002

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

Commission file number: 000-33001

NATUS MEDICAL INCORPORATED

(Exact name of registrant as specified in its charter)

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

1501 Industrial Road, San Carlos, CA 94070
(Address of principal executive offices) (Zip Code)

(650) 802-0400
(Registrant's telephone number, including area code)

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

The number of issued and outstanding shares of the registrant's Common Stock, $0.001 par value, as of June 30, 2002, was 16,079,894.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

	June 30, 2002	December 31, 2001(1)
	(unaudited)	
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 23,751	$ 30,351
Short-term investments	25,840	22,735
Accounts receivable, net of allowance for doubtful accounts of $193 in 2002 and $239 in 2001	4,416	5,209
Inventories	3,972	3,598
Prepaid expenses and other current assets	695	655
Total current assets	58,674	62,548
Property and equipment, net	1,654	1,757
Long-term investment	331	327
Deposits and other assets	1,289	303
Total assets	$ 61,948	$ 64,935
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Accounts payable	$ 807	$ 892
Notes payable	500	—
Accrued liabilities	2,542	2,702
Deferred revenues	354	312
Total liabilities	4,203	3,906
Commitments and contingencies		
Stockholders' equity:		
Common stock, $0.001 par value, 120,000,000 shares authorized; shares issued and outstanding: 16,079,894 in 2002 and 15,864,670 in 2001	86,366	86,007
Deferred stock compensation	(448)	(767)
Accumulated deficit	(28,080)	(24,299)
Accumulated other comprehensive (loss) income	(93)	88
Total stockholders' equity	57,745	61,029
Total liabilities and stockholders' equity	$ 61,948	$ 64,935

(1) Derived from the consolidated audited financial statements at December 31, 2001.

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

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Revenues	$ 6,470	$ 7,243	$12,546	$13,561
Cost of revenues*	2,920	2,710	5,436	5,138
Gross profit	3,550	4,533	7,110	8,423
Operating expenses:				
Marketing and selling	3,567	3,026	6,934	5,971
Research and development	1,275	1,018	2,331	2,029
General and administrative	991	954	1,979	1,736
Amortization of deferred stock compensation*	136	284	280	572
Total operating expenses	5,969	5,282	11,524	10,308
Loss from operations	(2,419)	(749)	(4,414)	(1,885)
Interest income	238	3	500	22
Interest expense	(3)	(21)	(5)	(21)
Other income (expense), net	228	(5)	206	(11)
Loss before provision for income taxes	(1,956)	(772)	(3,713)	(1,895)
Provision for income taxes	38	—	68	1
Net loss	(1,994)	(772)	(3,781)	(1,896)
Accretion of redeemable convertible preferred stock	—	346	—	692
Net loss available to common stockholders	$(1,994)	$(1,118)	$(3,781)	$(2,588)
Basic and diluted net loss per share	$ (0.12)	$ (1.22)	$ (0.24)	$ (2.85)
Common shares used in computing basic and diluted net loss per share	16,040	916	15,964	907
* Amortization of deferred stock compensation included in:				
Cost of revenues	$ 18	$ 42	$ 39	$ 83
Operating expenses:				
Marketing and selling	$ 78	$ 150	$ 152	$ 299
Research and development	11	28	25	60
General and administrative	47	106	103	213
Total	$ 136	$ 284	$ 280	$ 572

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

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30,	
	2002	2001
Operating activities:		
Net loss	$ (3,781)	$(1,896)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	487	368
Amortization of deferred stock compensation	319	655
Changes in operating assets and liabilities:		
Accounts receivable	718	349
Inventories	(409)	(285)
Prepaid expenses and other current assets	(44)	(174)
Accounts payable	(85)	547
Accrued liabilities and deferred revenues	(143)	129
Net cash used in operating activities	(2,938)	(307)
Investing activities:		
Acquisition of property and equipment	(348)	(309)
Deposits and other assets	(504)	(102)
Purchases of short-term investments	(37,767)	(310)
Sales of short-term investments	34,614	302
Cash paid for acquisition of business	—	(9)
Net cash used in investing activities	(4,005)	(428)
Financing activities:		
Issuance of common stock	359	44
Borrowings on bank loans	—	2,000
Deferred offering costs	—	(771)
Net cash provided by financing activities	359	1,273
Exchange rate effect on cash and equivalents	(16)	(6)
Net (decrease) increase in cash and equivalents	(6,600)	532
Cash and cash equivalents, beginning of period	30,351	681
Cash and cash equivalents, end of period	$ 23,751	$ 1,213
Non-cash investing and financing activities:		
Accretion of redeemable convertible preferred stock	$ —	$ 692
Forgiveness of convertible notes receivable and accounts receivable for acquisition of business	$ —	$ 189
Issuance of notes payable for acquisition of other assets	$ 500	$ —
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 5	$ 21
Cash paid for income taxes	$ 83	$ 34

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

NATUS MEDICAL INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1—Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for annual financial statements. The financial statements include all adjustments (consisting only of normal recurring adjustments) that the management of Natus Medical Incorporated ("Natus," "we," "us" or "the Company") believes necessary for fair presentation of our financial position, results of operations and cash flows for the periods presented. These interim financial results are not necessarily indicative of results to be expected for the full fiscal year. The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries and significant intercompany transactions have been eliminated. The accompanying financial information should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2001 included in our Annual Report on Form 10-K.

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 uncollectable accounts receivable, warranty costs and a valuation allowance for deferred tax assets. Actual results could differ from those estimates.

Revenue Recognition

We recognize revenues, net of discounts, from product sales, including sales to distributors, upon shipment when a purchase order has been received, the sales price is fixed and determinable and collection of the resulting receivable is probable. Rights of return are generally not provided. Advance payments from customers are recorded as deferred revenue until shipment of the related product. We provide for trade-ins of our own or competitive equipment. Trade-ins are recorded as a reduction of revenue at the time of shipping the replaced 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.

Recently Issued Accounting Pronouncements

In June 2002, the FASB issued SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, which addresses accounting for restructuring and similar costs. SFAS 146 supercedes previous accounting guidance, principally Emerging Issues Task Force Issue No. 94-3. We will adopt the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 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 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.

In October 2001, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, and addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. We adopted the provisions of SFAS No. 144 on January 1, 2002, and the adoption of SFAS No. 144 did not have a material effect on its financial position or results of operations.

In June 2001, the FASB issued SFAS No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that all business combinations initiated after June 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 June 30, 2001. The adoption of SFAS No. 141 and 142 did not have a material effect on our financial position or results of operations.

Comprehensive Loss

In accordance with SFAS No. 130, *Reporting Comprehensive Income*, we are required to report by major components and as a single total, the change in its net assets during the period from non-owner sources. The following are the components of comprehensive loss (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Net loss	$ (1,994)	$ (772)	$(3,781)	$(1,896)
Unrealized gain (loss) on available-for-sale securities	74	—	(48)	—
Foreign currency translation adjustment	(109)	25	(133)	8
Comprehensive loss	$ (2,029)	$ (747)	$(3,962)	$(1,888)

2—Inventories

Inventories consisted of (in thousands):

	June 30, 2002	December 31, 2001
Raw materials and subassemblies	$2,947	$ 2,497
Finished goods	1,025	1,101
Total	$3,972	$ 3,598

3—Basic and Diluted Net Loss Per Common Share

For all periods presented, both basic and diluted net loss per common share were computed by dividing the net loss available to common stockholders by the number of weighted average common shares outstanding during the respective periods. Stock options to purchase approximately 802,000 shares and 788,000 shares as of June 30, 2002 and 2001, respectively, were not dilutive and, therefore, were not included in the computation of diluted net loss per common share amounts.

