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 September 30, 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 November 8, 2004, was 17,059,561.

Table of Contents

NATUS MEDICAL INCORPORATED

TABLE OF CONTENTS

		Page No.
PART I.	**FINANCIAL INFORMATION**	3
Item 1.	Financial Statements	3
	Condensed Consolidated Balance Sheets as of September 30, 2004 (unaudited) and December 31, 2003	3
	Condensed Consolidated Statements of Operations for the three months ended September 20, 2004 and 2003 and the nine months ended September 30, 2004 and 2003 (unaudited)	4
	Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2004 and 2003 (unaudited)	5
	Notes to Condensed Consolidated Financial Statements (unaudited)	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	13
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	34
Item 4.	Controls and Procedures	35
PART II.	**OTHER INFORMATION**	36
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	36
Item 6.	Exhibits	36
Signatures		37

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NATUS MEDICAL INCORPORATED

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

	September 30, 2004	December 31, 2003(1)
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 10,662	$ 9,435
Short-term investments	23,078	28,200
Accounts receivable, net of allowance for doubtful accounts of $461 and $395	6,567	5,682
Inventories	4,379	5,263
Prepaid expenses and other current assets	513	528
Total current assets	45,199	49,108
Property and equipment, net	2,549	2,668
Long-term investment	—	341
Deposits and other assets	31	111
Intangible assets	7,415	3,594
Goodwill	1,700	1,198
Total assets	$ 56,894	$ 57,020
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Accounts payable	$ 1,571	$ 1,659
Accrued liabilities	4,149	2,229
Deferred revenue	301	500
Total current liabilities	6,021	4,388
Commitments and contingencies	—	—
Stockholders' equity:		
Common stock, $0.001 par value, 120,000,000 shares authorized; shares issued and outstanding: 17,083,007 and 16,511,874	89,167	87,038
Deferred stock compensation	(2)	(33)
Accumulated deficit	(38,420)	(34,495)
Accumulated other comprehensive income	128	122
Total stockholders' equity	50,873	52,632
Total liabilities and stockholders' equity	$ 56,894	$ 57,020

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

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

Table of Contents

NATUS MEDICAL INCORPORATED

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Revenue	$ 9,011	$ 7,669	$25,980	$21,393
Cost of revenue	3,864	3,358	11,370	8,718
Gross profit	5,147	4,311	14,610	12,675
Operating expenses:				
Marketing and selling	2,318	3,171	8,399	9,656
Research and development	670	913	2,648	2,764
General and administrative	1,180	1,327	5,204	3,810
Restructuring	—	—	776	—
Acquired in process research and development	550	—	550	—
Total operating expenses	4,718	5,411	17,577	16,230
Income (loss) from operations	429	(1,100)	(2,967)	(3,555)
Interest income	117	34	313	362
Interest expense	—	(4)	(3)	(10)
Other income (expense), net	(29)	118	(130)	140
Income (loss) before provision for income taxes	517	(952)	(2,787)	(3,063)
Provision for income taxes	65	1	66	2
Income (loss) from continuing operations	452	(953)	(2,853)	(3,065)
Discontinued operations	(305)	(16)	(1,072)	(16)
Net Income (loss)	$ 147	$ (969)	$ (3,925)	$ (3,081)
Earnings (loss) per common share				
Basic:				
Income (loss) from continuing operations	$ 0.03	$ (0.06)	$ (0.17)	$ (0.19)
Loss from discontinued operations	$ (0.02)	—	$ (0.06)	—
Net Income (loss)	$ 0.01	$ (0.06)	$ (0.23)	$ (0.19)
Diluted:				
Income (loss) from continuing operations	$ 0.03	$ (0.06)	$ (0.17)	$ (0.19)
Loss from discontinued operations	$ (0.02)	—	$ (0.06)	—
Net Income (loss)	$ 0.01	$ (0.06)	$ (0.23)	$ (0.19)
Weighted-average Common shares used to compute:				
Basic earnings per common share	17,011	16,454	16,740	16,388
Diluted earnings per common share	17,899	16,454	16,740	16,388

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

NATUS MEDICAL INCORPORATED

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30,	
	2004	**2003**
Operating activities:		
Net loss	$ (3,925)	$ (3,081)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Accounts receivable reserve	66	27
Depreciation and amortization	1,339	1,024
In-process research and development	550	—
Stock-based compensation	383	106
Loss on disposal of assets	632	17
Changes in operating assets and liabilities:		
Accounts receivable	(556)	1,164
Inventories	1,409	(852)
Prepaid expenses and other current assets	17	(86)
Accounts payable	(519)	53
Accrued liabilities and deferred revenue	1,269	(460)
Net cash provided by (used in) continuing operations	665	(2,088)
Investing activities:		
Acquisition, net of cash acquired	(5,232)	(3,735)
Purchase of property and equipment	(1,457)	(770)
Deposits and other assets	5	(16)
Purchases of short-term investments	(31,976)	(42,615)
Sales of short-term investments	37,190	39,627
Redemption of long-term investments	341	(4)
Purchase of treasury stock	(307)	—
Net cash used in investing activities	(1,436)	(7,513)
Financing activities:		
Issuance of common stock	2,084	370
Net cash provided by financing activities	2,084	370
Exchange rate effect on cash and cash equivalents	(86)	(4)
Net increase (decrease) in cash and cash equivalents	1,227	(9,235)
Cash and cash equivalents, beginning of period	9,435	17,768
Cash and cash equivalents, end of period	$ 10,662	$ 8,533
Non-cash investing and financing activities:		
The Company purchased all the capital stock of Fischer-Zoth for $5,232. In conjunction with the acquisition, liabilities were assumed as follows:		
Fair value of assets acquired	$ 6,117	
Cash paid	(5,232)	
Liabilities assumed	$ 885	
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 3	$ 10
Cash paid for income taxes	$ 1	$ 1

