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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 March 31, 2004

☐ **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 ☐

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

The number of issued and outstanding shares of the registrant's Common Stock, $0.001 par value, as of May 7, 2004, was 16,691,657.

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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)

	March 31, 2004	December 31, 2003(1)
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,602	$ 9,435
Short-term investments	30,339	28,200
Accounts receivable, net of allowance for doubtful accounts of $408 and $395	4,426	5,682
Inventories	4,302	5,263
Prepaid expenses and other current assets	662	528
Total current assets	48,331	49,108
Property and equipment, net	2,942	2,668
Long-term investment	342	341
Deposits and other assets	75	111
Intangible assets	3,536	3,594
Goodwill	1,204	1,198
Total assets	$ 56,430	$ 57,020
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Accounts payable	$ 1,543	$ 1,659
Accrued liabilities	2,433	2,229
Deferred revenue	326	500
Total current liabilities	4,302	4,388
Commitments and contingencies	—	—
Stockholders' equity:		
Common stock, $0.001 par value, 120,000,000 shares authorized; shares issued and outstanding: 16,648,677 and 16,511,874	87,143	87,038
Treasury stock	(307)	—
Deferred stock compensation	(18)	(33)
Accumulated deficit	(34,942)	(34,495)
Accumulated other comprehensive income	252	122
Total stockholders' equity	52,128	52,632
Total liabilities and stockholders' equity	$ 56,430	$ 57,020

(1) Derived from the consolidated audited financial statements at December 31, 2003.

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 March 31,	
	2004	2003
Revenue	$ 8,703	$ 6,661
Cost of revenue	3,895	2,512
Gross margin	4,808	4,149
Operating expenses:		
Marketing and selling	2,971	3,057
Research and development	1,027	1,031
General and administrative	1,426	1,145
Total operating expenses	5,424	5,233
Loss from operations	(616)	(1,084)
Interest income	97	163
Interest expense	(3)	(3)
Other income, net	76	7
Loss before provision for income taxes	(446)	(917)
Provision for income taxes	1	—
Net loss attributable to common stockholders	$ (447)	$ (917)
Basic and diluted net loss per share	$ (0.03)	$ (0.06)
Shares used in computing basic and diluted net loss per share	16,579	16,328

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)

	Three Months Ended March 31,	
	2004	2003
Operating activities:		
Net loss	$ (447)	$ (917)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	408	316
Amortization of deferred stock compensation	15	64
Loss on disposal of assets	47	6
Changes in operating assets and liabilities:		
Accounts receivable	1,256	992
Inventories	960	(727)
Prepaid expenses and other current assets	(134)	(251)
Accounts payable	(115)	(668)
Accrued liabilities and deferred revenue	29	(148)
Net cash provided by (used in) operating activities	2,019	(1,333)
Investing activities:		
Acquisition of property and equipment	(672)	(61)
Deposits and other assets	32	25
Purchases of short-term investments	(17,491)	(15,774)
Sales of short-term investments	15,427	9,001
Purchase of long-term investments	(1)	(1)
Net cash used in investing activities	(2,705)	(6,810)
Financing activities:		
Issuance of common stock	105	117
Purchase of treasury stock	(307)	—
Net cash provided by (used in) financing activities	(202)	117
Exchange rate effect on cash and cash equivalents	55	(111)
Net decrease in cash and cash equivalents	(833)	(8,137)
Cash and cash equivalents, beginning of period	9,435	17,768
Cash and cash equivalents, end of period	$ 8,602	$ 9,631
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 3	$ 3
Cash paid for income taxes	$ 1	$ —

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 interim condensed consolidated financial statements of Natus Medical Incorporated ("Natus," "we," "us," or "the Company") have been prepared in accordance with accounting principles generally accepted in the United Sates of America ("GAAP"). The accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent in all material respects with those presented in Note 1 to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

Interim financial reports are prepared in accordance with the rules and regulations of the Securities and Exchange Commission, accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. The interim financial information is unaudited, but reflects all normal adjustments that are, in the opinion of management, necessary for fair presentation of our financial position, results of operations, and cash flows for the periods presented. Operating results for the three months ended March 31, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004.

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

2—Comprehensive Loss

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

	Three Months Ended March 31,	
	2004	2003
Net loss	$ (447)	$ (917)
Unrealized gain (loss) on available-for-sale securities	75	(6)
Foreign currency translation adjustment	55	(111)
Comprehensive Loss	$ (317)	$ (1,034)

3—Inventories

Inventories consisted of (in thousands):

	March 31, 2004	December 31, 2003
Raw materials and subassemblies	$ 2,066	$ 1,983
Finished goods	2,236	3,280
Total	$ 4,302	$ 5,263

4—Reserve For Product Warranties

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

NATUS MEDICAL INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

4—Reserve For Product Warranties (Continued)

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

Activity in the warranty reserve during the three months ended March 31, 2004 and 2003 are as follows:

	Three Months Ended March 31,	
	2004	2003
Balance—Beginning of period	$ 298	$ 200
Aggregate changes in accruals related to new warranties	67	19
Aggregate reductions for repairs under warranty	(32)	(22)
Balance—End of period	$ 333	$ 197

5—Basic and Diluted Net Loss Per Common Share

Basic net loss per common share excludes dilution and is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding during the respective period. Diluted loss per share reflects the potential dilution that could occur if stock options were exercised. As a result of net losses for all periods presented, there is no difference between basic and diluted net loss per share. Options to purchase 2,557,735 and 2,268,187 shares of common stock for the three-month periods ending March 31, 2004 and 2003, respectively were not included in the computation of diluted net loss per share because the loss position would have rendered the additional shares antidilutive.

6—Stock-Based Compensation

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

NATUS MEDICAL INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

6—Stock-Based Compensation (continued)

The Company typically grants stock option awards at market value; consequently, no compensation expense is recorded. In 2001, options were granted at an exercise price deemed to be less than their fair market value which resulted in the recording of deferred stock compensation of $2,659,000, based on the difference between the exercise price and the deemed fair value of the options. The difference was recorded as deferred stock-based compensation in stockholders' equity and is being amortized on a straight-line basis over the vesting period of the related options. Amounts amortized during the three months ended March 31, 2004 and 2003 (in thousands) are as follows:

	Three Months Ended March 31,	
	2004	2003
Amortization of stock compensation included in:		
Cost of revenue	$ 1	$ 8
Operating expenses		
Marketing and selling	$ 9	$ 30
Research and development	1	4
General and administrative	4	22
Total	$ 14	$ 56

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

	Three Months Ended March 31,	
	2004	2003
Net loss, as reported	$ (447)	$ (917)
Add: Stock based employee compensation, net of related tax effects	15	64
Less: Compensation expense for stock options determined under the fair value method, net of related tax effects	(300)	(299)
Pro forma net loss	$ (732)	$ (1,152)
Basic and Diluted EPS:		
As reported	$ (0.03)	$ (0.06)
Pro forma	$ (0.04)	$ (0.07)

7—Segment, Customer, and Geographic Information

The Company currently operates in one reportable segment and develops, manufactures, and markets products used by clinicians for the detection, monitoring, treatment, and tracking of common medical disorders that may occur during the time from conception to a baby's first birthday. With the exception of the Neometrics data management system, the nature of the Company's products and production processes as well as the type of customers and distribution methods are consistent among all of the Company's product lines. While the Neometrics data management system is not a medical device or related supply, we believe over time it will

NATUS MEDICAL INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

7—Segment, Customer, and Geographic Information (continued)

become highly integrated with our other products in tracking information generated through detection, monitoring, and treatment. We acquired our Neometrics data management system product line on July 1, 2003.

Revenue from customers by geographic area is as follows (in thousands):

	Three Months Ended March 31,	
	2004	2003
Revenue:		
United States	$ 6,426	$ 4,842
Europe and United Kingdom	1,466	747
All other	811	1,072
	$ 8,703	$ 6,661

For both the three months ended March 31, 2004 and 2003, no sales to a single end-user customer or distributor accounted for greater than 10% of total revenue.