4—Customer and Geographic Information

We operate in one reportable segment and are 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 our products and production processes as well as the type of customers and distribution methods are consistent among all of our devices.

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

	Three Months Ended		Six Months Ended	
	June 30, 2002	June 30, 2001	June 30, 2002	June 30, 2001
United States	$ 5,589	$ 5,907	$10,707	$11,030
Japan	445	947	982	1,928
All other	436	389	857	603
Total	$ 6,470	$ 7,243	$12,546	$13,561

For both the three and the six months ended June 30, 2002, no sales to a single customer accounted for greater than 10% of total revenues. Sales to one customer, a distributor, accounted for approximately 13% and 14% of the total revenues for the three and six months ended June 30, 2001, respectively.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q 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 future operations, financial condition and prospects, and business strategies. The words "may," "will," "continue," "estimate," "project," "intend," "believe," "expect," "anticipate" and other similar expressions generally identify forward-looking statements. Forward-looking statements in this Item 2 include, but are not limited to, statements regarding the following: the effectiveness and advantages of our products, 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.

Investors in our common stock 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 "Factors Affecting Future Results," 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 develop, manufacture and market products for the detection and management of common medical disorders in infants. Currently, we sell our ALGO products for hearing screening and our Natus CO-Stat™ products for the analysis of hemolysis and management of jaundice.

Our revenues consist of revenues 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 products in the three and six months ended June 30, 2002 and 2001. Although we commercially launched our CO-Stat product in January 2001, we expect that a substantial majority of our revenues will continue to be generated from sales of our ALGO 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 86% and 82% of our revenues during the three months ended June 30, 2002 and 2001, respectively. Domestic sales were 85% and 81% of our revenues during the six months ended June 30, 2002 and 2001, respectively. We plan to continue to invest in expanding our international operations because we believe international markets represent a significant

growth opportunity. We acquired the distribution operations of our United Kingdom distributor in January 2001 and also began direct distribution operations in Japan in July 2001, when we acquired the activities of our Japanese distributor. The results of operations of these acquired businesses have been included in our consolidated results from those dates. 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. Prior to 2001, most of our international sales have been through distributors and have been characterized by lower gross margins due to the discount the distributors receive from our list prices.

We recognize revenue, net of discounts, from product sales, including sales to distributors, upon shipment when a purchase order has been received, the sales price is fixed and determinable and collection of the resulting receivable is probable. We generally do not provide rights of return on our products. We, however, do make provision 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. Advance payments from customers are recorded as deferred revenue until shipment of the related product. Our reserve for bad debts is also estimated based in part on our historical results and in part on judgments on our ability to collect current accounts receivable. To date, bad debts expenses have been substantially in line with projected amounts. It is often difficult and costly to enforce debt in international markets where collection efforts take place in countries where we have no permanent physical presence. Our past bad debt experience may not be indicative of the bad debt expenses we may experience in the future. Allowances for estimated warranty costs are estimated based on our historical results. To date, warranty and extended warranty costs have been in line with projected amounts. However, our past product warranty experience may not be indicative of the warranty costs we may experience in the future. We provide ALGO screening equipment to our customers on loan without charge while we repair or service their screening equipment. Similarly, our reserve for excess and obsolete inventory is also estimated based in part on our historical results and in part on expectations of future product sales. To date excess and obsolete inventory costs have been substantially in line with projected amounts. Our past experience may not be indicative of the excess and obsolete inventory costs we may experience in the future.

The American Academy of Pediatrics has reported that neonatal jaundice is one of the biggest medical problems facing newborn babies. Our Natus Co-Stat™ End Tidal Breath Analyzer is a point of care non-invasive device that clinicians can use for the management of neonatal jaundice. In January 2001 we reorganized and expanded our domestic sales force to commercially launch CO-Stat. We expect to maintain spending on marketing to and educating the pediatric community to help address this common, but treatable newborn medical condition. Because we have not previously marketed newborn jaundice management products we cannot be certain that our planned resources will be sufficient to support the expansion of sales of our CO-Stat products.

We capitalize the initial cost of obtaining patents and amortize these costs over their expected future lives. In March 2002, we acquired technology patents from a third party at a cost of $1 million. We will review the intangible assets annually for impairment. We have expressed our intention to acquire other technologies, patents and new products. We may not be successful in marketing those new products or products derived from, or protected by, such technologies and patents. In addition, the expected lives of such assets may need to be adjusted based on future knowledge and events. Claims made in patents may be challenged and refuted. As a result, the value of such technologies, patents or products may be impaired which could result in reducing the then carrying value or accelerating the rate of amortization of the value of such assets.

Our net loss available to common stockholders during 2001 included accretion charges to increase over time the carrying amount of our redeemable convertible preferred stock to the amount we would be required to pay if the preferred stock were to be redeemed through 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. 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.

Results of Operations

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues*	45.1	37.4	43.3	37.9
Gross profit	54.9	62.6	56.7	62.1
Operating expenses:				
Marketing and selling	55.1	41.8	55.3	44.0
Research and development	19.7	14.1	18.6	15.0
General and administrative	15.4	13.1	15.8	12.8
Amortization of deferred stock compensation*	2.1	3.9	2.2	4.2
Total operating expenses	92.3	72.9	91.9	76.0
Loss from operations	(37.4)	(10.3)	(35.2)	(13.9)
Other income, net	7.2	(0.3)	5.6	(0.1)
Loss before provision for income taxes	(30.2)	(10.6)	(29.6)	(14.0)
Provision for income taxes	0.6	0.0	0.5	0.0
Net loss	(30.8)	(10.6)	(30.1)	(14.0)
Accretion of redeemable convertible preferred stock	—	4.8	—	5.1
Net loss available to common stockholders	(30.8)%	(15.4)%	(30.1)%	(19.1)%
* Amortization of deferred stock compensation included in:				
Cost of revenues	0.3%	0.5%	0.3%	0.6%
Operating expenses:				
Marketing and selling	1.2%	2.0%	1.2%	2.2%
Research and development	0.2	0.4	0.2	0.4
General and administrative	0.7	1.5	0.8	1.6
Total	2.1%	3.9%	2.2%	4.2%

Three and Six Months Ended June 30, 2002 and 2001

Revenues

Our revenues consist almost exclusively of revenues from the sale of ALGO screening equipment and its related disposable supplies. Our revenues decreased $773,000, or 11%, to $6.5 million in the three months ended June 30, 2002 from $7.2 million in the three months ended June 30, 2001. This decrease was primarily attributable to a decrease in revenues from screening equipment. Our revenues decreased $1.0 million, or 7%, to $12.5 million in the six months ended June 30, 2002 from $ 13.6 million in the six months ended June 30, 2001. No end customer accounted for more than 10% of our revenues in the three or six months ended June 30, 2002 and 2001. Sales to our Japanese distributor, Nippon Eurotec, accounted for 13% of our revenues in the three months ended June 30, 2001.