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

Table of Contents

NATUS MEDICAL INCORPORATED

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1—Basis of Presentation

The accompanying interim condensed consolidated financial statements of Natus Medical Incorporated ("Natus," "we," "us," or "the Company") have been prepared in accordance with accounting principles generally accepted in the United Sates of America ("GAAP"). 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 and nine months ended September 30, 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. Certain prior period amounts have been reclassified to conform to current period presentation, including segregation of results of discontinued operations.

Comprehensive Loss

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net Income (loss)	$ 147	$ (969)	$(3,925)	$(3,081)
Unrealized gain (loss) on available-for-sale securities	24	(19)	92	(34)
Foreign currency translation adjustment	(83)	70	(86)	(4)
Comprehensive loss	$ 88	$ (918)	$(3,919)	$(3,119)

2—Inventories

Inventories consisted of (in thousands):

	September 30, 2004	December 31, 2003
Raw materials and subassemblies	$ 1,890	$ 1,983
Finished goods	2,489	3,280
Total	$ 4,379	$ 5,263

Inventory is valued at the lower of cost or market. The Company regularly evaluates the value of its inventory based on a combination of factors, including historical usage rates, forecasted sales, product life cycles, and market acceptance of new products. Inventory that is obsolete or in excess of anticipated usage is written down to realizable value through inventory valuation reserves or direct write off.

Table of Contents

NATUS MEDICAL INCORPORATED

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

3—Reserve For Product Warranties

The Company provides a one-year warranty on its 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.

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, 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 and nine months ended September 30, 2004 and 2003 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Balance, beginning of period	$ 200	$ 188	$ 298	$ 200
Aggregate changes in accruals related to new warranties	42	20	92	52
Aggregate payments for repairs under warranty	(39)	(27)	(124)	(71)
Aggregate changes for accruals related to preexisting warranties	—	—	(63)	—
Balance, end of period	$ 203	$ 181	$ 203	$ 181

4—Basic and Diluted Net Loss Per Common Share

The Company computes net income (loss) per share in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 128, *Earnings per Share*. Basic net income (loss) per share is based upon the weighted average number of common shares outstanding during the period. Diluted net income per share is based upon the weighted average number of common shares outstanding and dilutive common stock equivalents during the period. Common stock equivalents are options under the Company’s stock option plan and are calculated under the treasury stock method. Common equivalent shares from unexercised stock options are excluded from the computation when there is a loss, as their effect is anti-dilutive.

For the three months ended September 30, 2004, common stock equivalents of approximately 888,000 shares were included in the weighted average shares outstanding used to calculate diluted income per share. For the nine months ended September 30, 2004, common stock equivalents of approximately 770,000 shares were not used to calculate diluted net loss per share because of their anti-dilutive effect. For the three and nine months ended September 30, 2003, common stock equivalents of approximately 471,000 and 466,000 shares, respectively, were not used to calculate net loss per share because of their anti-dilutive effect.

5—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

Table of Contents

5—Stock-Based Compensation (continued)

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 SFAS No. 123, *Accounting for Stock-Based Compensation* and Emerging Issues Task Force ("EITF") Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.

The Company typically grants stock option awards at market value; consequently, no compensation expense is recorded. 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, with prior period charges being reversed in the current period to the extent that unvested options for which expense had been recorded are cancelled due to a break in employment.

During the nine months ended September 30, 2004, we recorded stock compensation expense totaling $362,000, including $352,000 recorded in the three months ended June 30, 2004 related to a modification of the terms of certain stock options granted to the Company's former chief executive officer, that extended the exercise date of the options.

Stock-based compensation during the three and nine months ended September 30, 2004 and 2003 (in thousands) consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Stock-based compensation included in:				
Cost of revenue	$ —	$ (2)	$ 1	$ 15
Operating expenses:				
Marketing and selling	17	(30)	17	31
Research and development	—	1	—	8
General and administrative	9	8	365	52
Operating expenses total	26	(21)	382	91
Total	$ 26	$ (23)	$ 383	$ 106

NATUS MEDICAL INCORPORATED

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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 September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Net income (loss), as reported	$ 147	$ (969)	$(3,925)	$(3,081)
Add: Stock based employee compensation, net of related tax effects	5	(23)	362	106
Less: Compensation expense for stock options determined under the fair value method, net of related tax effects	(558)	(384)	(1605)	(1054)
Pro forma net loss	$ (406)	$ (1,376)	$(5,168)	$(4,029)
Basic and diluted EPS:				
As reported	$ 0.01	$ (0.06)	$ (0.23)	$ (0.19)
Pro forma	$ (0.02)	$ (0.08)	$ (0.31)	$ (0.25)

6—Segment, Customer, and Geographic Information

The Company currently operates in one reportable segment, developing, manufacturing, and marketing 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 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 September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Revenue:				
United States	$ 7,016	$ 6,497	$19,817	$16,623
Europe and United Kingdom	1,054	607	3,140	1,629
All other	941	565	3,023	3,141
Total	$ 9,011	$ 7,669	$25,980	$21,393

For the three and nine month periods ended September 30, 2004 and 2003, sales to no single end-user customer or distributor accounted for greater than 10% of total revenue.