8—Indemnifications

Under its bylaws, the Company has agreed to indemnify its directors and officers for certain events or occurrences arising as a result of their serving in such capacities. The Company has a directors and officers' liability insurance policy that limits the Company's exposure and enables it to recover a portion of any amounts paid resulting from the indemnification of its directors and officers. In addition, the Company enters into indemnification agreements with other parties in the ordinary course of business. In some cases the Company has obtained liability insurance providing coverage that limits its exposure for these other indemnified matters. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. The Company believes the estimated fair value of these indemnification agreements is minimal and has not recorded a liability for these agreements as of March 31, 2004.

9—Subsequent Events

In January 2004, the Company entered into a Transition Agreement and Release, including a severance agreement, with Tim C. Johnson, the Company's former president and chief executive officer. Pursuant to the agreement, the Company and Mr. Johnson agreed on the terms and conditions of termination of his employment with the Company and for an orderly transition of his employment duties to his successor. Mr. Johnson continued to serve in his prior capacities until his successor was appointed in April 2004, at which time Mr. Johnson's employment by the Company terminated. Pursuant to the severance terms of the agreement, the Company expects to record a charge of approximately $518,000 during the three months ending June 30, 2004, representing the cost of maintaining Mr. Johnson's salary and group health benefits for a period of eighteen months. Mr. Johnson joined the company in 1991 and had served in various executive capacities during his fourteen-year tenure with the company.

In addition, pursuant to the Transition Agreement and Release, upon Mr. Johnson's termination from employment the provisions of certain stock options granted to him during his employment were modified, including the immediate vesting of any stock options not previously vested, and an extension to April 2007 of the time period to exercise certain stock option grants. Because both of these provisions are considered material modifications to the terms of the stock option grants, the Company expects to record a non-cash charge for stock compensation expense of approximately $350,000 during the three months ending June 30, 2004. The charge is based on the intrinsic value of the options on the date of the Transition Agreement and Release, which was January 30, 2004.

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

Natus' trademarks include: AABR®, Accuwell™, Accuscreen™, ALGO-1 Plus® Newborn Hearing Screeners, ALGO1e®, ALGO2®, ALGO®, ALGO DataBook®, CEM™, CMS™, Dri-Prep® Prepping Pads, Ear Couplers® Earphones, Flexicoupler® Earphones, Jelly Button® Sensors, Jelly Tab® Sensors, MiniMuffs® Neonatal Noise Attenuators, MSDS™, natus®, neoBLUE™ LED Phototherapy device, Neocoat™, Neometrics™, WebEBP™, VRS™. The Biliband® Eye Protectors, Foldadome™ oxygen hoods, Igloo® neonatal heatshield, Oxydome™, Oxypod® and Oxy-Igloo® products are duly licensed to Natus by Nascor Pty. Ltd.

Overview

The following discussion and analysis supplement the management's discussion and analysis in the company's Annual Report on Form 10-K for the year ended December 31, 2003, and presume that readers have read or have access to the discussion and analysis in the company's Annual Report. Management's discussion and analysis should be read in conjunction with the Company's condensed consolidated financial statements and accompanying footnotes, the discussion below of certain risks and uncertainties, and the cautionary forward-looking statements at the end of this section.

Natus Medical is dedicated to addressing the needs of the newborn medical market, or as we define it, the period from conception to a child's first birthday. Within that interval, we have initially focused on products used by clinicians as they provide care to newborns in the critical minutes and hours after delivery and prior to discharge from the hospital. We call this space the "delivery-to-discharge" segment of the newborn medical market. Natus currently develops, manufactures, and markets products used by clinicians for the detection, monitoring, treatment, and tracking of common medical disorders in newborns.

Our products are designed for use by clinicians as they provide care to newborns in the critical minutes and hours after delivery and prior to discharge from the hospital. We have identified the following six areas of assessment of the newborn performed by clinicians prior to discharge:

- Neurologic Function
- Jaundice Management
- Metabolic Function
- Thermoregulation
- Pulmonary Function
- Infection

We currently sell products that address clinical needs of newborns in five of these six areas of neonatal clinical assessment. Additionally, our Neometrics data management applications are designed to allow clinicians, hospitals, and state and federal governments to better manage information on each newborn's care that is generated in the critical time period following delivery, including in particular the information pertaining to metabolic and hearing screening results. Our research and development efforts have identified other product opportunities for us in this market segment and we intend to develop and acquire technologies, products, or businesses that enable us to market additional products and services in the "delivery-to-discharge" market segment.

Our principal product lines consist of our ALGO screening products for hearing screening, our neoBLUE LED Phototherapy device ("neoBLUE") for the treatment of jaundice, our Accuwell metabolic screening products used for the predictive indication of metabolic disorders, our Neometrics newborn screening data management system, our MiniMuffs Neonatal Noise Attenuators ("MiniMuffs") products for the attenuation of noise for newborns, and our line of neonatal oxygen delivery hoods and heatshields.

Our revenue is generated almost exclusively from the sale of supplies and services, which are generally recurring, and related devices and systems. Supplies and services revenue results from sales of supplies used with

our ALGO medical devices, our product line of oxygen delivery hoods and heatshields, our Accuwell metabolic screening products, software maintenance agreements for our Neometrics data management system, as well extended service agreements on our medical devices. Devices and systems revenue results from the sale of our ALGO and neoBLUE medical devices, and our Neometrics' newborn screening data management system.

Domestic sales accounted for 74% and 73% of our revenue during the three months ended March 31, 2004 and 2003, respectively. We intend to continue expansion of our international operations because we believe international markets represent a significant growth opportunity. We anticipate that international revenue will increase as a percent of revenue in the future. If international sales increase, we may not experience corresponding growth in operating income due to the higher cost of selling outside of the United States (U.S.) We sell our products through a direct sales force in the U.S., through our subsidiary in the United Kingdom (U.K.), and to distributors in approximately 30 other countries. International sales made to distributors are characterized by lower gross margins due to the discount the distributors receive from our list prices.

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

Application of Critical Accounting Policies

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

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

Revenue Recognition

We recognize revenue, net of discounts, from sales of medical devices and related supplies, and metabolic screening products, including sales to distributors, when a purchase order has been received, when title transfers (generally upon shipment), when the selling price is fixed or determinable, and when collection of the resulting receivable is probable. Terms of sales to distributors are EXW, an international incoterm, reflecting that goods are shipped "ex works," in which title and risk of loss are assumed by the distributor at the shipping point. Payment terms are either open trade credit or export letter of credit. Revenue from our Neometrics newborn screening data management system, which is generally highly customized, is recognized on the percentage of completion basis over the development and implementation period of the associated installation, which typically ranges from six to eighteen months. Revenue from extended service and maintenance agreements, for both medical devices and data management systems, is recognized ratably over the service period. Advance payments from customers are recorded as deferred revenue and recognized as revenue as otherwise described above. We generally do not provide rights of return or price protection on products, whether sold by our direct sales force or distributors. We accept trade-ins of our own and competitive medical devices. Trade-ins are recorded as a reduction of the replacement medical device sale. Provisions are made for initial standard warranty obligations of one year, and post-sale training and customer support at the time the related revenue is recognized.

We must exercise judgment when assessing the sufficiency of our allowance for estimated uncollectible accounts receivable. Our estimates are based on our historical collection experience within the markets in which we operate as well as assessment of our average accounts receivable aging days and any other specific

information of which we may be aware, such as bankruptcy filings or liquidity problems of our customers. Any future determination that our allowance for estimated uncollectible accounts receivable is understated could result in increased operating expense and reduce our results of operations.

At March 31, 2004 our deferred revenue under extended service and maintenance agreements, and billings in excess of recognized revenue on percentage-of-completion contracts was approximately $326,000. Other advance payments from customers were not material at March 31, 2004. Our allowance for estimated uncollectible accounts receivable was $408,000 at March 31, 2004.