Revenues from ALGO hearing screening equipment decreased by $690,000, or 29%, to $1.7 million in the three months ended June 30, 2002 from $2.4 million in the three months ended June 30, 2001. Revenues from screening equipment decreased by $1.4 million, or 31%, to $3.2 million in the six months ended June 30, 2002 from $4.6 million in the six months ended June 30, 2001. Lower sales in Japan were the primary reason for the declines. In early 2001, we introduced the ALGO Portable hearing screener into the Japanese market. This new product introduction significantly increased equipment sales in Japan during the first half of 2001. There were no similar product introductions in Japan in 2002. Additionally, the economy in Japan remains weak and resulted in a reduced rate of introduction of new infant hearing screening programs.

Revenues from ALGO disposable supplies decreased by $153,000, or 3%, to $4.5 million in the three months ended June 30, 2002 from $4.6 million in the three months ended June 30, 2001. Revenues from disposable supplies increased $262,000, or 3%, to $8.8 million in the six months ended June 30, 2002 from $8.6 million in the six months ended June 30, 2001. Sales of our ALGO Ear Coupler in the three months ended June 30, 2002 were adversely impacted by the introduction of competitive products, as well as slower than expected sales in international markets. We have also encountered delays in bringing our new ALGO 3 Flexicoupler supply into full production, which limited their availability.

Revenues from sales outside the United States decreased by $456,000, or 34%, to $881,000 in the three months ended June 30, 2002 from $1.3 million in the three months ended June 30, 2001. Revenues from sales outside the United States decreased $692,000, or 27%, to $1.8 million in the six months ended June 30, 2002 from $2.5 million in the six months ended June 30, 2001. These decreases were due primarily to lower quantities of screening equipment sold in Japan during the six months ended June 30, 2002, as compared to early fiscal 2001 when we introduced the ALGO portable to the Japanese market.

Costs of Revenues and Operating Expenses

Cost of revenues includes material costs, personnel expenses, amortization of deferred stock compensation, packaging and shipping costs, other manufacturing costs, warranty expenses and technology license fees. Our cost of revenues increased $210,000, or 8%, to $2.9 million in the three months ended June 30, 2002 from $2.7 million in the three months ended June 30, 2001.

Cost of revenues as a percent of total revenues was 45.1% in the three months ended June 30, 2002, compared with 37.4% reported in the three months ended June 30, 2001. Cost of revenues as a percentage of total revenues was adversely impacted by higher early production costs associated with the ALGO 3 product line and increased manufacturing costs. We expect the ALGO 3 product costs to reduce in the future as we recognize the benefits of lower cost components and improvements in the manufacturing process. Cost of revenues for screening equipment as a percent of total revenues was adversely impacted by a higher manufacturing costs and higher trade-ins in the three months ended June 30, 2002 than in the three months ended June 30, 2001 and increased participation by customers buying under group purchasing organization contracts. While providing an opportunity for increasing revenues, trade-ins and group purchasing organization contracts typically also have the impact of lowering both the selling prices and the gross margins on such sales transactions.

Our cost of revenues increased $298,000, or 6%, to $5.4 million in the six months ended June 30, 2002 from $5.1 million in the six months ended June 30, 2001. The increase was due primarily to increases in our manufacturing costs. As a percent of revenues, the cost of revenues increased to 43.3% in the six months ended June 30, 2002 from 37.9% in the six months ended June 30, 2001. The reduction in gross profits as a percent of revenues in the six months ended June 30, 2002 was primarily a result of lower unit selling prices for screening equipment due to increased trade-in allowances, lower unit prices associated with an increased participation by customers buying under group purchasing organization contracts and higher initial production costs associated with the introduction of the ALGO 3 product line.

Marketing and selling expenses consist primarily of salaries, commissions, travel and promotional and advertising costs. Our marketing and selling expenses increased $541,000, or 18%, to $3.6 million in the three months ended June 30, 2002 from $3.0 million in the three months ended June 30, 2001. Our marketing and selling expenses increased $963,000, or 16%, to $6.9 million in the six months ended June 30, 2002 from $6.0 million in the six months ended June 30, 2001. The increases are primarily attributable to the increased costs of operating our Japanese subsidiary that were not present during the first half of 2001. We did not operate in Japan until July 2001. Costs also increased as a result of the full-year impact of the expansion of the domestic CO-Stat sales force that was phased in during the first half of 2001.

Research and development expenses consist of engineering costs to develop new products, enhance existing products and validate the design of our new or enhanced products. Our research and development expenses increased $257,000, or 25%, to $1.3 million in the three months ended June 30, 2002 from $1.0 million in the three months ended June 30, 2001. Our research and development expenses increased $302,000, or 15%, to $2.3 million in the six months ended June 30, 2002 from $2.0 million in the three months ended June 30, 2001. Increased use of outside consultants for new product development was the primary cause of the increases.

General and administrative expenses consist of corporate, finance, human resource, administrative and legal expenses. Our general and administrative expenses increased $37,000, or 4%, to $991,000 in the three months ended June 30, 2002 from $954,000 in the three months ended June 30, 2001. Our general and administrative expenses increased $243,000, or 14%, to $2.0 million in the six months ended June 30, 2002 from $1.7 million in the six months ended June 30, 2001. The increases in costs are primarily associated with increases in payroll costs as well as other costs associated with becoming a public company.

We recorded aggregate amortization of deferred stock compensation of $154,000 and $326,000 in the three months ended June 30, 2002 and 2001, respectively. We recorded aggregate amortization of deferred stock compensation of $319,000 and $655,000 in the six months ended June 30, 2002 and 2001, respectively.

Other income and expense consists of interest income and capital gains and losses associated with changes in our investment portfolio, interest expense, currency exchange loss and other miscellaneous income and expenses. Other income increased $235,000 to $238,000 in the three months ended June 30, 2002 from $3,000 for the three months ended June 30, 2001. Other income increased $478,000 to $500,000 in the six months ended June 30, 2002 from $22,000 for the six months ended June 30, 2001. The increase was associated with the investment of the remaining net proceeds of our initial public offering in July of 2001.

Foreign exchange gains were $228,000 in the three months ended June 30, 2002 and $208,000 in the six months ended June 30, 2002. Exchange gains and losses were insignificant in 2001. The gains resulted primarily from reductions in local currency equivalents of U.S. Dollar obligations associated with the recent weakening of the U.S. Dollar against the British Pound and the Japanese Yen. Such gains were partially offset by unrealized translation losses that are not included in net income, but that were reported as a component of other comprehensive income.

Liquidity and Capital Resources

As of June 30, 2002, we had cash, cash equivalents and short-term investments of $49.6 million, stockholders' equity of $57.7 million and working capital of $54.5 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 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 was $2.9 million for the six months ended June 30, 2002, compared to net cash used in operating activities of $307,000 for the six months ended June 30, 2001. Cash used in operating activities for the six months ended June 30, 2002 resulted primarily from the net loss during the period and an increase in inventories, offset in part by non-cash items such as deferred stock compensation and depreciation and amortization and a decrease in accounts receivable. The increase in inventories was due primarily to having inventory at our Japanese subsidiary at June 30, 2002, compared with inventory in Japan having been owned by our independent distributor in 2001, as well as additional domestic inventory associated with the ALGO 3 product line. Net cash used in operating activities for the six months ended June 30, 2001 resulted primarily from the net loss during the period and increases in inventory partially offset by a decrease in accounts receivable, an increase in accounts payable and non-cash items such as deferred stock compensation and depreciation and amortization during the six months ended June 30, 2001.