7—Restructuring Charges

In June 2004, the Company recorded a restructuring charge of approximately $776,000 relating to an operating cost reduction plan that resulted in an immediate reduction of 25 employees and the accrual of associated employee termination-related benefits of $629,000 primarily for severance compensation and salary continuation. The remainder of the charge was associated with the liquidation of the Company's subsidiary in Japan, which was initiated in June 2004, including the write-down of capital assets, inventory, and prepaid

NATUS MEDICAL INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

7—Restructuring Charges

expenses of $80,000, facilities related costs of $38,000, and liquidation service fees of $29,000. Employees involved in the workforce reduction were not required to render additional services to the company and their employment with the company ceased on June 30, 2004. In accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* , these costs were accrued as incurred. The Company did not record any additional restructuring costs in the three months ended September 30, 2004.

During the three months ended September 30, 2004 substantially all of the accrued costs associated with the liquidation of our Japanese subsidiary were paid out, and approximately $523,000 of severance compensation was paid out, leaving approximately $267,000 of employee termination costs unpaid. Amounts unpaid relate primarily to severance agreements with two former officers of the company that contain provisions for salary continuation payments through June 2005. This amount is included as a component of accrued expenses on the balance sheet.

8—Discontinued Operations

In June 2004 the Company announced its intent to divest its Neogenesis line of products, which it acquired in July 2003. This component is accounted for as a discontinued operation in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* for all periods presented.

On September 30, 2004 the Company sold its Neogenesis line of products to Genesis Northwest, Inc. Assets with a book value of approximately $300,000 were sold for $10,000 cash and a $364,000 promissory note payable in equal monthly payments of approximately $3,500 beginning April 2005 and continuing through October 2009, at which time the balance of $200,000 becomes due. The Company has reserved for the entire promissory note because of the uncertainty of its collectability.

Amounts reported in discontinued operations are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Loss from operations of discontinued component:				
Revenue	$ 240	$ 291	$ 608	$ 291
Cost of revenue	130	187	598	187
Gross profit	110	104	10	104
Operating expenses	115	120	782	120
Discontinued operations	(5)	(16)	(772)	(16)
Reported loss on disposal:				
Gain on sale of discontinued operations	64	—	64	—
Less amount reserved based on collectability	364	—	364	—
Reported loss on sale of discontinued operations	(300)	—	(300)	—
Discontinued operations	$ (305)	$ (16)	$(1,072)	$ (16)

NATUS MEDICAL INCORPORATED

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

9—Business Combinations

In September 2004, the Company purchased for $5.6 million in cash, including direct costs of the acquisition, all the common stock of privately held Fischer-Zoth GmbH and affiliated entities (Fischer-Zoth), as well as intangible assets held individually by the owners of Fischer-Zoth. In addition, there is the potential for additional purchase consideration contingent upon the purchased entities achieving certain performance objectives. The maximum amount of additional purchase consideration payable related to completed technology is 1.5 million Euro in total, based on the annual results of sales during the three twelve-month periods ending September 30, 2007. Additional purchase consideration related to in process research and development technology is not capped, however, the Company has reasonable expectations that the amount will not exceed 410,000 Euro in total, payable at the end of each of the six twelve-month periods ending December 31, 2010. If any additional purchase consideration is paid, it will be recorded as goodwill at the time such payment is made.

Founded in 1995, Fischer-Zoth develops, manufacturers, and markets Otoacoustic Emissions (OAE) products for the detection and assessment of hearing disorders. With headquarters near Munich, Germany, Fischer-Zoth markets and sells its products worldwide through distributors in over 50 countries. Fischer-Zoth's OAE products utilize proprietary, patented signal processing analysis software and are used in conjunction with a disposable supply. The Company plans to retain Fischer-Zoth's sales channels in Europe and Asia. Fischer-Zoth's results of operations are included in the financial statements from September 28, 2004 forward.

The following table summarizes the preliminary estimated fair value of the net assets acquired in the acquisition:

Net assets acquired are as follows (in thousands):

Current assets	$1,310
Property and equipment	86
Patents	1,600
Other intangible assets (primarily developed technology)	2,450
Goodwill	507
Total assets acquired	5,953
Current liabilities	(884)
Long term liabilities	—
Total liabilities assumed	(884)
Acquired in-process research and development	550
Net assets acquired	$5,619

The final determination of the purchase price allocation will be based on the fair values of the assets and liabilities on the date of the acquisition. The purchase price allocation will remain preliminary until the Company is able to complete a third party valuation of significant intangible assets acquired and evaluate the fair value of the other assets and liabilities acquired. The final amounts allocated to assets and liabilities acquired could differ significantly from the amounts presented in the unaudited pro forma condensed consolidated financial information above.

Pro forma financial information for the three and nine months ended September 30, 2004 and 2003, as though the acquisition of Fischer-Zoth had been completed as of the earliest of these periods are presented below.