Inventory is carried at the lower of cost or market value

As a medical device manufacturer, we may be exposed to a number of factors that could result in portions of our inventory becoming either obsolete or in excess of anticipated usage. These factors include, but are not limited to, technological changes in our markets, competitive pressures in products and prices, and our own introduction of new product lines.

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

Carrying value of intangible assets

We amortize intangible assets with finite lives over their useful lives, which range from 5 to 15 years for licensed technology, customer relationships, and tradenames, and 21 years for patents. Any future changes that would limit their useful lives or any determination that these assets are carried at amounts greater than their fair value could result in additional charges. We carry goodwill and any other intangible assets with indefinite lives at original cost but do not amortize them; any future determination that these assets are carried at amounts greater than their fair value could result in additional charges.

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

A portion of our goodwill is denominated in the local currency of our foreign subsidiaries, and may fluctuate in carrying amount from period to period as the result in the changes in exchange rates between the U.S. dollar and the respective local currency.

At March 31, 2004 we had intangible assets with a carrying value of approximately $4.7 million.

Liability for product warranties

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

At March 31, 2004 our reserve for product warranties was approximately $333,000.

Valuation allowance for deferred tax assets

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

At December 31, 2003, our net deferred tax assets were zero, net of a $9.3 million valuation allowance.

Results of Operations

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

	Three Months Ended March 31,	
	2004	2003
Revenue	100.0%	100.0%
Cost of revenue	44.7	37.7
Gross profit	55.3	62.3
Operating expenses:		
Marketing and selling	34.1	45.9
Research and development	11.8	15.5
General and administrative	16.4	17.2
Total operating expenses	62.3	78.6
Loss from operations	(7.0)	(16.3)
Other income, net	1.9	2.5
Loss before provision for income taxes	(5.1)	(13.8)
Provision for income taxes	—	—
Net loss attributable to common stockholders	(5.1)	(13.8)

Three Months Ended March 31, 2004 and 2003

Revenue

Our revenue is derived almost exclusively from the sale of supplies and services, which are generally recurring, and related devices and systems. Supplies and services revenue is derived from sales of disposable supplies for our ALGO hearing screening devices, our MiniMuffs, our line of neonatal oxygen delivery hoods and heatshields, our Accuwell reagents used for newborn metabolic screening, software maintenance agreements for our Neometrics data management system, as well as extended service agreements on our medical devices. Devices and systems revenue is derived from the sale of our ALGO and neoBLUE medical devices, and our Neometrics newborn screening data management system.

Our revenue increased $2.0 million, or 31%, to $8.7 million in the three months ended March 31, 2004, from $6.7 million in the same period in 2003. The Neometrics' lines of business accounted for $920,000 of the increase, with the remainder resulting primarily from increased sales of our ALGO hearing screening and neoBLUE devices. Revenue from devices and systems increased $1.1 million, or 59%, to $2.9 million in the three months ended March 31, 2004, from $1.9 million in the same period in 2003. Revenue from supplies and services increased $1.0 million, or 22%, to $5.8 million in the three months ended March 31, 2004, from $4.8 million in the same period in 2003. Revenue from supplies and services were 66% of total revenue in the three months ended March 31, 2004, compared to 71% of total revenue in the same period in 2003.

Revenue from sales outside the U.S. was $2.3 million in the three months ended March 31, 2004, up from $1.8 million in the same period in 2003. In the three months ended March 31, 2004, revenue from Europe and the United Kingdom increased $719,000 to $1.5 million, revenue from Asia increased $96,000 to $688,000, and revenue from Oceania decreased $347,000 to $131,000. The reduction in revenue from Oceania resulted from decreased unit sales of our ALGO hearing screening devices. In the three months ended March 31, 2004, international sales of devices and systems increased $505,000 to $1.7 million, and international sales of supplies and services decreased $19,000 to $560,000. The reduction in international sales of supplies and services resulted primarily from reduced supply sales in Japan. In January 2004 we changed our distribution method in Japan, which resulted in lower average selling prices of our ALGO hearing screening supplies, however, the reduction in revenue was offset by decreased costs of operating our Japanese subsidiary.

No end-user customer or distributor accounted for more than 10% of our revenue in either the three months ended March 31, 2004 or 2003.

Cost of Revenue

Cost of revenue includes the cost of materials, personnel expenses, packaging and shipping costs net of related revenue, other manufacturing costs, warranty expenses, and technology license fees. Our cost of revenue increased $1.4 million to $3.9 million in the three months ended March 31, 2004, from $2.5 million in the same period in 2003. The increase was about equally attributable to incremental costs of our Neometrics lines of business and materials costs on our other products. Cost of revenue as a percent of total revenue was 45% in the three months ended March 31, 2004, compared with 38% reported in the same period in 2003. The increase in the cost of revenue percentage was primarily associated with cost overruns on several Neometrics data management system installations. In particular, during the three months ended March 31, 2004, we had a cost overrun in completing an upgrade of one data management system that was covered under a long-term maintenance agreement for which associated revenue had been recognized ratably during previous periods. In addition, we recorded increases to reserves for inventory and warranty costs of approximately $159,000 and $40,000 respectively, which contributed to the increased cost of revenue percentage; we did not record any increases to these reserves in the three months ended March 31, 2003.

Operating Expenses

Marketing and selling expenses consist primarily of salaries, commissions, travel, promotional, and advertising costs. Our marketing and selling expenses decreased $86,000, or 3%, to $3.0 million in the three

months ended March 31, 2004 from $3.1 million in the same period in 2003. In the three months ended March 31, 2004 compared to the same period in 2003, we experienced reduced costs of operating our Japanese subsidiary of approximately $210,000. Additionally, we have completed a promotional offer to transition customers to our Flexicoupler earphones supply and patient cables for our ALGO newborn hearing screener, for which we incurred costs in 2003. These costs savings were offset by increases in sales commissions, and selling costs associated with our Neometrics business lines.

Research and development expenses consist of engineering costs to develop new products, enhance existing products, and validate the design of new or enhanced products. Our research and development expenses decreased by $4,000 and were $1.1 million in the three months ended March 31, 2004 and 2003. We incurred increased costs relating to our Neometrics business lines, which were offset by a reduction in the cost of outside consultants.

General and administrative expenses consist of corporate, finance, information technology, human resources, administrative, and legal expenses. Our general and administrative expenses increased $281,000, or 25%, to $1.4 million in the three months ended March 31, 2004 from $1.1 million in the same period in 2003. Approximately half of the cost increase was associated with our Neometrics business lines. In addition, recruiting costs contributed to approximately $84,000 of the increase, with the remainder resulting primarily from increased salary costs.

We recorded aggregate amortization of deferred stock compensation of $15,000 and $64,000 in the three months ended March 31, 2004 and 2003, respectively. A portion of the deferred stock compensation was included in cost of revenue, with the remainder allocated to operating expenses.

Other income and expenses consist of interest income, interest expense, net capital gains and losses from our investment portfolio, net currency exchange gains and losses, and other miscellaneous income and expenses. Other income and expenses were $170,000 in the three months ended March 31, 2004, compared to $167,000 for the same period in 2003.

Foreign currency gains were $30,000 in the three months ended March 31, 2004, compared with losses of $3,000 during the same period in 2003. The net gains and losses resulted primarily from fluctuations in local currency equivalents of the U.S. dollar in the U.K. and Japan. Unrealized translation gains and losses are not included in net income, but are reported as a component of other comprehensive income.

Liquidity and Capital Resources

As of March 31, 2004, we had cash, cash equivalents, and short-term investments of $38.9 million, stockholders' equity of $52.1 million, and working capital of $44.0 million, compared with cash, cash equivalents, and short-term investments of $37.6 million, stockholders' equity of $52.6 million, and working capital of $44.7 million as of December 31, 2003.