Net cash used in investing activities is strongly impacted by the amount of cash needed to fund operations and investment choices associated with excess cash. Net cash used in investing activities was $4.0 million for the six months ended June 30, 2002 and $428,000 for the six months ended June 30, 2001. Net cash used in investing activities during these periods was primarily for the purchase of short-term investments (net of sales) in the six months ended June 30, 2002 and new computers, equipment and furniture as we expanded operations in the six months ended June 30, 2001. Our decision to hold investments in one form or another is driven primarily by the rate of return on the investment at the time of renewal versus the risks associated with the investment. Because we do not want to be considered an investment company the types of investments we may make are limited. We select from appropriate available cash equivalent investments and short-term government issuances based on investment yields and other criteria at the time of renewing expired time deposits. As cash equivalent investments are reported as cash, and short term government issuances are reported under investing activities. Fluctuations in cash and investing activities are often attributable to these investment decisions. We had no material capital expenditure commitments as of June 30, 2002 and we currently do not intend to enter into any material capital expenditure commitments for the remainder of 2002. We have a $327,000 interest-bearing certificate of deposit with a bank that matures in April 2004. This investment 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 sole collateral for this guarantee is 27,088 shares of our stock that is held by the officer. Due to this arrangement, we have classified the investment as held to maturity.

Net cash provided by financing activities was $359,000 for the six months ended June 30, 2002 and $1.3 million for the six months ended June 30, 2001. The net cash provided by financing activities for the six months ended June 30, 2002 resulted primarily from the proceeds of purchases of stock by employees pursuant to our stock option and purchase plans. The net cash used in financing activities for the six months ended June 30, 2001 resulted primarily from the proceeds of purchases of stock by employees pursuant to our stock option and short-term borrowing under our then line of credit, net of deferred offering costs.

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 expansion of product development efforts and the success of these development efforts;
- the cost and timing of expansion of marketing and selling activities; and
- available borrowings under line of credit arrangements and the availability of other means of financing.

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. $500,000 of the notes was paid on April 1, 2002 and $500,000 of the notes will be due on July 1, 2002. We also entered into a product development agreement with respect to the acquired rights, which will involve payments in the aggregate amount of $500,000 between April 1, 2002 and June 30, 2003.

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 heavily 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.

Recent Accounting Pronouncements

In June 2002, the FASB issued SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, which addresses accounting for restructuring and similar costs. SFAS 146 supercedes previous accounting guidance, principally Emerging Issues Task Force Issue No. 94-3. We will adopt the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 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 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.

In October 2001, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets* . SFAS No. 144 supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, and addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 is effective for fiscal years beginning after December 15, 2002. We adopted the provisions of SFAS No. 144 on January 1, 2002, and the adoption of SFAS No. 144 did not have a material effect on its financial position or results of operations.

In June 2001, the FASB issued SFAS No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that all business combinations initiated after June 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 change to current period earnings. We adopted SFAS No. 142 on January 1, 2002 and stopped amortizing goodwill that resulted from business combinations completed prior to June 30, 2001. The adoption of SFAS No. 141 and 142 did not have a material effect on our financial position and results of operations.

Factors Affecting Future Results

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, including net losses available to common stockholders of $3.8 million in the six months ended June 30, 2002, $4.6 million in 2001 and $1.1 million in 2000. In addition, we had an accumulated deficit of $28.1 million as of June 30, 2002. We expect to incur net losses in 2002.

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

- continue to invest in research and development to enhance our ALGO and CO-Stat products and develop new technologies;
- develop additional applications for our current technology, such as the use of our CO-Stat breath 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; and
- develop additional infrastructure and hire additional management and other employees to keep pace with our growth.

As a result of these increased expenses, we will 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 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 products. Revenues from our ALGO products accounted for approximately 95% of our revenues in the six months ended June 30, 2002, approximately 97% of our revenues in 2001 and approximately 98% of our revenues in 2000. We expect that the revenues from our ALGO product family will continue to account for a substantial majority of our revenues for at least the next two years. To date, our MiniMuff product, which is a disposable ear cover for newborns, has accounted for only a small percentage of our revenues. We have not derived any significant revenues from sales of our CO-Stat products. Any factors adversely affecting the pricing of our ALGO screening equipment and related disposables or demand for our ALGO products, including physician acceptance or the selection of competing products, could cause our revenues to decline and our business to suffer.

If more physicians do not adopt our ALGO and CO-Stat products, we will not achieve future sales growth

We acquired the ALGO product family in 1987, and we introduced our CO-Stat product in January 2001. More neonatologists and pediatricians must adopt our products for us to increase our sales. We believe that physicians will not continue to 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 and may be quicker on a per test basis. Physicians are traditionally slow to adopt new products and testing practices, 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 products relative to other screening 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 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 harm 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 terrorist attacks 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. Economic and political uncertainties, both domestically and abroad, resulting from these attacks have resulted in declines in new technology investments by our customers, including investment in our products. In addition, at least during the short term, some hospitals focused their resources on emergency preparedness and issues related to readiness for disasters rather than on compliance with newborn hearing screening mandates to take effect. For example, we did not receive product orders that we anticipated in the weeks after the terrorist attacks, which resulted in a decline in revenues in the quarter ended September 30, 2001. New rules and regulations that went into effect in New York in October 2001 require inpatient hearing screening for newborns under certain circumstances. We did not receive the orders we anticipated that we would have received late in the quarter ended September 30, 2001 from the adoption of these rules and regulations. We do not know what further effect future terrorist attacks, or resulting military actions by the United States, 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.

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

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. This could make our business difficult to manage. For example, in the fourth quarter of 1997, a local government agency in Belgium made a one-time purchase of equipment for each of the hospitals in its jurisdiction and approximately one year's supply of disposables. This purchase resulted in an abnormally high level of sales during that period and the following quarter.

We have limited historical experience selling our CO-Stat products and cannot determine how the sales cycle for the CO-Stat 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 any 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 decline.

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, 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 and marketing additional newborn testing 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. 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 on our ability to begin commercial, volume sales of our CO-Stat products

We introduced our CO-Stat product family for clinical research uses in July 1999 and began commercially marketing it in January 2001. To date, CO-Stat products have accounted for only a limited portion of our revenues and we have sold only 21 CO-Stat analyzers. We have limited experience marketing our CO-Stat product for commercial use. However, our future growth and profitability will depend on our ability to commercially sell our CO-Stat products and to sell our CO-Stat products in volume. We cannot be certain that our entry into the hemolysis monitoring segment of the newborn testing market with our CO-Stat products will be successful, that the hemolysis monitoring market will develop at all or that physicians, governments or other third party payors will accept and adopt these products.

Physicians may not adopt our CO-Stat products if we cannot show that these products are cost-effective or if long-term clinical data does not support our early results, which would harm our operating results

While one clinical study has concluded that our CO-Stat product is more cost-effective than another test used for jaundice monitoring, we cannot be certain that additional clinical studies of the cost-effectiveness of our CO-Stat product compared to other tests used for jaundice monitoring will produce results that are favorable to our products. The commercial acceptance of our CO-Stat products depends in part upon favorable results from these studies if they are conducted. If our

CO-Stat products are not shown to be cost-effective, we may not be able to persuade clinicians to adopt our products and our results of operations may suffer.