NATUS MEDICAL INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

9—Business Combinations (continued)

There were no extraordinary items or changes in accounting principles in the pro forma results, nor were there any material, nonrecurring items.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Revenue	$ 9,856	$ 8,395	$28,965	$23,570
Net income (loss)	$ 227	$ (894)	$ (3,448)	$ (2,855)
Basic and diluted earnings (loss) per share	$ 0.01	$ (0.05)	$ (0.21)	$ (0.17)

In July 2003, the Company purchased substantially all of the assets of Neometrics, Inc. for $3.6 million in cash plus the assumption of certain liabilities. The purchase agreement provides for additional consideration to be paid, subject to Neometrics achieving certain financial goals during the three twelve-month periods following the acquisition date. The Company has determined that no additional consideration was payable for first twelve-month period following the date of the acquisition. Based on the terms of the purchase agreement, the maximum amount of remaining additional purchase consideration to be paid is now $800,000.

10—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 mitigates the Company's exposure. 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 mitigates its exposure for these other indemnified matters. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. The Company believes the estimated fair value of these indemnification agreements is minimal and has not recorded a liability for these agreements as of September 30, 2004.

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

Natus®, AABR®, ALGO®, ALGO 1e®, ALGO 2®, ALGO DataBook®, 70/40®, Ear Couplers®, Flexicoupler®, Jelly Tab®, Jelly Button®, and MiniMuffs® are registered trademarks of Natus. Natus Elite™, Convert2Natus™, neoBLUE™, neoBLUE mini™, Neometrics™, Metabolic Screening Database System (MSDS)™, Case Management System (CMS)™, Voice Response System (VRS)™, Web Electronic Birth Page (Web-EBP)™, and Accuscreen™ are non-registered trademarks of Natus. Solutions for Newborn CareSM is a non-registered service mark of Natus. Echo-Screen®, AOAE®, and Cochlea-Scan® are registered trademarks of Fischer-Zoth GmbH, a subsidiary of Natus.

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, 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 newborn hearing screening, our Echoscreen OAE devices for hearing screening, our neoBLUE LED Phototherapy devices for the treatment of jaundice, our Neometrics newborn screening data management products, 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 and Echoscreen medical devices, our product line of oxygen delivery hoods and heatshields, software maintenance agreements for our Neometrics data management system, and extended service agreements on our medical devices. Devices and systems revenue results from the sale of our ALGO, Echoscreen, and neoBLUE medical devices, and our Neometrics' newborn screening data management products.

Domestic sales accounted for 78% and 85% of our revenue during the three months ended September 30, 2004 and 2003, respectively, and 76% and 78% of our revenue during the nine months ended September 30, 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 over 50 other countries. International sales made to distributors are characterized by lower gross profits due to the discount the distributors receive from our list prices.

Our net income or loss can be markedly impacted by our decisions regarding the level of resources applied to our business. We 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.

In September 2004, we purchased privately held Fischer-Zoth GmbH and affiliated entities (Fischer-Zoth), a manufacturer of Otoacoustic Emissions ("OAE") products for $5.6 million in cash, including direct costs of the acquisition, with the potential for additional purchase consideration contingent upon the purchased entities achieving certain performance objectives. Founded in 1995, Fischer-Zoth develops, manufacturers, and markets products for the detection and assessment of hearing disorders. With headquarters near Munich, Germany, Fischer-Zoth markets and sells its products worldwide through distributors in over 50 countries. Fischer-Zoth's OAE products utilize proprietary, patented signal processing analysis software and are used in conjunction with a disposable supply. The Company plans to retain Fischer-Zoth's sales channels in Europe and Asia.

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, 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. Payments received from customers prior to revenue recognition 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 adversely affect our results of operations. Our allowance for estimated uncollectible accounts receivable was $461,000 at September 30, 2004.

At September 30, 2004 our deferred revenue under extended service and maintenance agreements, and billings in excess of recognized revenue on percentage-of-completion contracts was approximately $301,000. Other advance payments from customers were not material at September 30, 2004.

Inventory is carried at the lower of cost or market value

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 event 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; in addition, 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 exceeding 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.

Our impairment testing is done at a level below the reportable segment level, and currently consists of three components: the Neometrics and Fischer-Zoth components, and the U.S. operations of Natus exclusive of the other two components.

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 September 30, 2004 we had goodwill and intangible assets with a carrying value of approximately $9.1 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 September 30, 2004 our reserve for product warranties was approximately $203,000.

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 are expected to be reversed 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 had a carrying value of zero.

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	42.9	43.8	43.8	40.8
Gross profit	57.1	56.2	56.2	59.2
Operating expenses:				
Marketing and selling	25.7	41.3	32.3	45.2
Research and development	7.4	11.9	10.2	12.9
General and administrative	13.2	17.3	20.0	17.8
Acquired IPR&D	6.1	—	2.1	—
Restructuring	—	—	3.0	—
Total operating expenses	52.4	70.5	67.6	75.9
Gain (loss) from operations	4.7	(14.3)	(11.4)	(16.7)
Other income, net	1.0	1.9	.7	2.3
Income (loss) before provision for income taxes	5.7	(12.4)	(10.7)	(14.4)
Provision for income taxes	(0.7)	—	(0.3)	—
Income (loss) from continuing operations	5.0	(12.4)	(11.0)	(14.4)
Discontinued operations	(3.4)	(0.2)	(4.1)	—
Net income (loss)	1.6%	(12.6)%	(15.1)%	(14.4)%

Three and Nine Months Ended September 30, 2004 and 2003

Revenue

Our revenue is derived 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 and Echoscreen hearing screening devices, our MiniMuffs, our line of neonatal oxygen delivery hoods and heatshields, 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, OAE, and neoBLUE medical devices, and our Neometrics newborn screening data management system.