Net cash provided by operating activities was $2.0 million for the three months ended March 31, 2004, compared with net cash used in operating activities of $1.3 million for the same period in 2003. Our net loss for the three months ended March 31, 2004 was $470,000 less than the loss during the comparable period in 2003. The reduction in inventories in 2004 resulted primarily from carrying less quantity of our ALGO Flexicoupler disposable supply product at March 31, 2004 than at the end of 2003, when we temporarily increased inventory levels of the product because our primary supplier was in the process of moving their production facility. Our accounts receivable typically decrease during our first quarter compared to the end of the fourth quarter, because of the magnitude and timing of orders shipped during the fourth quarter.

Net cash used in investing activities was $2.7 million for the three months ended March 31, 2004 compared to $6.8 million for the same period in 2003. Net cash used in investing activities in both periods was primarily the result of purchasing short-term investments in excess of those that were redeemed. Because of our investment

policy, the types of investments we may make are limited. Primarily all of our short-term investments are available-for-sale securities with maturities of less than fifteen months, and fluctuations between cash equivalents and short-term investments are often attributable to investment decisions.

We had no material capital expenditure commitments as of March 31, 2004. At March 31, 2004, we had a $342,000 interest-bearing certificate of deposit classified as a hold to maturity investment that was redeemed when it matured in April 2004.

Pursuant to the terms of the transition agreement between the Company and Tim C. Johnson, during the three months ending June 30, 2004 we expect to record an obligation of approximately $518,000 that will be payable over an eighteen month period beginning in April 2004.

Net cash used in financing activities was $202,000 for the three months ended March 31, 2004, compared to net cash provided by financing activities of $117,000 for the same period in 2003. The purchase of treasury stock during the three months ended March 31, 2004 was related to the transition agreement between the Company and Tim C. Johnson; we have no plans to purchase additional treasury stock.

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

- Amount and timing of revenue
- Extent to which our existing and new products gain market acceptance
- Extent to which we make acquisitions
- Cost and timing of expansion of product development efforts and the success of these development efforts
- Cost and timing of expansion of marketing and selling activities
- Available borrowings under line of credit arrangements and the availability of other means of financing

We believe that our current cash and cash equivalent balances and any cash generated from operations and from current or future debt financing will be sufficient to meet our operating and capital requirements for at least the next 18 months. However, it is possible that we may require additional financing within this period. We intend to continue to invest in the development of new products, 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.

Risk Factors

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

Since our inception, we have incurred significant net losses including net losses for the years 2001, 2002 and 2003, and we may incur net losses in the future. As of December 31, 2003, we had accumulated deficits of approximately $34.5 million. The quarter ended December 31, 2003 was our first profitable quarter since our initial public stock offering in July 2001. Additionally, our revenue and operating results have varied significantly from quarter to quarter in the past and may continue to fluctuate in the future. The following are among the factors that could cause our revenue, operating results, and margins to fluctuate significantly from quarter to quarter:

- Budgeting cycle of our customers, particularly government entities, in the U.S. and internationally
- Size and timing of specific sales, such as large purchases of our devices and systems or our supplies and services, by government agencies or hospital systems
- Trade-in allowances or other concessions in connection with the introduction of new products or improvements to existing products
- Length and unpredictability of our sales cycle, particularly for our Neometrics products with which we have limited sales experience and which may have sales cycles that are longer or different from the sales cycles of our ALGO screener products with which we are more familiar
- Marked changes caused by rapidly evolving technology for newborn screening products

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

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

- Continue to invest in research and development to enhance our ALGO hearing screening and neoBLUE phototherapy devices, and other products and technologies
- Develop additional applications for our current technology
- Increase our marketing and selling activities, particularly outside the U.S.
- Increase the size and number of locations of our customer support organization, particularly outside the U.S.
- Develop additional infrastructure and hire required management and other employees to keep pace with our growth

As a result of these possible increased expenses, we may need to generate significantly higher revenue to achieve profitability. We cannot be certain that we will achieve profitability in the future or, if we achieve profitability, sustain it.

We have relied, and expect to continue to rely, on sales of our ALGO hearing screening product family for the majority of our revenue, and a decline in sales of these products could cause our revenue to fall

We expect that the revenue from our ALGO hearing screening product family will continue to account for a majority of our revenue for at least the next eighteen months. Any factors adversely affecting the pricing of our

ALGO hearing screening devices and related supplies or demand for our ALGO hearing screening products, including physician acceptance or the selection of competing products, could cause our revenue to decline and our business to suffer.

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

We intend to develop and acquire additional products and technologies for the detection, treatment, monitoring and tracking of common medical conditions in infants and pregnant women. Developing and acquiring new products, and improving our existing products, to meet the needs of neonatologists, audiologists, pediatricians and nurses requires significant investments in research and development. If we fail to successfully sell new products and update our existing products, our operating results may decline as our existing products reach the end of their commercial life cycles.

We have very limited experience selling and marketing products other than our ALGO hearing screening products, and our failure to develop and manage our sales force or to effectively market and sell our Neometrics products and services, our neoBLUE phototherapy device, or our other products could limit our revenue growth

Our sales force has limited experience selling our Neometrics newborn screening data management system and metabolic screening products, and our neoBLUE phototherapy device, and our other products, and we cannot predict how successful our sales force will be in selling them, and other products we may develop or acquire, in the future. In order to successfully introduce and penetrate the market for these and other products, we must successfully sell them to hospital administrators and government agency purchasing managers who may not be familiar with our ALGO hearing screening products and who may make purchasing decisions on factors that are different from those that our sales people are accustomed to. We market almost all of our newborn hearing screening products in the U.S. through a direct sales force. There are significant risks involved in building and managing our sales force to effectively sell more diverse lines of products and services. We may be unable to hire and retain a sufficient number of qualified sales people with the skills and training to sell our product line effectively.

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

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

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

It is critical to the success of our sales efforts that we educate a sufficient number of clinicians, hospital administrators, and government agencies about our products and the costs and benefits of their use. The commercial success of our products depends upon physician, government agency, and other third-party payor confidence in the economic and clinical benefits of our products as well as their comfort with the efficacy, reliability, sensitivity, and specificity of our products. We believe that physicians may not use our products unless they determine, based on published peer-reviewed journal articles, long-term clinical data, and experience, that our products provide an accurate and cost-effective alternative to other means of testing or treatment. For

instance, there are currently alternative neonatal hearing screening products which may be less expensive or may be quicker on a per test basis than our ALGO devices. With respect to our neoBLUE phototherapy device, initial data from clinical research suggests that the device may be more effective in treating hyperbilirubinemia than other currently marketed phototherapy products. However, we cannot be certain that clinical studies will produce results that are favorable to our neoBLUE product. Physicians are traditionally slow to adopt new products, testing practices, and clinical treatments, partly because of perceived liability risks and the uncertainty of third-party reimbursement. If more clinicians, government agencies, and hospital administrators do not adopt our products, we may be unable to sustain our revenue 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:

- Publication of clinical study results that demonstrate the cost-effectiveness of our ALGO and neoBLUE products
- Changing governmental and physician group guidelines for screening of newborns, particularly with respect to full-term babies
- Performance, quality, price, and total cost of ownership of our neonatal screening and jaundice management products relative to other such products
- Our ability to maintain and enhance our existing relationships and to form new relationships with leading physicians, physician organizations, hospitals, state laboratory personnel, and third-party payors
- Changes in state and third-party payor reimbursement policies for newborn screening equipment and procedures
- Adoption of state and foreign laws requiring universal newborn screening

The domestic market for our ALGO screening products is maturing, and our plan to expand our international operations will result in increased costs and is subject to numerous risks; if our efforts are not successful, this could harm our business

The domestic market for our ALGO screening products is maturing and we plan to expand our international sales and marketing efforts to increase sales of our products in foreign countries. We must expand the number of distributors who sell our products, or increase our direct international presence, to significantly penetrate international markets. We have only begun over the past three years to significantly develop our distributor and direct sales force outside the U.S., where we currently maintain a direct sales force only in the U.K., and increasing our direct sales presence in the U.K. or elsewhere will require us to incur higher personnel and operating costs that may not result in additional revenues. A higher percentage of our sales to international distributors could also impair our revenues due to discount prices that we customarily make available to distributors. We may not realize corresponding growth in revenue from growth in international sales, due to the higher costs of sales outside of the U.S. Even if we are able to successfully expand our international selling efforts, we cannot be certain that we will be able to create or increase demand for our products outside of the U.S. Our international operations are subject to other risks, which include:

- Impact of possible recessions in economies outside the U.S.
- Political and economic instability, including instability related to war and terrorist attacks in the U.S. and abroad
- Contractual provisions governed by foreign law, such as local law rights to sales commissions by terminated distributors
- 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

- Difficulty in obtaining and maintaining foreign regulatory approval
- Attitudes by clinicians, and cost reimbursement policies, towards use of disposable supplies that are potentially unfavorable to our business

If guidelines requiring universal newborn screening do not continue to develop in foreign countries and governments do not require testing of all newborns as we anticipate, or if those guidelines have a long phase-in period, our revenues may not grow

The demand for our screening products depends, in part, upon governments' adoption of universal screening requirements for the disorders for which our products screen. In the U.S., 38 states have now adopted some form of universal hearing screening requirement, and all states have had mandates for metabolic screening in place for some time. To date, there has been only limited adoption of newborn hearing screening prior to hospital discharge by foreign governments, and the phase-in period varies from several months to several years. Even fewer foreign countries have adopted rules mandating universal metabolic screening prior to hospital discharge. The widespread adoption of these guidelines depends, in part, on our ability to educate foreign government agencies, neonatologists, pediatricians, third-party payors, and hospital administrators about the benefits of universal newborn screening as well as the use of our products to perform the screening and monitoring. Our revenues may not grow if governments do not require universal newborn screening prior to hospital discharge, or if physicians or hospitals are slow to comply with those guidelines, or if the government provides for a lengthy phase-in period for compliance.

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

We currently rely on our distributors or sub-distributors for a majority of our sales outside the U.S. Some distributors also assist us with regulatory approvals and education of physicians and government agencies. We intend to continue our efforts to increase our sales in Europe, Japan and other developed countries. If we fail to sell our products through our international distributors, we would experience a decline in revenues unless we begin to sell our products directly in those markets. We cannot be certain that we will be able to attract new international distributors to market our products effectively or provide timely and cost-effective customer support and service. Even if we are successful in selling our products through new distributors, the rate of growth of our revenue could be harmed if our existing distributors do not continue to sell a large dollar volume of our products. None of our existing distributors are obligated to continue selling our products.

If we terminate our relationships with distributors for poor performance, as we have done in the past, we may be subject to foreign laws governing our relationships with our distributors. These laws may require us to make payments to our distributors even if we terminate our relationship for cause. Some countries require termination payments under local 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 operating results may suffer because of foreign currency exchange rate fluctuations or strengthening of the U.S. dollar relative to local currencies

Prior to January 2001, substantially all of our sales contracts provided for payment in U.S. dollars. However, from 2001 through 2003 our revenue and expenses in Japan and the U.K. were denominated in the applicable foreign currency. While we have recently begun requiring payment in U.S. dollars from our reseller in Japan and have significantly reduced our Yen-denominated operating expenses, we have a significant amount on deposit in Yen-denominated accounts, and we continue to be subject to expenses in the U.K. that are denominated in GB Pounds. To date we have not undertaken any foreign currency hedging transactions and, as a result, our future revenue and expenses may be unpredictable due to exchange rate fluctuations that could result in foreign

exchange gains and losses associated with the translation of assets denominated in foreign currencies. Furthermore, a strengthening of the dollar could make our products less competitive in foreign markets where our sales contracts call for payment in U.S. dollars.

If health care providers are not adequately reimbursed for procedures conducted with our devices or supplies, or if reimbursement policies change adversely, we may never achieve significant revenue

Physicians, hospitals, and government agencies are unlikely to purchase our products if clinicians are not adequately reimbursed for the procedures conducted with our devices or supplies. Unless a sufficient amount of 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. Furthermore, even if reimbursement is provided, it may not be adequate to fully compensate the clinicians or hospitals. Some third-party payors may refuse adequate reimbursement unless the infant has demonstrable risk factors. If health care providers cannot obtain sufficient reimbursement from third-party payors for our products or the screenings conducted with our products, it is unlikely that our products will ever achieve significant market acceptance. Acceptance of our products in international markets will depend upon the availability of adequate reimbursement or funding within prevailing health care payment systems. Reimbursement, funding and health care payment systems vary significantly by country. Although we intend to seek reimbursement or funding approvals in international markets, we may not obtain these approvals in a timely manner or at all.

Even if third-party payors provide adequate reimbursement for procedures conducted with our products, adverse changes in reimbursement policies in general could harm our business. We are unable to predict changes in the reimbursement methods used by third-party health care payors, particularly those in countries and regions outside the U.S. For example, some payors are moving toward a managed care system in which providers contract to provide comprehensive health care for a fixed cost per person. 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 products separate from reimbursement for the procedure. Unless the cost of screening or treatment is reimbursed as a standard component of newborn care, universal screening is unlikely to occur and the number of infants likely to be screened with our products will be substantially reduced.

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

We contract with third parties for the supply of some of the components used in our products and the production of our disposable products. Some of our suppliers are not obligated to continue to supply us. For certain of these materials and components, relatively few alternative sources of supply exist. In addition, the lead-time involved in the manufacturing of some of these components can be lengthy and unpredictable. During 2002, we experienced delays on the part of a supplier to provide us with volume production of our ALGO 3 screening Flexicoupler supplies. If these suppliers become unwilling or unable to supply us with components meeting our requirements, it might be difficult to establish additional or replacement suppliers in a timely manner, or at all. This would cause our product sales to be disrupted and our revenue and operating results to suffer.

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

There is only one Natus approved supplier that provides hydrogel, the adhesive used in many of our disposable products. In addition, we have relied on single suppliers for several of the antibodies used in some of

our Neometrics metabolic screening test kits. A disruption in the supply of this adhesive, or these antibodies, could negatively affect our revenue. If we 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 revenue 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 revenue and gross profits from these sales

We have entered, and may in the future enter, into agreements with customers who purchase high volumes of our products. Our agreements with these customers may contain discounts off of our normal selling prices and other special pricing considerations, which could cause our revenue and profit margins to decline. In addition, we have entered into agreements to sell our products to members of group purchasing organizations, which negotiate volume purchase prices for medical devices and supplies for member hospitals, group practices and other clinics. While we make sales directly to group purchasing organization members, the members of these group purchasing organizations now receive volume discounts off our normal selling price and may receive other special pricing considerations from us from time to time. Sales to members of one group purchasing organization, Novation, LLC, accounted for approximately 22%, 29% and 25% of our total revenue in the twelve months ended December 31, 2003, 2002 and 2001 respectively. Sales to members of group purchasing organizations accounted for approximately 39%, 47% and 35% of our total revenue the twelve months ended December 31, 2003, 2002 and 2001 respectively. Other of our existing customers may be members of group purchasing organizations with which we do not have agreements. Our sales efforts through group purchasing organizations may conflict with our direct sales efforts to our existing customers. If we enter into agreements with new group purchasing organizations and some of our existing customers begin purchasing our products through those group purchasing organizations, our revenue and profit margins could decline.

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

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

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

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

- 510(k) clearance via Section 510(k) of the federal Food, Drug, and Cosmetics Act of 1938, as amended
- Premarket approval via Section 515 of the Food, Drug, and Cosmetics Act if the FDA has determined that the medical device in question poses a greater risk of injury

The FDA's 510(k) clearance process usually takes from three to 12 months, but can take longer. The process of obtaining premarket approval is much more costly, lengthy and uncertain. Premarket approval generally takes from one to three years, but can take even longer. We cannot assure you that the FDA will ever grant either 510(k) clearance or premarket approval for any product we propose to market. Furthermore, if the FDA concludes that these future products using our technology do not meet the requirements to obtain 510(k) clearance, we would have to seek premarket approval. We cannot assure you that the FDA will not impose the more burdensome premarket approval requirement on modifications to our existing products or future products, which in either case could be costly and cause us to divert our attention and resources from the development of new products or the enhancement of existing products.