If clinical studies do not continue to produce satisfactory clinical data supported by the independent efforts of clinicians, our new products may not be accepted by physicians or government agencies as meeting the standards of care for universal newborn screening. Our safety, effectiveness, reliability, sensitivity and specificity data for the CO-Stat product is based in part on a study of over 1,300 children conducted in 1998. We may find that data from longer-term follow-up studies or studies involving a larger number of children is inconsistent with our relatively short-term data. If longer-term studies or clinical experience indicate that the CO-Stat product does not provide sensitive, specific and reliable results, our products may not gain commercial acceptance and our revenues could decline. In addition, we could be subject to significant liability for screening that failed to detect hemolysis leading to jaundice or costs and emotional distress incurred by families whose children received results indicating elevated hemolysis when none existed. We could have similar problems with any other products 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.

Our revenues may not grow if densely populated states and foreign countries do not adopt guidelines requiring universal newborn hearing screening or jaundice monitoring 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 sales may not grow. As of June 30, 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

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, a market may not develop for our CO-Stat products.

Any failure in our efforts to educate clinician, 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 universal newborn hearing testing and universal newborn jaundice management using hemolysis monitoring. We rely on physician, government agency and other third party payor confidence in the benefits of testing with 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 the screening procedures or for screening equipment itself, 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 screening procedures conducted with our equipment or the disposable products needed to conduct the 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 hemolysis monitoring 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 for screening 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. For instance, we are currently participating in the National Health Service's selection process in the United Kingdom for newborn hearing screening equipment vendors for England and, potentially, Scotland and Wales. We have been advised that we were selected as an approved vendor of hearing screening products for the National Health Service, however, the contracting process has been delayed. In the event we do not receive a significant award under the contract to provide newborn hearing screening equipment to the National Health Service, we will have difficulty selling our hearing screening products in the United Kingdom. We cannot be certain of the amount or timing of revenues associated with the award.

Even if third party payors provide adequate reimbursement for some newborn hearing screening or hemolysis monitoring for jaundice management, 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 screening 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 products, and our failure to build and manage our sales force or to market and distribute our CO-Stat products or other products effectively will hurt our revenues and quarterly results

Since we only recently began to market our CO-Stat products, our sales force has little experience selling these products, and we cannot predict how successful they will be in selling them. In order to successfully introduce and build market share for our CO-Stat 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 small direct sales force of 18 persons as of June 30, 2002. 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 sales of our CO-Stat products.

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

We do not have experience manufacturing our CO-Stat products in commercial quantities, and we may encounter difficulties in the manufacturing of these products. We must also increase our manufacturing personnel or increase the volume of products we purchase from contract manufacturers that produce the CO-Stat products for us. If we encounter any of these difficulties, we may not be successful in marketing our CO-Stat 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 the second quarter of 2002, we experienced delays on the part of a supplier to provide us with volume production of our new ALGO 3 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.

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 assure you 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. For instance, in the three months ended June 2002, we entered into agreements relating to our hearing screening products with Broadlane, Inc. a supply cost management company. While we still 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. Sales to members of one group purchasing organization, Novation, LLC, accounted for approximately 30% of our total revenues in the six months ended June 30, 2002, approximately 25% of our total revenues in 2001 and 22% of our total revenues in 2000. Sales to members of group purchasing organizations accounted for approximately 47% of our total revenues in the six months ended June 30, 2002, approximately 35% of our total revenues in 2001 and approximately 23% of our total revenues in 2000. 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 group purchasing organizations and 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. Of our customers that purchased products from us in 2000, 93% also purchased products from us in 2001. 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 to sell our products in some markets outside of the United States, our revenues could decline if our existing distributors do not continue to purchase products from us or if our relationship with any of these distributors is terminated

We rely on our distributors for a majority of our sales outside the United States. These distributors also assist us with regulatory approvals and education of physicians and government agencies. Our revenues from sales through international distributors outside the United States represented approximately 11% of our revenues in the six months ended June 30, 2002 and approximately 14% of our total revenues in each of 2001 and 2000. 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 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.

In the past, we have terminated our relationships with distributors for poor performance. We are also 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 have 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. In addition, 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 terrorist attacks in the United States and abroad;
- 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 United States Food and Drug Administration clearances or approvals or to comply with Food and Drug Administration 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 Food and Drug Administration 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 Food and Drug Administration has determined that the medical device in question poses a greater risk of injury.

The Food and Drug Administration's 510(k) clearance process usually takes from four 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 Food and Drug Administration will ever grant either 510(k) clearance or premarket approval for any product we propose to market. Furthermore, if the Food and Drug Administration 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 Food and Drug Administration 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 Food and Drug Administration takes an enforcement action against us for off-label uses

We may not promote or advertise the ALGO, MiniMuff or CO-Stat 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 Food and Drug Administration 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 Food and Drug Administration, our sales could be delayed, our revenues could decline and our reputation among clinicians could be harmed.

Our business would be harmed if the Food and Drug Administration 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 Food and Drug Administration concerning compliance with pertinent regulatory requirements. If the Food and Drug Administration 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;
- 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 Food and Drug Administration and are subject to regulatory requirements similar to the Food and Drug Administration's regulatory requirements in foreign 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 the Food and Drug Administration 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 Food and Drug Administration's quality system regulation and comparable regulations of states and other countries. The Food and Drug Administration 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 Food and Drug Administration 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 the ALGO products include companies that market hearing screening equipment. For the CO-Stat products, we anticipate that our competitors will be large medical device companies that market laboratory bench equipment used for blood-based antibody and bilirubin tests and companies that sell devices that analyze the amount of yellow in the skin to estimate the level of bilirubin.

We believe that Bio-logic Systems Corp., Intelligent Hearing Systems 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. For example, Bio-logic recently announced that it received FDA approval to sell its disposable products for use with versions of our ALGO hearing screeners other than the ALGO 3. The sales of these products has adversely impacted our revenues from sales of our disposable products. We believe that Chromatics Color Sciences International, Inc., 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 jaundice. 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 or hemolysis monitoring 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, the Pemstar assets acquisition and any future 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.

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 hemolysis monitoring 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 fourteen issued United States patents, eight patent applications pending before the United States Patent and Trademark Office, two European patents that are registered in ten European communities, one patent granted in Germany, one patent granted in the United Kingdom and eleven patent applications pending before foreign governmental bodies. We have one patent granted in Japan, eight patent applications pending in Japan and four patent applications pending in Hong Kong. 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 hemolysis monitoring 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. 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;
- 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 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. From July 19, 2001 to June 30, 2002, our stock price had a high closing price of $15.20 and a low closing price of $3.90. 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.

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 including Tim C. Johnson, our chief executive officer, and William New, Jr., M.D., Ph.D., our chief technology officer, chairman and a founder. The loss of any of our key employees could adversely affect our business and slow our product development process. Although we maintain key person life insurance on Dr. New, we do not maintain key person life insurance on any of our other employees, and the amount of the policy on Dr. New may be inadequate to compensate us for his loss.

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, 2001, we had total federal and state net operating loss carryforwards of approximately $8.0 million and $1.7 million, respectively, available to reduce future taxable income. If not utilized to offset taxable income in future periods, these net operating loss carryforwards 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 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 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 are unable to use our net operating loss carryforwards to offset our taxable income, our future tax payments will be higher and our financial results may suffer.

