

NATUS MEDICAL INC  
Form 10-Q  
May 21, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2013

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-33001

**NATUS MEDICAL INCORPORATED**

(Exact name of registrant as specified in its charter)

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

**77-0154833**  
(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 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of issued and outstanding shares of the registrant's Common Stock, \$0.001 par value, as of May 16, 2013 was 30,387,256.

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****NATUS MEDICAL INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

(in thousands, except share and per share amounts)

	March 31, 2013	December 31, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 24,354	\$ 23,057
Accounts receivable, net of allowance for doubtful accounts of \$3,318 in 2013 and \$2,617 in 2012	93,005	89,960
Inventories	38,028	40,756
Prepaid expenses and other current assets	5,795	6,379
Deferred income tax	8,676	8,719
<b>Total current assets</b>	<b>169,858</b>	<b>168,871</b>
Property and equipment, net	25,994	26,512
Intangible assets	105,031	96,594
Goodwill	97,220	92,048
Other assets	9,681	7,828
<b>Total assets</b>	<b>\$ 407,784</b>	<b>\$ 391,853</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 29,249	\$ 32,537
Short-term borrowings	33,300	11,300
Current portion of long-term debt	8,522	8,526
Accrued liabilities	27,590	32,938
Deferred revenue	14,064	13,305
<b>Total current liabilities</b>	<b>112,725</b>	<b>98,606</b>
Long-term liabilities:		
Long-term debt	10,892	13,034
Other liabilities	2,401	3,038
Deferred income tax	8,834	8,423
<b>Total liabilities</b>	<b>134,852</b>	<b>123,101</b>
Stockholders' equity:		
Common Stock, \$0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 30,339,098 in 2013 and 30,106,933 in 2012	278,463	275,395
Retained earnings	15,081	11,638
Accumulated other comprehensive loss	(20,612)	(18,281)
<b>Total stockholders' equity</b>	<b>272,932</b>	<b>268,752</b>

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Total liabilities and stockholders' equity	\$ 407,784	\$ 391,853
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The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
Revenue	\$ 85,834	\$ 59,408
Cost of revenue	36,601	26,086
<b>Gross profit</b>	<b>49,233</b>	<b>33,322</b>
Operating expenses:		
Marketing and selling	22,196	16,643
Research and development	8,212	6,746
General and administrative	13,966	9,505
Total operating expenses	44,374	32,894
Income from operations	4,859	428
Other income (expense), net	(334)	180
Income before provision for income tax	4,525	608
Provision for income tax	1,083	319
<b>Net income</b>	<b>\$ 3,442</b>	<b>\$ 289</b>
Other comprehensive income:		
Foreign currency translation	(2,331)	411
<b>Comprehensive income</b>	<b>\$ 1,111</b>	<b>\$ 700</b>
Earnings per share:		
Basic	\$ 0.12	\$ 0.01
Diluted	\$ 0.11	\$ 0.01
Weighted average shares used in the calculation of earnings per share:		
Basic	29,570	28,856
Diluted	30,319	29,533

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

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**NATUS MEDICAL INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**

(in thousands)