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

We may not promote or advertise the ALGO screener, MiniMuffs, neoBLUE phototherapy device products, or any of our Neometrics diagnostic test kits, or any future cleared or approved devices, for uses not within the scope of our clearances or approvals or make unsupported promotional claims about the benefits of our products. If the FDA determines that our claims are outside the scope of our clearances or are unsupported it could require us to revise our promotional claims or take enforcement action against us. If we were subject to such an action by the FDA, our sales could be delayed, our revenue could decline, and our reputation among clinicians could be harmed.

Our business would be harmed if the FDA determines that we have failed to comply with applicable regulations or we do not pass an inspection

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

- Fines, injunctions and civil penalties
- Recall or seizure of our products
- Issuance of public notices or warnings
- Imposition of operating restrictions, partial suspension, or total shutdown of production
- Refusal of our requests for 510(k) clearance or premarket approval of new products
- Withdrawal of 510(k) clearance or premarket approvals already granted
- Criminal prosecution

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

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

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

Every manufacturer of a finished medical device, including Natus and some of our contract manufacturers and suppliers, is required to demonstrate and maintain compliance with the FDA's quality system regulation and comparable regulations of states and other countries. The FDA enforces the quality system regulation through periodic inspections. Although we have passed inspections in the past, we cannot assure you that we, or our contract manufacturers, will pass any future quality system regulation inspections. If we, or our contract manufacturers, fail one of these inspections in the future, our operations could be disrupted and our manufacturing and sales delayed significantly until we can demonstrate adequate compliance. If we or our contract manufacturers fail to take adequate corrective action in a timely fashion in response to a quality system regulations inspection, the FDA could shut down our or our contract manufacturers' manufacturing operations and require us, among other things, to recall our products, either of which would harm our business.

Incidents related to hazardous materials could adversely affect our business

Portions of our operations in our Portland, Oregon facility previously required the controlled use of hazardous and radioactive materials. Although we do not currently conduct operations that require us to use hazardous or radioactive materials, we have such materials in controlled storage on site in preparation for disposal. Our storage and disposal of such materials is subject to applicable state and federal laws and regulations. We believe our safety procedures for storage and disposal of such materials comply with applicable federal, state, and local regulations; however, the risk of accidental contamination of property or injury to individuals from these materials cannot be completely eliminated. In the event of such an incident, we could be liable for any damages that result, which could adversely affect our business. Our storage and disposal of such waste potentially exposes us to environmental liability if, in the future, such storage or disposal is deemed to have violated such laws and/or regulations or if the storage, treatment and disposal facilities are inadequate and are proved to have damaged the environment.

Environmental, health and safety regulation by the government could adversely affect our operations

Our operations are subject to complex and stringent environmental, health, safety and other governmental laws and regulations. While we believe that we have obtained the requisite approvals and permits for our existing operations, and that our business is operated in accordance with applicable laws in all material respects, we remain subject to a varied and complex body of laws and regulations. Existing laws and regulations may be revised or reinterpreted, or new laws and regulations may become applicable to us, that may have a negative effect on our business and results of operations.

We experience intense competition from other medical device companies or state-funded programs, and this competition could adversely affect our revenue and our business

We sell our products in intensely competitive and rapidly evolving markets. We face competition from other companies in all of our product lines. Our competitors range from small privately-held companies to multinational corporations, and their product offerings vary in scope and breadth. Our competitors may enjoy competitive advantages over us and they may be able to devote greater resources to the development, promotion, and sales of their products.

Our business could be harmed if our competitors establish cooperative relationships with large medical device vendors or rapidly acquire market share through industry consolidation or by bundling together, or with other products, their hearing screening, jaundice treatment, data systems, or newborn metabolic screening products

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

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

We acquired intellectual property assets and technology patents from Pemstar Pacific Consultants during 2002, and we acquired the assets of Neometrics Inc. and affiliated entities during 2003. We expect to make additional acquisitions of products, technology assets or businesses in the future as part of our efforts to increase revenue and expand our product offerings. In addition to direct costs, acquisitions pose a number of risks, including:

- Integration of the acquired products into our business
- Integration of the personnel of the acquired company into our business
- Failure to realize expected synergies
- Failure of acquired products to achieve projected sales

- Failure to maintain customers of, or other relationships existing with respect to the acquired business
- Failure to successfully develop the acquired technology into the desired products or enhancements
- Assumption of unknown liabilities
- Failure to understand and compete effectively in markets and with products or technologies with which we have limited previous experience
- Write-off of goodwill and intangible assets related to such acquisitions

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. If we fail to achieve the anticipated financial, strategic, and other benefits of acquisitions or investments, our operating results may suffer.

Our operating results could suffer if future changes in technology or market conditions result in adjustments to our recorded asset balance for intangible assets

We currently have significant intangible assets, including goodwill and other acquired intangibles. The determination of related estimated useful lives and whether these assets are impaired involves significant judgments. Our ability to accurately predict future cash flows related to these intangible assets might be hindered by events that we have no control over. Due to the highly competitive nature of the medical device industry, new technologies could impair the value of our intangible assets if they create market conditions where our products are no longer competitive.

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 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. The Company holds approximately 21 U.S. patents and 20 foreign patents.

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

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

- Result in costly litigation and damage awards
- Divert our management's attention and resources

- Cause product shipment delays or suspensions
- 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 by someone claiming to have been injured using one of our products or claiming that one of our products failed to perform properly. A product liability claim could result in substantial damages and be costly and time consuming to defend, either of which could materially harm our business or financial condition. 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 depend upon key employees in a competitive market for skilled personnel, and, without additional employees, we cannot grow or achieve and maintain profitability

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

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

As of December 31, 2003, we had a total federal and state net operating loss carryforwards of approximately $14.4 million and $4.1 million, respectively, available to reduce future taxable income. These net operating loss carryforwards, if not utilized to offset taxable income in future periods, will expire in various amounts beginning in 2004 through 2023. 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, U.S. income tax law imposes limitations on the ability of corporations to use net operating loss carryforwards if the corporation experiences a more than 50% change in ownership during any three-year period. We cannot assure you that we will not take actions, such as the issuance of additional stock, which would cause an ownership change to occur. Accordingly, we may be limited to the amount we can use in any given year, so even if we have substantial net income, we may not be able to use our net operating loss carryforwards before they expire. In addition, the net operating loss carryforwards are subject to examination by the Internal Revenue Service (“IRS”), and are thus subject to adjustment or disallowance resulting from any such IRS examination. We have not undertaken a study to determine whether such limitations exist, and if so, the extent of such limitations. However, we believe it is probable that some amounts of our net operating losses will be affected.

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

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 has fluctuated, and may continue to 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
- General market conditions, particularly for companies with a relatively small number of shares available for sale in the public market

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

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

As of May 7, 2004, our executive officers, directors, principal stockholders and individuals or entities affiliated with them beneficially own in the aggregate approximately 46% of our outstanding common stock; one stockholder owns approximately 24%. If some or all of these stockholders act together, they could significantly influence all matters that our stockholders vote upon, including the election of directors and determination of significant corporate actions. This concentration of ownership could delay or prevent a change of control transaction that could otherwise be beneficial to our stockholders.