Item 3. 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. Our revenues for sales outside the United States were approximately 14% of our total revenues in 2000, approximately 17% of our total revenues in 2001 and approximately 15% of our revenues in the six months ended June 30, 2002. 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. 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 not have changed by a material amount for the six months ended June 30, 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. 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 make our products less competitive in those countries.

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 June 30, 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. If market interest rates were to increase by 10% from levels at June 30, 2002, the fair value of our portfolio would decline by an immaterial amount. Additionally, since we generally have the ability to hold these investments to maturity, these declines in fair value may never be realized.

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

PART II. OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds

We have used approximately $2.0 million of the proceeds from our initial public offering to repay the outstanding amounts on our revolving bank line of credit. The offering expenses incurred by us were approximately $2.4 million. There were no direct or indirect payments to any of our directors or officers or any other person or entity. None of the offering proceeds have been used for the construction of plant, building or facilities or the purchase or installation of machinery or equipment or for purchases of real estate or the acquisition of other businesses. We have used net proceeds to fund operating losses. We are currently investing the net offering proceeds for further use as additional working capital. The net proceeds have been invested pursuant to our investment policy.

In March 2002, we entered into an agreement to acquire certain intellectual property and product rights 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. $500,000 of the notes was due on April 1, 2002 and the remaining $500,000 was due and paid on July 1, 2002. We also entered into a product development agreement with respect to the acquired rights, which will involve payments in the aggregate amount of $500,000 between April 1, 2002 and approximately June 30, 2003.

A portion of the net proceeds may be used for other acquisitions of technologies, businesses or products that are complementary to ours. Other than these amounts and future estimated capital expenditures in the amount of approximately $1.0 million in the next 12 months, we have no specific plan for the proceeds from our initial public offering.

Item 4. Submission of Matters to a Vote of Security Holders

On May 15, 2002, we held our Annual Meeting of Stockholders. We solicited votes by proxy pursuant to proxy solicitation materials first distributed to our stockholders on or about April 15, 2002. The following is a brief description of the matters voted on at the meeting and a statement of the number of votes cast for and against the number of abstentions:

1. Election of James J. Bochnowski as a Class I director until the next Annual Meeting of Stockholders or until his successors is elected.

Nominee	In Favor	Withheld
James J. Bochnowski	11,422,410	689,347

2. The ratification of the appointment of Deloitte & Touche LLP as independent public accountants of the Company for the fiscal year ending December 31, 2002:

For	Against	Abstain
2,102,859	3,948	4,950

3. The ratification of the option grant limitation contained in the 2000 Stock Option Plan for purpose of Section 162(m) of the Internal Revenue Code, as amended:

For	Against	Abstain
1,904,110	115,782	91,865

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

10.20	Transition Agreement and Release dated April 26, 2002 between Registrant and William H. Lawrenson
99.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C Section 1350 as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

The Company did not file any reports on Form 8-K during the three months ended June 30, 2002.

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SIGNATURES

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

NATUS MEDICAL INCORPORATED

Dated: August 14, 2002

By: /s/ TIM C. JOHNSON

Tim C. Johnson
Chief Executive Officer, President,
Chief Operating Officer and Director
(Principal Executive Officer)

Dated: August 14, 2002

By: /s/ WILLIAM H. LAWRENSON

William H. Lawrenson
Vice President, Finance,
Chief Financial Officer and
Assistant Secretary
(Principal Financial and
Accounting Officer)

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Natus Medical Incorporated

Index to Exhibits

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Exhibit 10.20

TRANSITION AND RELEASE AGREEMENT

RECITALS

This Transition and Release ("Agreement") is made by and between William H. Lawrenson, ("Employee") and Natus Medical Inc. ("Company") (collectively referred to as the "Parties"):

WHEREAS, Employee is an employee and officer of the Company;

WHEREAS, the Company and Employee entered into a Employment, Confidential Information and Invention Assignment Agreement (the "Confidentiality Agreement") and an Indemnity Agreement, and;

WHEREAS, the Employee has resigned his employment with Company effective August 31, 2002 (the "Termination Date")

WHEREAS, the Company and Employee have entered into a stock option agreements dated December 17, 1997, October 23, 1998, May 5, 1999, July 6, 1999, May 9, 2000 and April 20, 2001 granting me the option to purchase 129,803 total shares of the Company's common stock subject to the terms and conditions of the Company's 1991 and 2000 Stock Option Plans and the Stock Option Agreement (the "Stock Agreements"):

WHEREAS, the Parties, and each of them, wish to resolve any and all disputes, claims, complaints, grievances, charges, actions, petitions and demands that the Employee may have against the Company as defined herein, including, but not limited to, any and all claims arising or in any way related to Employee's employment with, or separation from, the Company;

1 Resignation and Transition

Employee hereby tenders his resignation as Chief Financial Officer of Natus Medical Inc. (the Company) effective August 31, 2002 (the Termination Date), under the terms and conditions in this agreement.

Upon execution of this agreement, the transition period (the Transition Period) shall commence, which will terminate August 31, 2002.

Employee will remain as Chief Financial Officer of the Company for as long as the Company deems fit, but in no event after the Termination Date. The Company will inform Employee of the date on which it wishes Employee to step down as CFO, at its convenience, at which time and in exchange for consideration detailed hereunder, including continuation of salary and benefits through the Termination Date, the Employee will resign as the Chief Financial Officer, and as a Director of Company's Subsidiaries, (collectively "CFO").

If Employee ceases to serve as CFO prior to the Termination Date, it will not terminate the Employee's employment during the Transition Period, but such resignation as CFO will terminate his status as an officer and manager of the Company. During the Transition Period and subsequent to resigning as CFO, Employee will no longer be an officer within the Company, and will become a regular staff employee reporting to the President of the Company or to the President's designee.

Employee will devote 100% of his time to the Company during April and May 2002; thereafter during June and July 2002 Employee will devote 60% (nominally three days per five day week) of his time to the Company; during August 2002 until the Termination Date, Employee shall be given a leave of absence and shall not be required to attend the Company.

During the Transition Period, the Company may hold Employee on either active or paid leave of absence status, as the Company may, at its option, determine and inform Employee by written notice. If Employee is on active status during the Transition Period, Employee will perform his duties as CFO, including, but not limited to:

- Assist the Company in finding and hiring a replacement Chief Financial Officer (hereinafter New CFO),
- Acquaint the New CFO with the systems and operation of the Finance and Administrative Departments,
- Assist in the transition of staff to New CFO,
- Introduce New CFO to the investment community and provide New CFO with contact lists,
- Assist in the completion of the BaaN V implementation,
- When requested to do so by the Company, promptly resign as Chief Financial Officer of the Company and as Director of its subsidiaries, and
- Perform other reasonable mutually agreeable tasks associated with the transition.

During the Transition Period and through and until the Termination Date, on each regularly scheduled pay day, Company will pay Employee his current full-time (100%) salary and benefits and reimburse Employee actual and reasonable travel costs associated with approved travel on behalf of the Company.