	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Operating activities:</b>		
Net income	\$ 3,442	\$ 289
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,133	2,846
Provision for losses on accounts receivable	372	254
Warranty reserve	656	216
Loss on disposal of property and equipment	6	2
Share-based compensation	1,360	1,157
Excess tax benefit on the exercise of stock options	(81)	107
Changes in operating assets and liabilities:		
Accounts receivable	(787)	(1,799)
Inventories	64	3,953
Prepaid expenses and other assets	734	(321)
Accounts payable	(3,302)	(318)
Deferred income tax	(304)	86
Accrued liabilities and deferred revenue	(6,228)	(342)
<b>Net cash provided by (used in) operating activities</b>	<b>(935)</b>	<b>6,130</b>
<b>Investing activities:</b>		
Acquisition of businesses, net of cash acquired	(18,600)	
Purchases of property and equipment	(687)	(1,218)
Purchase of intangible assets	(669)	
<b>Net cash used in investing activities</b>	<b>(19,956)</b>	<b>(1,218)</b>
<b>Financing activities:</b>		
Proceeds from stock option exercises and ESPP purchases	2,115	130
Excess tax benefit on the exercise of stock options	81	(107)
Proceeds from short-term borrowings	22,000	
Payments on borrowings	(2,142)	(40)
<b>Net cash provided by (used in) financing activities</b>	<b>22,054</b>	<b>(17)</b>
<b>Exchange rate changes effect on cash and cash equivalents</b>	<b>134</b>	<b>(295)</b>
<b>Net increase in cash and cash equivalents</b>	<b>1,297</b>	<b>4,600</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>23,057</b>	<b>32,816</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 24,354</b>	<b>\$ 37,416</b>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	\$ 613	\$ 12

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Cash paid for income taxes	\$ 4,241	\$ 1,432
Non-cash investing activities:		
Property and equipment included in accounts payable	\$ 261	\$

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



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**NATUS MEDICAL INCORPORATED AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)**

**1 - Basis of Presentation**

The accompanying interim condensed consolidated financial statements of Natus Medical Incorporated ( Natus, we, us, our, or the Company ) have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ). Except as noted below, the accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent in all material respects with those presented in Note 1 to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

Interim financial reports are prepared in accordance with the rules and regulations of the Securities and Exchange Commission; accordingly, they do not include all of the information and notes required by GAAP for annual financial statements. The interim financial information is unaudited, but reflects all normal adjustments that are, in the opinion of management, necessary for the fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. The condensed consolidated balance sheet as of December 31, 2012 was derived from audited financial statements, but does not include all disclosures required by GAAP. The accompanying financial statements should be read in conjunction with the financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

Operating results for the three months ended March 31, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

**Recent Accounting Pronouncements**

*Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income* - In February 2013, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update No. ( ASU ) 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. This topic requires us to provide information about the amounts reclassified out of accumulated other comprehensive income by component and the line items of net income to which significant amounts are reclassified. This topic is for annual and interim periods beginning after December 15, 2012. The amendment did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

*Testing Indefinite-Lived Intangibles for Impairment* - In July 2012, the FASB amended guidance on *Testing Indefinite-Lived Intangibles for Impairment*. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of its indefinite-lived intangible assets are less than their carrying amounts. If an entity determines that it is more likely than not that the fair value of each asset exceeds its carrying amount, it would not need to calculate the fair value of the asset in that year. If the entity concludes otherwise, it is required to perform an impairment test comparing the carrying value of the intangible asset with its fair value and recognize an impairment loss if necessary. The new guidance became effective for us on January 1, 2013. Adoption of this guidance did not have and is not expected to have an impact on our financial position, results of operations, or cash flows.

**2 - Business Combinations**

**Grass Technologies**

On February 2, 2013, we completed an asset purchase of the Grass Technologies Product Group ( Grass ) from Astro-Med Inc. for a cash consideration of \$18.6 million. Grass manufactures and sells clinically differentiated neurodiagnostic and monitoring products, including a portfolio of electroencephalography (EEG) and polysomnography (PSG) systems for both clinical and research use and related accessories and proprietary electrodes. A total of \$160,000 of direct costs associated with the acquisition was expensed as incurred and reported as a component of general and administrative expenses.

The Company will account for the acquisition as a business combination. Under the acquisition method of accounting, the assets acquired and liabilities assumed from Grass are recorded in the consolidated financial statements at their respective fair values as of the acquisition date. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill. Grass s results of operations are included in the consolidated financial statements since February 2, 2013, the date of the acquisition.