Anti-takeover provisions in our charter documents and under Delaware law may affect the price of our common stock, and make it more difficult to remove our management. Further, these provisions may make it more difficult to acquire a large portion of our securities, to initiate a tender offer or a proxy contest, or to acquire us, even though such events may be beneficial to our stockholders

Provisions of our certificate of incorporation and bylaws may affect the price of our common stock, and could make it more difficult for a third party to remove our management. Further, these provisions may make it more difficult to acquire a large portion of our securities, to initiate a tender offer or a proxy contest or acquire us, even if doing so would benefit our stockholders. Among other things, these provisions:

- Authorize the issuance of "blank check" preferred stock that could be issued by our Board of Directors to increase the number of outstanding shares and thwart a takeover attempt
- Limit who may call a special meeting of stockholders
- May discourage, delay, or prevent a third party from removing our management
- Acquiring a large portion of our securities, initiating a tender offer or proxy contest, or acquiring us, even if our stockholders might receive a premium for their shares in the acquisition over then current market price

Forward Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements include, among other things, statements concerning our expectations, beliefs, plans, intentions, future operations, financial condition and prospects, and business strategies. The words "may," "will," "continue," "estimate," "project," "intend," "believe," "expect," "anticipate," and other similar expressions generally identify forward-looking statements. Forward-looking statements in this Item 2 include, but are not limited to, statements regarding the following: our development or acquisition of technologies, products or businesses, the future composition of our revenue, future revenue from international operations, international markets as a growth opportunity, the impact of adoption of accounting standards, acceptance of our products and the products of our competitors, fluctuation of our operating results and gross margins, expansion in and opportunities relating to international markets, future marketing and selling expenses, future operating results, warranty allowances, impact of our application of resources, spending relating to our products, sufficiency of future resources such as employees, future investments, identification of, investment in, and development of new products and enhancement of existing products, future liquidity and capital requirements, our investment policy, sufficiency of cash and cash equivalents and availability of funds, effect of and exposure to foreign currency exchange rates, market risk exposure, cost-effectiveness of our products, third-party reimbursement, consolidation of our industry and consequences of intellectual property disputes.

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

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, Europe and Asia. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. In January 2001 we established a distribution subsidiary in the United Kingdom, and in July 2001 we established a distribution subsidiary in Japan. Revenue and expenses of our U.K. subsidiary are generally denominated in the local foreign currency. Expenses of our Japan subsidiary are generally denominated in the local currency. Beginning in January 2004 we began selling directly from our U.S. operations to our top-tier distributor in Japan; consequently, substantially all revenue for sales to our Japan top-tier distributor are now denominated in U.S. dollars. As our operations in the United Kingdom and Japan increase, we expect that our exposure to foreign currency fluctuations will increase. Changes in exchange rates may also affect the volume of our sales or our foreign currency sales prices compared to those of our foreign competitors and could make our products less competitive in those countries. If the U.S. 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 three months ended March 31, 2004. For purposes of this calculation, we have assumed that the exchange rates would change in the same direction relative to the U.S. dollar.

Our interest income is sensitive to changes in 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 through maturity on investments held at March 31, 2004.

We do not use derivative financial instruments for speculative or trading purposes. However, the fair value of our available-for-sale securities is sensitive to changes in interest rates in the United States, and the fair value of our portfolio will fall if market interest rates increase. However, since we generally have the ability to hold these investments to maturity, these declines in fair value may never be realized. If market interest rates were to increase by 10% from levels at March 31, 2004, the fair value of our portfolio would decline by an immaterial amount. At March 31, 2004 our available-for-sale securities consist of federal agency bonds with maturities of less than fifteen months.

All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of March 31, 2004. Actual results may differ as our analysis of the effects of changes in interest rates does not account for, among other things, sales of securities prior to maturity and repurchase of replacement securities, the change in mix or quality of the investments in the portfolio and changes in the relationship between short-term and long-term interest rates.

ITEM 4. Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as of the end of the period covered by this report. Based upon that evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to ensure that material information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

There was no significant change in our internal control over financial reporting that occurred during the quarter ended March 31, 2004 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 2. Changes in Securities and Use of Proceeds

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.

During the three months ended March 31, 2004, we used proceeds from our initial public offering to purchase equipment costing approximately $672,000 and for working capital needs.

ITEM 6. Exhibits and Reports on Form 8-K

(a) Exhibits

10.28	Employment Agreement between the Company and James B. Hawkins dated April 12, 2004.
31.1	Certification of Principal Executive Officer pursuant Section 302 of Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C Section 1350 as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

We filed a current report on Form 8-K dated January 30, 2004 announcing the resignation of our president and chief executive officer and a current report on Form 8-K dated February 26, 2004 to report the Company's fourth quarter and year end financial results.

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SIGNATURES

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

NATUS MEDICAL INCORPORATED

Dated: May 13, 2004

By: /s/ JAMES B. HAWKINS

James B. Hawkins
President and Chief Executive Officer
(Principal Executive Officer)

Dated: May 13, 2004

By: /s/ STEVEN J. MURPHY

Steven J. Murphy,
Vice President Finance
(Principal Financial Officer)

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NATUS MEDICAL INCORPORATED

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Exhibit 10.28

NATUS MEDICAL, INC.

JAMES B. HAWKINS EMPLOYMENT AGREEMENT

This Agreement is entered into as of April 12, 2004, (the "**Effective Date**") by and between Natus Medical, Inc. (the "**Company**"), and James B. Hawkins ("**Executive**").

1. *Duties and Scope of Employment.*

(a) *Positions and Duties*. As of the Effective Date, Executive shall be an employee of the Company, and starting on April 19, 2004, shall serve as President and Chief Executive Officer of the Company. Executive will render such business and professional services in the performance of his duties, consistent with Executive's position within the Company, as shall reasonably be assigned to him by the Company's Board of Directors ("Board"). The period of Executive's employment under this Agreement is referred to herein as the "Employment Term."

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

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

3. *Compensation.*

(a) *Base Salary*. During the Employment Term, the Company will pay Executive an annual salary of three-hundred-and-ten thousand dollars ($310,000.00) as compensation for his services (the "Base Salary"). The Base Salary will be paid periodically in accordance with the Company's normal payroll practices and be subject to the usual, required withholding. Executive's salary will be subject to review and adjustments will be made based upon the Company's normal performance review practices.

(b) *Performance Bonus*. Executive shall be eligible to receive an annual bonus of a maximum of one-hundred thousand dollars ($100,000.00) less applicable withholding taxes, upon achievement of performance objectives to be determined by the Board in its sole discretion, which such objectives shall be established within ninety (90) days of the Effective Date.

(c) *Stock Options*. *Stock Options*. Executive shall be eligible to receive options to purchase seven-hundred-thousand (700,000) shares of Common stock of the Company, pursuant to and governed by the terms of the Natus 2000 Supplemental Stock Option Plan, with an exercise price at the closing market price on the day prior to the Effective Date. Vesting begins after your first six (6) months of employment and is retroactive to your start date. Stock vests at 1/48th per month. Options must be exercised within ten (10) years of date of hire. Notwithstanding any other provision of the Agreement, under no circumstances shall Executive have any right to exercise stock options before Executive has completed one-hundred-eighty-days of employment.

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

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

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

7. *Severance.*

(a) *Involuntary Termination.* If, after more than one hundred eighty (180) days from commencement of employment, Executive's employment with the Company terminates other than for "Cause" (as defined herein), death or disability, and Executive signs and does not revoke a standard release of claims with the Company, then, subject to Section 11, Executive shall be entitled to (i) receive continuing payments of severance pay (less applicable withholding taxes) at a rate equal to his Base Salary rate, as then in effect, for a period of twelve (12) months from the date of such termination, to be paid periodically in accordance with the Company's normal payroll policies; (ii) the immediate vesting and exercisability of 100% of the shares subject to all of Executive's stock options to purchase Company Common Stock (whether currently outstanding or granted in following the Effective Date) outstanding on the date of such termination (the "**Stock Options**") and (iii) continued payment by the Company of the group health continuation coverage premiums for Executive and Executive's eligible dependents under Title X of the Consolidated Budget Reconciliation Act of 1985, as amended ("**COBRA**") as in effect through the lesser of (x) twelve (12) months from the effective date of such termination, (y) the date upon which Executive and Executive's eligible dependents become covered under similar plans, or (z) the date Executive no longer constitutes a "Qualified Beneficiary" (as such term is defined in Section 4980B(g) of the Internal Revenue Code of 1986, as amended (the "**Code**")); provided, however, that Executive will be solely responsible for electing such coverage within the required time periods.