On the Termination Date, the Company will pay Employee the remainder of his regular monthly salary for August 2002 calculated from the end of the previous pay period through August 31, as well as any and all accrued vacation and other amounts normally due terminating employees, and make available to Employee those continuation benefits, such as normal COBRA benefits, and any other benefits as are normally offered other employees at the time of their termination. Employee's health insurance benefits will cease at the end of the month which contains the Termination Date, subject to Employee's right to continue his health insurance under COBRA. Employee's participation in all other benefits and incidents of employment will cease on the Termination Date. Employee will cease accruing employee benefits as of the Termination Date, except as otherwise specified herein, including, but not limited to, vacation time and paid time off.

In the event that the BaaN IV system has been successfully migrated to the BaaN V system by not later than the Termination Date, the company shall accelerate the vesting of approximately 15,000 unvested options to purchase shares associated with Employee's option dated May 9, 2000. The exercise of the options shall continue to be subject to the applicable stock option agreements.

Employee shall be permitted to retain possession of his Company-provided laptop computer (or reasonable substitute/replacement thereof), provided that all Company information or data shall be removed therefrom.

Release of Claims

Employee agrees that the foregoing consideration represents settlement in full of all outstanding obligations owed to Employee by the Company and its officers, managers, supervisors, agents. Employee on his own behalf, and on behalf of his respective heirs, family members, executors, agents, and assigns, hereby fully and forever releases the Company and its officers, directors, employees, agents, investors, shareholders, administrators, affiliates, divisions, subsidiaries, predecessor

and successor corporations, and assigns, from, and agrees not to sue concerning, any claim, duty, obligation or cause of action relating to any matters of any kind, whether presently known or unknown, suspected or unsuspected, that Employee may possess arising from any omissions, acts or facts that have occurred up until and including the effective Date of this Agreement including, without limitation:

- any and all claims relating to or arising from Employee's employment relationship with the Company and the termination of that relationship;
- ***any and all claims relating to, or arising from, Employee's right to purchase, or actual purchase of shares of stock of the Company, including, without limitation, any claims for fraud, misrepresentation, breach of fiduciary duty, breach of duty under applicable state corporate law, and securities fraud under any state or federal law;***
- ***any and all claims under the law of any jurisdiction including, but not limited to, wrongful discharge of employment; constructive discharge from employment; termination in violation of public policy; discrimination; breach of contract, both express and implied; breach of a covenant of good faith and fair dealing, both express and implied; promissory estoppel; negligent or intentional infliction of emotional distress; negligent or intentional misrepresentation; negligent or intentional interference with contract or prospective economic advantage; unfair business practices; defamation; libel; slander; negligence; personal injury; assault; battery; invasion of privacy; false imprisonment; and conversion;***
- ***any and all claims for violation of any federal, state or municipal statute, including, but not limited to, Title VII of the Civil Rights Act of 1964, the Civil Rights Act of 1991, the Age Discrimination in Employment Act of 1967, the Americans with Disabilities Act of 1990, the Fair Labor Standards Act, the Employee Retirement Income Security Act of 1974, The Worker Adjustment and Retraining Notification Act, Older Workers Benefit Protection Act; the California Fair Employment and Housing Act, and the California Labor Code;***
- ***any and all claims for violation of the federal, or any state, constitution;***
- ***any and all claims arising out of any other laws and regulations relating to employment or employment discrimination;***
- ***any claim for any loss, cost, damage, or expense arising out of any dispute over the non-withholding or other tax treatment of any of the proceeds received by Employee as a result of this Agreement; and***
- ***any and all claims for attorneys' fees and costs.***

The Company and Employee agree that the release set forth in this section shall be and remain in effect in all respects as a complete general release as to the matters released. The Parties agree that this Agreement severs all relationships between them and shall act as a mutual release of all claims of any nature which one party may have against the other party as of the Effective Date, except that the following claims shall not be released hereby: (i) claims by either party against the other under or pursuant to this Agreement, (ii) claims under applicable law in respect of statutory employment rights (such as COBRA or ERISA claims), and (iii) claims or rights of Employee under law or Company's certificate of incorporation and bylaws as to indemnification against third party claims arising with respect to his service as an officer and director of Company prior to the effective date.

Employee acknowledges and agrees that any breach of any provision of this Agreement shall constitute a material breach of this Agreement and shall entitle the Company immediately to recover the termination benefits provided to Employee under this Agreement.

Employee shall continue to maintain the confidentiality of all confidential and proprietary information of the Company and shall continue to comply with the terms and conditions of the Confidentiality Agreement between Employee

and the Company. Employee shall return all of the Company's property and confidential and proprietary information in his possession to the Company on the Termination Date.

Employee acknowledges that he/she is waiving and releasing any rights he/she may have under the Age Discrimination in Employment Act of 1967 ("ADEA") and that this waiver and release is knowing and voluntary. Employee and the Company agree that this waiver and release does not apply to any rights or claims that may arise under ADEA after the Effective Date of this Agreement. Employee acknowledges that the consideration given for this waiver and release Agreement is in addition to anything of value to which Employee was already entitled. Employee further acknowledges that he/she has been advised by this writing that:

- he should consult with an attorney prior to executing this Agreement;
- he has up to twenty-one (21) days within which to consider this Agreement;
- he has seven (7) days following his execution of this Agreement to revoke the Agreement;
- this ADEA waiver shall not be effective until the revocation period has expired; and
- nothing in this Agreement prevents or precludes Employee from challenging or seeking a determination in good faith of the validity of this waiver under the ADEA, nor does it impose any condition precedent, penalties or costs for doing so, unless specifically authorized by federal law.

Civil Code Section 1542. The Parties represent that they are not aware of any claim by either of them other than the claims that are released by this Agreement. I acknowledges that he has been advised by legal counsel and is familiar with the provisions of California Civil Code Section 1542, which provides as follows:

A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR SUSPECT TO EXIST IN HIS FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM MUST HAVE MATERIALLY AFFECTED HIS SETTLEMENT WITH THE DEBTOR.

Employee, being aware of said code section, agrees to expressly waive any rights he may have thereunder, as well as under any other statute or common law principles of similar effect.

Employee represents that he has no lawsuits, claims, or actions pending in his name, or on behalf of any other person or entity, against the Company or any other person or entity referred to herein. Employee also represents that he does not intend to bring any claims on his own behalf or on behalf of any other person or entity against the Company or any other person or entity referred to herein.

Employee understands and agrees that, as a condition of this Agreement, he shall not be entitled to any employment with the Company, its subsidiaries, or any successor, and he hereby waives any right, or alleged right, of employment or re-employment with the Company, its subsidiaries or related companies, or any successor.

The Parties acknowledge that Employee's agreement to keep the terms and conditions of this Agreement confidential was a material factor on which all parties relied in entering into this agreement. Employee hereto agrees to use his best efforts to maintain in confidence: (1) the existence of this Agreement, (ii) the contents and terms of this Agreement, (iii) the consideration for this Agreement, and 9iv) any allegations relating to the company or its officers or employees with respect to employee's employment with the Company, except as otherwise provided for in this Agreement (hereinafter collectively referred to as "Settlement Information"). Employee agrees to take every reasonable precaution to prevent disclosure of any Settlement Information to third parties, and agrees that there will be no publicity, directly or indirectly, concerning any Settlement Information. Employee agrees to take every precaution to disclose Settlement Information only to those attorneys, accountants, governmental entities and family members who have a reasonable need to know of such Settlement Information. The Parties agree that if Company proves that Employee breached this Confidentiality provision, it

shall be entitled to an award of is costs spent enforcing this provision, including all reasonable attorney' fees associated with the enforcement action, without regard to whether the company can establish actual damages from the breach by Employee.