Our revenue increased $1.3 million, or 18%, to $9.0 million in the three months ended September 30, 2004, from $7.7 million in the same period in 2003. The increase was due primarily from sales of our ALGO hearing screening and neoBLUE devices. Our revenue increased $4.6 million, or 21%, to $26.0 million in the nine months ended September 30, 2004, from $21.4 million in the same period in 2003.

Revenue from devices and systems increased $1.0 million, or 52%, to $3.0 million in the three months ended September 30, 2004, from $2.0 million in the same period in 2003. Revenue from devices and systems increased $3.6 million, or 65% to $9.1 million in the nine months ended September 30, 2004, from $5.5 million in the same period in 2003. Revenue from supplies and services increased $288,000, or 5%, to $5.8 million in the three months ended September 30, 2004 from $5.6 in the same period in 2003. Revenue from supplies and services increased $1 million or 6%, to $16.6 million in the nine months ended September 30, 2004, from

$15.6 million in the same period in 2003. The higher rate of increase in revenue from devices and systems during the three and nine months ended September 30, 2004, compared the same periods in 2003, resulted primarily from sales of the neoBLUE devices in both domestic and international markets, and the ALGO 3i hearing screening device in international markets.

Revenue from supplies and services was 65% of total revenue in the three months ended September 30, 2004, compared to 72% of total revenue in the same period in 2003. Revenue from supplies and services was 64% of total revenue in the nine months ended September 30, 2004, compared to 73% of total revenue in the same period in 2003. For all of the amounts presented above, revenue from the Neogenesis product line has been excluded and is reported in discontinued operations.

Revenue from sales outside the U.S. was $2 million in the three months ended September 30, 2004, up 70% or $823,000 from $1.2 million in the same period in 2003, and was $6.2 million in the nine months ended September 30, 2004, up 29% or $1.4 million from $4.8 million in the same period in 2003. In the three months ended September 30, 2004, compared to the same period in 2003, revenue from Europe and the United Kingdom increased $447,000 to $1.1 million, revenue from Asia increased $163,000 to $536,000, and revenue from Oceania increased $241,000 to $392,000. In the nine months ended September 30, 2004, compared to the same period in 2003, revenue from Europe and the United Kingdom increased $1.5 million to $3.1 million, revenue from Asia increased $71,000 to $2.3 million, and revenue from Oceania decreased $172,000 to $669,000. In the nine months ended September 30, 2004, international sales of devices and systems increased $1.5 million to $4.0 million, and international sales of supplies and services decreased $39,000, to $2.1 million, both compared to the same period in 2003. The reduction in revenue from international sales of supplies and services for the nine months ended September 30, 2004 was primarily related to a change in our distribution method in Japan, where we now sell directly from the U.S. to distributors in Japan, rather than through our Japanese subsidiary, which we had done prior to 2004. This change resulted in lower average selling prices of our ALGO hearing screening supply products. These price reductions were offset by reduced costs of our Japanese subsidiary, which we are currently in the process of liquidating.

No end-user customer or distributor accounted for more than 10% of our revenue in any of the three or nine month periods ended September 30, 2004 or 2003. A customer that accounted for approximately 6% of our revenue during the first nine months of 2004 recently advised us that it might not continue the customer relationship. If we are unable to retain this customer relationship, we will likely lose this revenue stream beginning in the fourth quarter of 2004.

Cost of Revenue

Cost of revenue includes the cost of material, personnel expenses, packaging, shipping costs, other manufacturing costs, warranty expenses, and technology license fees. Our cost of revenue increased $506,000, or 15%, to $3.9 million in the three months ended September 30, 2004 from $3.4 million in the same period in 2003. Our cost of revenue increased $2.7 million, or 30%, to $11.4 million in the nine months ended September 30, 2004 from $8.7 million in the same period in 2003. The increases in both periods were primarily attributable to overall increased sales and incremental costs of our Neometrics data management systems. Cost of revenue as a percent of total revenue was 42.9% in the three months ended September 30, 2004, compared with 43.8% reported in the three months ended September 30, 2003. Cost of revenue as a percent of total revenue was 43.8% in the nine months ended September 30, 2004, compared with 40.8% reported in the nine months ended September 30, 2003. The increase in the cost of revenue as a percentage of total revenue for the nine months ended September 30, 2004 was primarily associated with cost overruns on several Neometrics data management system installations. In particular, during the first half of 2004, we had a cost overrun in completing an upgrade of one data management system that was covered under a long-term maintenance agreement.

Operating Expenses

In June 2004 the company initiated an operating cost reduction plan ("June 2004 restructuring") that resulted in the immediate reduction of 24 employees, and we also initiated a plan to liquidate our Japanese subsidiary. Cost

reductions in the three months ended September 2004 compared to the same period in 2003, as more fully described below, were substantially the result of the June 2004 restructuring, with exceptions being noted.