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Valuing certain components of the acquisition, primarily intangible assets, accounts receivable, deferred revenue and accrued expenses required us to make significant estimates that may be adjusted in the future; consequently, the purchase price allocation is considered preliminary. Final determination of these estimates could result in an adjustment to the preliminary purchase price allocation, with an offsetting adjustment to goodwill.

The following table summarizes the preliminary purchase price allocation of the fair value of the assets acquired and liabilities assumed at the date of acquisition, (in thousands):

Accounts receivable	\$ 3,281
Prepaid and other assets	33
Identifiable intangible assets:	
Developed Technology	2,500
Customer-related	5,200
Tradenames	3,000
Property and equipment	237
Goodwill	5,196
Accounts payable	(328)
Accrued expenses	(171)
Deferred revenue	(348)
 Total purchase price	 \$ 18,600

*Identifiable intangible assets.* Intangible assets included in the purchase price allocation consist of: (i) developed technology of \$2.5 million assigned a weighted average economic life of eight years being amortized on the straight line method (ii) customer-related intangible assets of \$5.2 million assigned an economic life of 13 years being amortized on the straight line method, and (iii) trademarks and tradenames of \$3 million that have an indefinite life and are not being amortized. All straight-line method of amortization above is based on the expected pattern of future benefits related to those respective intangible assets.

Accounts receivable, net of allowance for doubtful accounts, prepaid and other assets, accounts payable and accrued expenses are stated at their historical carrying value, which approximate fair value given the short-term nature of these assets and liabilities. The fair value of fixed assets ( Level 2 inputs ) was determined using market data for similar assets. The fair value of the intangible assets summarized above were derived from significant unobservable inputs (Level 3 inputs ) determined by management using our discounted cash flow models from income projections prepared by management, estimated royalty rates, estimated customers attrition rates and using weighted average cost of capital of 13%.

*Goodwill.* Approximately \$5.2 million has been allocated to goodwill. Goodwill is calculated as the difference between the acquisition date fair value of the consideration transferred and the provisional values assigned to the assets acquired and liabilities assumed and represents primarily the expected synergies of combining the operations of the Company and the Grass business. None of the goodwill is expected to be deductible for tax purposes. In accordance with ASC 350-20, goodwill will not be amortized but instead will be tested for impairment at least annually (more frequently if certain indicators are present). In the event that management determines that the value of goodwill has become impaired, we will incur an accounting charge for the amount of impairment during the fiscal quarter in which the determination is made.

**Nicolet**

We acquired the Nicolet neurodiagnostic business ( Nicolet ) from CareFusion on July 2, 2012 pursuant to a Share and Acquisition Purchase Agreement. The Nicolet business develops clinically differentiated neurodiagnostic and monitoring products, including a portfolio of electroencephalography (EEG) and electromyography (EMG) systems and related accessories, as well as vascular and obstetric Doppler sensors and connectivity products. The acquisition strengthened the Company's existing neurology portfolio and provided new product categories. The acquisition also better positions the Company in international markets, as over 50 percent of the Nicolet business is in markets outside of the United States.

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We acquired all of the outstanding common shares of CareFusion subsidiaries comprising the Nicolet business in the United States, Ireland, and the United Kingdom, and certain assets and liabilities of Nicolet sales divisions principally in China, Brazil, Germany, Italy, the Netherlands, and Spain for \$55.5 million, after reflecting a working capital adjustment of \$2.4 million recorded in December 2012. A total of \$2.6 million of direct costs associated with the acquisition were expensed as incurred and reported as a component of general and administrative expenses during fiscal 2012.

The acquisition has been accounted for as a business combination. Under the acquisition method of accounting, the assets acquired and liabilities assumed from Nicolet are recorded in the consolidated financial statements at their respective fair values as of the acquisition date. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill. Nicolet's results of operations are included in the consolidated financial statements since July 2, 2012, the date of the acquisition.