Employee agrees he will not act in any manner that might damage the business of the Company. Employee agrees that he will not counsel or assist any attorneys or their clients in the presentation or prosecution of any disputes, differences, grievances, claims, charges, or complaints by any third party against the Company and/or any officer, director, employee, agent, representative, shareholder or attorney of the Company, unless under a subpoena or other court order to do so. Employee further agrees both to immediately notify the Company upon receipt of any court order, subpoena, or any legal discovery device that seeks or might require the disclosure or production of the existence or terms of this Agreement, and to furnish, within three (3) business days of its receipt, a copy of such subpoena or legal discovery device to the Company.

Employee and Company agrees to refrain from any defamation, libel or slander of the Company or tortious interference with the contracts and relationships of the Company or Employee. All inquiries by potential future employers of Employee will be directed to Human Resources. Upon inquiry, the Company shall only state the following: Employee's last position and dates of employment.

Employee agrees that for a period of twelve (12) months immediately following the Effective Date of this Agreement, Employee shall not either directly or indirectly solicit, induce, recruit or encourage any of the Company's employees to leave their employment, or take away such Is, or attempt to solicit, induce, recruit, encourage, take away or hire employees of the Company, either for him/herself or any other person or entity.

The Parties understand and acknowledge that this Agreement constitutes a compromise and settlement of disputed claims. No action taken by the Parties hereto, or either of them, either previously or in connection with this Agreement shall be deemed or construed to be: (a) an admission of the truth or falsity of any claims heretofore made or (b) an acknowledgment or admission by either party of any fault or liability whatsoever to the other party or to any third party.

Employee represents that he has no knowledge of any wrongdoing involving improper or false claims against a federal or state governmental agency, or any other wrongdoing that involves Employee or other present or former Company employees.

The Parties shall each bear their own costs, expert fees, attorneys' fees and other fees incurred in connection with this Agreement.

Employee agreed to indemnify and hold harmless the Company from and against any and all loss, costs, damages or expenses, including, without limitation, attorneys' fees or expenses incurred by the Company arising out of the breach of this Agreement by Employee, or from any false representation made herein by Employee, or from any action or proceeding which may be commenced, prosecuted or threatened by Employee or for Employee's benefit, upon Employee's initiative, or with Employee's aid or approval, contrary to the provisions of this Agreement. Employee further agrees that in any such action or proceeding, this Agreement may be pled by the Company as a complete defense, or may be asserted by way of counterclaim or cross-claim.

The Parties agree that any and all disputes arising out of the terms of this Agreement, their interpretation, and any of the matters herein released, shall be subject to binding arbitration in San Mateo County before the American Arbitration Association under its National Rules for the Resolution of Employment Disputes or the California Code of Civil Procedure. The Parties agree that the prevailing party in any arbitration shall be entitled to injunctive relief in any court of competent jurisdiction to enforce the arbitration award. The Parties agree that the prevailing party in any arbitration shall be awarded its reasonable attorneys' fees and costs. **The parties hereby agree to waive their right to have any dispute between them resolved in a court of law by a judge or jury.** This section will not prevent either party from seeking injunctive relief (or any other provisional remedy) from any court having jurisdiction over the Parties and the subject matter of their dispute relating to its obligations under this Agreement and the agreements incorporated herein by reference.

The Company represents and warrants that the undersigned has the authority to act on behalf of the Company and to bind the Company and all who may claim through it to the terms and conditions of this Agreement. Employee represents and warrants that he has the capacity to act on his own behalf and on behalf of all who might claim through him/her to bind them to the terms and conditions of this Agreement. Each party warrants and represents that there are no liens or claims of lien or assignments in law or equity or otherwise of or against any of the claims or causes of action released herein.

Each party represents that it has had the opportunity to consult with an attorney, and has carefully read and understands the scope and effect of the provisions of this Agreement. Neither party has relied upon any representations or statements made by the other party hereto which are not specifically set forth in this Agreement.

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 shall continue in full force and effect without said provision so long as the remaining provisions remain intelligible and continue to reflect the original intent of the Parties.

This Agreement represents the entire agreement and understanding between the Company and I concerning the subject matter of this Agreement and Employee's relationship with the Company, and supersedes and replaces any and all prior agreements and understandings between the Parties concerning the subject matter of this Agreement and Employee's relationship with the Company, with the exception of the Confidentiality Agreement, Indemnity and applicable Stock Agreements.

The failure of any party to insist upon the performance of any of the terms and conditions in this Agreement, or the failure to prosecute any breach of any of the terms and conditions of this Agreement, shall not be construed thereafter as a waiver of any such terms or conditions. This entire Agreement shall remain in full force and effect as if no such forbearance or failure of performance had occurred.

Any modification or amendment of this Agreement, or additional obligation assumed by either party in connection with this Agreement, shall be effective only if placed in writing and signed by both Parties or by authorized representatives of each party.

This Agreement shall be deemed to have been executed and delivered within the State of California, and it shall be construed, interpreted, governed, and enforced in accordance with the laws of the State of California, without regard to choice of law principles.

This Agreement is effective after it has been signed by both parties and after eight (8) days have passed since Employee has signed the Agreement (the "Effective Date"), unless revoked by I within seven (7) days after the date the Agreement was signed by Employee.

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.

Voluntary Execution of Agreement. This Agreement is executed voluntarily and without any duress or undue influence on the part or behalf of the Parties hereto, with the full intent of releasing all claims. The Parties acknowledge that:

They have read this Agreement;

b. They have been represented in the preparation, negotiation, and execution of this Agreement by legal counsel of their own choice or that they have voluntarily declined to seek such counsel;

/// [continued next page; remainder of this page blank]

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c. They understand the terms and consequences of this Agreement and of the releases it contains; and

d. They are fully aware of the legal and binding effect of this Agreement.

IN WITNESS WHEREOF, the Parties have executed this Agreement on the respective dates set forth below.

Natus Medical Inc.

Dated: April 26, 2002 By: /s/ TIM C. JOHNSON

Tim C. Johnson
Chief Executive Officer

William H. Lawrenson, an individual

Dated: April 26, 2002 By: /s/ WILLIAM H. LAWRENSON

William H Lawrenson

End of agreement

Exhibit 99.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SABANES-OXLEY ACT OF 2002

I, Tim C. Johnson, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sabanes-Oxley Act of 2002, that the quarterly Report of Natus Medical Incorporated on form 10-Q for the three months ended June 30, 2002 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Natus Medical Incorporated.

By: /s/ TIM C. JOHNSON

Tim C. Johnson
President, Chief Executive Officer
and Chief Operating Officer

Dated: August 14, 2002

I, William H. Lawrenson, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sabanes-Oxley Act of 2002, that the Quarterly Report of Natus Medical Incorporated on Form 10-Q for the three months ended June 30, 2002 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and that information contained in such Quarterly Report on form 10-Q fairly presents in all material respects the financial condition and results of operations of Natus Medical Incorporated.

By: /s/ WILLIAM H. LAWRENSON

William H. Lawrenson
Vice President finance and Chief Financial Officer

Dated: August 14, 2002