(b) *Voluntary Termination; Termination for Cause.* If Executive's employment with the Company terminates voluntarily by Executive (other than as described in subsection (c) below) or for Cause by the Company or due to Executive's death or disability, or involuntarily for any reason within one hundred and eighty (180) days of commencement of employment, then (i) all vesting of Stock Options will immediately cease, (ii) all payments of compensation by the Company to Executive hereunder will terminate immediately (except as to amounts already earned), and (iii) Executive will only be eligible for severance benefits, if any, in accordance with the Company's established policies as then in effect.

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

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

delivered in full, or

delivered as to such lesser extent which would result in no portion of such severance benefits being subject to excise tax under Section 4999 of the Code,

whichever of the foregoing amounts, taking into account the applicable federal, state and local income taxes and the excise tax imposed by Section 4999, results in the receipt by Executive on an after-tax basis, of the greatest

amount of severance benefits, notwithstanding that all or some portion of such severance benefits may be taxable under Section 4999 of the Code. Unless the Company and Executive otherwise agree in writing, any determination required under this Section 8 shall be made in writing by the Company's independent public accountants immediately prior to Change of Control (the "**Accountants**"), whose determination shall be conclusive and binding upon Executive and the Company for all purposes. For purposes of making the calculations required by this Section 8, the Accountants may make reasonable assumptions and approximations concerning applicable taxes and may rely on reasonable, good faith interpretations concerning the application of Sections 280G and 4999 of the Code. The Company and Executive shall furnish to the Accountants such information and documents as the Accountants may reasonably request in order to make a determination under this Section. The Company shall bear all costs the Accountants may reasonably incur in connection with any calculations contemplated by this Section 8.

9. *Definitions.*

(a) *Cause*. For purposes of this Agreement, "**Cause**" shall mean (i) commission of any act of dishonesty, fraud, misrepresentation or other act of moral turpitude by Executive, (ii) Executive's conviction of a felony, (iii) a willful act by Executive which constitutes disloyalty or gross misconduct injurious to the Company, (iv) misrepresentation or concealment by Executive of any fact for the purpose of securing or maintaining this Agreement, or (v) continued violations by Executive of Executive's employment duties which are willful on Executive's part after Executive has been given written demand for performance from the Board which specifically sets forth the factual basis for the Board's belief that Executive has not substantially performed Executive's duties.

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

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

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

(iii) the date of the consummation of the sale or disposition by the Company of all or substantially all the Company's assets.

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

10. *Confidential Information; Representation*. Executive agrees to enter into the Company's standard Confidential Information and Invention Assignment Agreement (the "**Confidential Information Agreement**") upon commencing employment hereunder. Executive represents and warrants that all personal background information provided by him, or to be provided during the term of his employment, in response to background questions asked by the Company pertaining to Executive's employment, is true and accurate, and does not and will not contain any material omissions, nor shall it omit any material information. Executive further represents and warrants that he has not committed any act as described in section 9(a)(i), (ii) or (iv) hereof.

11. *Conditional Nature of Severance Payments.*

(a) *Noncompete*. Executive acknowledges that the nature of the Company's business is such that if Executive were to become employed by, or substantially involved in, the business of a competitor of the Company following the termination of Executive's employment with the Company, it would be very difficult for Executive not to rely on or use the Company's trade secrets and confidential information. Thus, to avoid the inevitable disclosure of the Company's trade secrets and confidential information, Executive agrees and acknowledges that Executive's right to receive the severance payments set forth in Section 7 (to the extent Executive is otherwise entitled to such payments) shall be conditioned upon Executive not directly or indirectly engaging in (whether as an employee, consultant, agent, proprietor, principal, partner, stockholder, corporate officer, director or otherwise), nor having any ownership interest in or participating in the financing, operation, management or control of, any person, firm, corporation or business that competes with Company or is a customer of the Company. Upon any breach of this section, all severance payments pursuant to this Agreement shall immediately cease.

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

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

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

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

If to the Company:

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

If to Executive:

at the last residential address known by the Company.

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

15. *Arbitration*.

(a) *General.* In consideration of Executive's service to the Company, its promise to arbitrate all employment related disputes and Executive's receipt of the compensation, pay raises and other benefits paid to Executive by the Company, at present and in the future, Executive agrees that any and all controversies, claims, or disputes with anyone (including the Company and any employee, officer, director, shareholder or benefit plan of the Company in their capacity as such or otherwise) arising out of, relating to, or resulting from Executive's service to the Company under this Agreement or otherwise or the termination of Executive's service with the Company, including any breach of this Agreement, shall be subject to binding arbitration under the Arbitration Rules set forth in California Code of Civil Procedure Section 1280 through 1294.2, including Section 1283.05 (the "**Rules**") and pursuant to California law. Disputes which Executive agrees to arbitrate, and thereby agrees to waive any right to a trial by jury, include any statutory claims under state or federal law, including, but not limited to, claims under Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act of 1990, the Age Discrimination in Employment Act of 1967, the Older Workers Benefit Protection Act, the California Fair Employment and Housing Act, the California Labor Code, claims of harassment, discrimination or wrongful termination and any statutory claims. Executive further understands that this Agreement to arbitrate also applies to any disputes that the Company may have with Executive.

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

manner consistent with the Rules and that to the extent that the AAA's National Rules for the Resolution of Employment Disputes conflict with the Rules, the Rules shall take precedence.

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

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

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

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

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

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

18. *Headings*. All captions and section headings used in this Agreement are for convenient reference only and do not form a part of this Agreement.

19. *Tax Withholding.* All payments made pursuant to this Agreement will be subject to withholding of applicable taxes.

20. *Governing Law*. This Agreement will be governed by the laws of the State of California (with the exception of its conflict of laws provisions).

21. *Acknowledgment*. Executive acknowledges that he has had the opportunity to discuss this matter with and obtain advice from his private attorney, has had sufficient time to, and has carefully read and fully understands all the provisions of this Agreement, and is knowingly and voluntarily entering into this Agreement.

22. *Counterparts*. This Agreement may be executed in counterparts, and each counterpart shall have the same force and effect as an original and shall constitute an effective, binding agreement on the part of each of the undersigned. IN WITNESS WHEREOF, each of the parties has executed this Agreement, in the case of the Company by their duly authorized officers, as of the day and year first above written.

COMPANY:

NATUS MEDICAL, INC.

By: /s/ WILLIAM NEW, JR. Date: 4/12/04

Title: Chairman of the Board

EXECUTIVE:

/s/ JAMES B. HAWKINS Date: 4/12/04

James B. Hawkins

Exhibit 31.1

CERTIFICATION

I, James B. Hawkins, certify that:

1. I have reviewed this report on Form 10-Q of Natus Medical Incorporated;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 13, 2004

/s/ JAMES B. HAWKINS

James B. Hawkins
President and Chief Executive Officer

Exhibit 31.2

CERTIFICATION

I, Steven J. Murphy, certify that:

1. I have reviewed this report on Form 10-Q of Natus Medical Incorporated;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 13, 2004

/s/ STEVEN J. MURPHY

Steven J. Murphy
Vice President Finance

EXHIBIT 32.1

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

In connection with the Quarterly Report of Natus Medical Incorporated (the "Company") on Form 10-Q for the quarter ended March 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James B. Hawkins, President and Chief Executive Officer of the Company, certify, pursuant to Title 18, United States Code, Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

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

/s/ JAMES B. HAWKINS

Print Name: James B. Hawkins
Title: President and Chief Executive Officer
Date: May 13, 2004

In connection with the Quarterly Report of Natus Medical Incorporated (the "Company") on Form 10-Q for the quarter ended March 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Steven J. Murphy, Vice President Finance of the Company, certify, pursuant to Title 18, United States Code, Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

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

/s/ STEVEN J. MURPHY

Print Name: Steven J. Murphy
Title: Vice President Finance
Date: May 13, 2004