Marketing and selling expenses consist primarily of salaries, commissions, travel, promotional, and advertising costs. Our marketing and selling expenses decreased $853,000, or 27%, to $2.3 million in the three months ended September 30, 2004 from $3.2 million in the same period in 2003, and decreased, $1.3 million or 13%, to $8.4 million in the nine months ended September 30, 2004 from $9.7 million in the same period in 2003. In the three and nine months ended September 30, 2004, we experienced reduced costs of operating our Japanese subsidiary of approximately $220,000 and $680,000 respectively. Additionally, in late 2003 we substantially 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 of $550,000 in the nine months ended September 2003. These cost savings were offset by increased selling costs associated with our Neometrics data management system of approximately $600,000, including amortization of intangibles of approximately $50,000.

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 $243,000, or 27%, to $670,000 in the three months ended September 30, 2004 from $913,000 in the same period in 2003, and decreased $116,000, or 4%, to $2.6 million in the nine months ended September 30, 2004 from $2.8 million in the same period in 2003. The decreases were largely the result of the June 2004 restructuring, offset by increased costs related to our Neometrics business lines.

General and administrative expenses consist of corporate, finance, information technology, human resources, administrative, and legal expenses. Our general and administrative expenses decreased $147,000, or 11%, to $1.2 million in the three months ended September 30, 2004 from $1.3 million in the same period in 2003. The reduction resulted primarily from cost savings related to the June 2004 restructuring, offset partially by increases in insurance coverage costs. Our general and administrative expenses increased $1.4 million, or 57%, to $5.2 million in the nine months ended September 30, 2004 from $3.8 million in the same period in 2003. The increase was primarily the result of costs associated with the departure of our former chief executive officer and costs associated with the June 2004 restructuring, which were recorded in the second quarter of 2004.

For the three months ended June 30, 2004, the Company recorded a restructuring charge of approximately $776,000. The restructuring resulted in the accrual of employee termination-related benefits of $629,000. The remainder of the charge was associated with the liquidation of our Japanese sales subsidiary. We did not incur any restructuring costs in the three months ended September 30, 2004.

In September 2004, we purchased privately-held Fischer-Zoth and affiliated entities for $5.6 million dollars in cash, including direct costs of the acquisition. In accordance with FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, we immediately expensed $550,000 of the purchase cost, representing the value of in-process research and development acquired from Fischer-Zoth for which there is no alternative use.

We recorded stock-based compensation expense/(reversal) of $26,000 and $(23,000) in the three months ended September 30, 2004 and 2003, respectively. We recorded stock-based compensation of $383,000 and $106,000 in the nine months ended September 30, 2004 and 2003, respectively. Included in the nine month amounts for 2004 was a charge of $352,000 related to a modification of the terms of certain stock options granted to the Company's former chief executive officer. For the three months ended September 30, 2004 and 2003 respectively, total stock-based compensation of none and reversal of $(2,000), was included in cost of revenue, and $26,000 and reversal of $(21,000), was allocated to operating expenses. For the nine months ended September 30, 2004 and 2003 respectively, $1,000 and $15,000, was included in cost of revenue and $382,000 and $91,000, was allocated to operating expenses.

Other income and expense consists of net capital gains and losses from our investment portfolio, net currency exchange gains and losses, and other miscellaneous income and expenses. In the three months ended September 30, 2004 and 2003, respectively, we reported net other expense of $29,000 and net other income of $118,000. In the nine months ended September 30, 2004 and 2003, respectively, we reported net other expense of $130,000 and net other income of $140,000. We reported foreign exchange losses of $29,000 in the three months ended September 30, 2004, and reported foreign exchange gains of $3,000 in the three months ended September 30, 2003. We reported foreign exchange losses of $10,000 in the nine months ended September 30, 2004, and reported foreign exchange gains of $1,000 in the nine months ended September 30, 2003. Foreign exchange gains and losses resulted primarily from fluctuations in local currency equivalents of the U.S. dollar in the U.K. and Asia. Unrealized translation gains and losses are not included in net income, but are reported as a component of other comprehensive income.

In June 2004 the Company announced its intent to divest its Neogenesis line of products, which it acquired in July 2003. This component is accounted for as a discontinued operation in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Accordingly, amounts in the Company's financial statements and related notes for all periods shown reflect discontinued operations accounting. On September 30, 2004 the Company sold the Neogenesis line of products to Genesis Northwest, Inc., a company headed by a former employee of the Neogenesis business. Assets with a book value of approximately $300,000 were sold for a purchase price of $10,000 in cash, and a $364,000 promissory note with equal monthly payments of approximately $3,500 beginning April 2005 and continuing through October 2009 at which time the balance of $200,000 becomes due. The company has reserved for the $364,000 present value of the promissory note because of the uncertainty of its collectibility. For the three and nine months ended September 30, 2004, respectively, the Company reported losses from discontinued operations of $5,000 and $772,000, and recorded a loss, from the sale of the Neogenesis business of $300,000 after reserving for the receivable.

As a result of the factors discussed above, we reported income from continuing operations of $452,000, or $.03 per diluted share, and net income of $147,000 or $0.01 per diluted share for the three months ended September 30, 2004, as compared to a net loss from continuing operations of $953,000 and a net loss of $969,000, or $0.06 per diluted share for both measures, for the same period in 2003. We reported a net loss of $3.9 million, or $0.23 per diluted share, for the nine months ended September 30, 2004, as compared to a net loss of $3.1 million, or $0.19 per diluted share, for the same period in 2003.

Liquidity and Capital Resources

As of September 30, 2004, we had cash, cash equivalents, and short-term investments of $33.7 million, stockholders' equity of $50.9 million and working capital of $39.2 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 for the nine months ended September 30, 2004 was $665,000 compared with net cash used in operating activities of $2.1 million for the same period in 2003. Our net loss for the nine months ended September 30, 2004 was $884,000 more than the loss during the comparable period in 2003. This increase in net loss was offset by a decrease in inventories and an increase in accrued liabilities.

Net cash used in investing activities for the nine months ended September 30, 2004 was $1.4 million, compared to net cash used in investing activities of $7.5 million for the same period in 2003. Net cash used in investing activities in the 2004 period was primarily the result of the acquisition of Fischer-Zoth, offset by the sale of short-term investments in excess of those purchased. Net cash use in investing activities in the 2003 period was primarily the result of the acquisition of Neometrics and the purchase of short-term investments in excess of those that were redeemed. At September 30, 2004, 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 September 30, 2004.

Pursuant to the terms of the transition agreement between the Company and its former chief executive officer, we recorded an obligation of approximately $518,000 that is payable over an eighteen month period beginning in April 2004. As a result of our restructuring in June 2004, we have an additional remaining obligation at September 30, 2004 for employee termination-related costs of $267,000, which is payable through June 2005.

Net cash provided by financing activities was $2.1 million for the nine months ended September 30, 2004, compared to $370,000 for the same period in 2003. Net cash provided by financing activities for both periods resulted primarily from the proceeds of sale of our stock to employees pursuant to our stock option and employee stock purchase plans.

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 the operations of Fischer-20th will be cash positive. We believe that our current cash and cash equivalent balances, including short-term investments, any cash provided by or used in 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. 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 attain 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 September 30, 2004, we had accumulated deficits of approximately $38.4 million. Additionally, our revenue and operating results have varied significantly from quarter to quarter in the past and may continue to fluctuate in the future. The following are among the factors that could cause our revenue, operating results, and margins to fluctuate significantly from quarter to quarter:

- Budgeting cycle of our customers, particularly government entities, 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
- Market changes caused by rapidly evolving technology for newborn screening products

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. Further, we cannot be certain that we will achieve 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.

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 Fischer-Zoth products, our neoBLUE phototherapy devices, or our other products could limit our revenue growth

Our sales force has limited experience selling our Neometrics newborn screening data management system, our neoBLUE phototherapy devices, 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.

We sell our Fischer-Zoth products through distributors in over fifty countries; however, sales of these products in the United States have been limited. We have no experience selling Fischer Zoth products in the United States. We may encounter unexpected difficulties in managing the larger international distribution channel that we acquired with the Fischer-Zoth acquisition and may be unable to penetrate the domestic market for its products.

We have in the past acquired, and may in the future, continue to acquire businesses, product lines and technology, and we may not achieve the desired benefits of these acquisitions, in which case our results of operations and financial condition could be adversely affected

As part of our overall strategy, we may continue to acquire or invest in complementary companies, products or technologies and enter into strategic alliances with other companies, such as the Neometrics acquisition that we completed in July 2003 and the Fischer-Zoth acquisition completed in September 2004. In order to be successful in these activities, we must:

- Invest in companies and technologies that contribute to the growth of our business
- Incorporate acquired operations into our business and maintain uniform standards, controls and procedures
- Retain the key employees of the acquired operation and
- Develop the capabilities necessary to exploit newly acquired technologies.

The benefits of our past and any future acquisitions or strategic alliances may prove to be less than anticipated and may not outweigh the costs reported in our financial statements. Acquisitions or strategic alliances can cause significant diversions of management time and resources, particularly as is the case with international acquisitions such as our purchase of Fischer-Zoth. We may not be successful in overcoming these risks or any other problems encountered in connection with these or other business combinations, investments or strategic alliances. These transactions may adversely affect our business, financial position and operating results.

If we acquire new businesses, products or technologies in the future, we may be required to assume contingent liabilities and amortize significant amounts of other intangible assets and, over time, recognize significant charges for impairment of goodwill. If we consummate any potential future acquisitions in which the consideration consists of stock or other securities, our existing stockholders' ownership may be significantly diluted. If we proceed with any potential future acquisitions in which the consideration is cash, we may be required to use a substantial portion of our available cash.

In order to accurately recognize revenue on long-term development and implementation contracts associated with our Neometrics newborn screening data 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 profit 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 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 devices, 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

If we do not meet our restructuring objectives, we may have to implement additional plans in order to reduce our operating costs, and we cannot assure you that we will not be adversely affected by our restructuring activities

In the second quarter of 2004, we implemented a restructuring plan to more closely align our cost structure with our revenue. The plan included primarily the reduction of our workforce. The benefits that we expect to achieve from this restructuring are estimates only, and we may not achieve the full amount of cost savings that we have planned. If we do not meet our restructuring objectives, we may have to implement additional plans to reduce our operating costs, which could have an adverse effect on our financial results. Further, as part of the restructuring we terminated the employment of many employees who provided valuable services to us, and we cannot be assured that those employees who remain will be able to perform all of the functions that remain to be filled within the company without adversely affecting our business.

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 profit on sales of our products that the distributor would have earned. Any required payments would adversely affect our operating results.

Our operating results may suffer because of 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. We have recently begun requiring payment in U.S. dollars from our reseller in Japan and have significantly reduced our Yen-denominated operating expenses. However, we continue to be subject to expenses in the U.K. that are denominated in GB Pounds, and with the acquisition of Fischer-Zoth in September 2004 we have expenses denominated in the Euro. 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 many of 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. A disruption in the supply of this adhesive 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 in 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, or neoBLUE phototherapy device products, or any future cleared or approved devices, for uses not within the scope of our clearances or approvals or make unsupported promotional claims about the benefits of our products. If the FDA determines that our claims are outside the scope of our clearances or are unsupported it could require us to revise our promotional claims or take enforcement action against us. If we were subject to such an action by the FDA, our sales could be delayed, our 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, which we divested in September 2004, previously required the controlled use of hazardous and radioactive materials. Although we had not recently conducted operations that required us to use hazardous or radioactive materials, we had such materials in controlled storage on site at times in the past. In the event there was an accidental contamination of property or injury to individuals from these materials, either in the past or the future, 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 large 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.

We believe our greatest competitive threats can be categorized into the following areas:

- Technology - from existing companies, or new companies entering into our markets, who may improve upon existing technologies or invent new technologies that become more appealing for our customers to purchase than our products.
- Market Pricing - from existing competitors who may be able to offer products that are comparable to those of Natus at a lower price, and/or products of a lower quality, but for which pricing makes those products more attractive to our customers than Natus' products. Our competitors may enjoy economies of scale unavailable to Natus; lower costs of product development; lower costs of production, manufacturing and service; or lower costs of marketing, sales and administration.

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, or data management systems, or other 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, and we acquired Fisher-Zoth in September 2004. 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.

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, 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.

Our stock price may continue to be volatile

Our stock price has fluctuated, and may continue to fluctuate, for a number of reasons including:

- Actual or anticipated variations in quarterly operating results
- Failure to achieve, or changes in, financial estimates by securities analysts
- 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
- General market conditions, particularly for companies with a relatively small number of shares available for sale in the public market

Many of these factors, which can have a substantial impact upon the trading price of our stock, are beyond our control. Stock price fluctuations may be exaggerated for companies such as us where the trading volume of our common stock is relatively low. A significant change in the price of our common stock could subject us to securities litigation claims which 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 November 8, 2004, our executive officers, directors, principal stockholders and individuals, or entities affiliated with them beneficially own in the aggregate approximately 25% of our outstanding common stock, and one single stockholder owns approximately 14%. 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

Table of Contents

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; warranty allowances; acceptance of our products and the products of our competitors; fluctuation of our operating results and gross profits; expansion in and opportunities relating to international markets; costs associated with operating in international markets; future marketing and selling expenses; benefits and objectives of restructuring initiatives; future operating results; intent to divest under-performing product lines; impact of our application of resources; spending relating to our existing products; future investments; development of new products and enhancement of existing products; acquisition of products, technologies, or businesses; liquidity and capital requirements; our investment policy; sufficiency of future resources such as employees, 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. 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 Germany 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 September 2004 we acquired Fischer-Zoth, which develops and manufactures products at its headquarters, near Munich, Germany, and sells those products through distribution channels in over 50 countries. Revenue and expenses of our U.K. and German subsidiaries are generally denominated in the local foreign currency. As our operations in the United Kingdom and Germany 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 nine months ended September 30, 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 September 30, 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 September 30, 2004, the fair value of our portfolio would decline by an immaterial amount. At September 30, 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 September 30, 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 September 30, 2004 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 2. Unregistered Sales of Equity 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 September 30, 2004, we used proceeds from our initial public offering to purchase the assets of privately-held Fischer-Zoth GmbH located near Munich, Germany, and related entities for $5.6 million, including direct costs of the acquisition, and to acquire equipment costing approximately $120,000, for working capital needs, and to fund discontinued operations.

ITEM 6. Exhibits

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.

SIGNATURES

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

NATUS MEDICAL INCORPORATED

Dated: November 12, 2004 By: /s/ JAMES B. HAWKINS

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

Dated: November 12, 2004 By: /s/ STEVEN J. MURPHY

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

Table of Contents

NATUS MEDICAL INCORPORATED

INDEX TO EXHIBITS

Exhibit No.	
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U. S. C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 31.1

CERTIFICATION

I, James B. Hawkins, certify that:

1. I have reviewed this quarterly 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: November 12, 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 quarterly 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: November 12, 2004

/s/ STEVEN J. MURPHY

Steven J. Murphy
Vice President Finance

EXHIBIT 32.1

CERTIFICATIONS OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL 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 September 30, 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, to the best of my knowledge:

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

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company for the quarterly period covered by the report.

/s/ JAMES B. HAWKINS

Print Name: James B. Hawkins
Title: President and Chief Executive Officer
Date: November 12, 2004

In connection with the Quarterly Report of Natus Medical Incorporated (the "Company") on Form 10-Q for the quarter ended September 30, 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, to the best of my knowledge:

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

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company for the quarterly period covered by the report.

/s/ STEVEN J. MURPHY

Print Name: Steven J. Murphy
Title: Vice President Finance
Date: November 12, 2004