Valuing certain components of the acquisition, primarily inventories, required us to make significant estimates that may be adjusted in the future; consequently, the purchase price allocation is considered preliminary. Final determination of these estimates could result in an adjustment to the preliminary purchase price allocation, with an offsetting adjustment to goodwill.

During the three months ending March 31, 2013, we recorded adjustments to the preliminary purchase price allocation for accrued expenses that resulted in a net increase to goodwill of \$239,000.

**Pro forma financial information**

The following unaudited pro forma information combining results of operations of the Company for the three months ended March 31, 2013 and 2012 are presented as if the acquisitions of Grass and Nicolet had occurred on January 1, 2012:

**Unaudited Pro forma Financial Information**

(in thousands)

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2013</b>	<b>2012</b>
Revenue	\$ 86,839	\$ 87,323
Income (loss) from operations	\$ 5,239	\$ (960)

The unaudited pro forma financial information is provided for comparative purposes only and is not necessarily indicative of what actual results would have been had the acquisitions occurred on the dates indicated, nor does it give effect to synergies, cost savings, and other changes expected to result from the acquisitions. Accordingly, the pro forma financial results do not purport to be indicative of results of operations as of the date hereof, for any period ended on the date hereof, or for any other future date or period.

Grass's revenue of \$2.3 million and income from operations of \$334,000 are included in our condensed consolidated statements of income and comprehensive income for the period from February 2, 2013 (acquisition date) to March 31, 2013.

For purposes of preparing the unaudited pro forma financial information for the period January 1, 2013 through March 31, 2013, Grass's statement of operations for the month ended January 31, 2013 was combined with the company's consolidated statement of operations and comprehensive income for the three months ended March 31, 2013.

For purposes of preparing the unaudited pro forma financial information for the period January 1, 2012 through March 31, 2012, Grass's statement of operations for the three months ended March 31, 2012 was combined with the Company's consolidated statement of operations and comprehensive income for the three months ended March 31, 2012.

For purposes of preparing the unaudited pro forma financial information for the period January 1, 2012 through March 31, 2012, Nicolet's consolidated statement of revenue and direct expenses for the three months ended March 31, 2012 was combined with the Company's consolidated statement of operations and comprehensive income for the three months ended March 31, 2012.



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The unaudited pro forma consolidated results for the three month period ended March 31, 2013 reflect the historical information of Natus and Grass, adjusted for the following pre-tax amounts:

Additional amortization expense of \$59,300 related to the fair value of identifiable intangible assets acquired;

Decrease of depreciation expense of \$14,800 related to the fair value adjustment to property and equipment acquired;

Decrease in general and administrative expense of \$160,000 related to the direct acquisition costs that were recorded in the three months ended March 31, 2012.

The unaudited pro forma consolidated results for the three month period ended March 31, 2012 reflect the historical information of Natus, Grass and Nicolet, adjusted for the following pre-tax amounts:

Elimination of Nicolet's historical intangible asset amortization expense of approximately \$211,500;

Additional amortization expense related to Grass of \$178,000 and Nicolet of \$1 million related to the fair value of identifiable intangible assets acquired;

Decrease of Grass's depreciation expense of approximately \$44,500 and Nicolet's depreciation expense of approximately \$391,000 related to the fair value adjustment to property and equipment acquired;

Increase in general and administrative expense relating to Grass's direct acquisition costs of approximately \$160,000 and Nicolet's direct acquisition costs of \$2.6 million;

Increase in cost of goods sold relating to Nicolet's fair value inventory adjustments of \$571,000.

**3 - Basic and Diluted Earnings Per Common Share**

Basic earnings per share is based upon the weighted average number of common shares outstanding during the period. Diluted earnings per share is based upon the weighted average number of common shares outstanding and dilutive common stock equivalents outstanding during the period. Common stock equivalents are options granted and shares of restricted stock issued under our stock awards plans and are calculated under the treasury stock method. Common equivalent shares from unexercised stock options and unvested restricted stock are excluded from the computation when there is a loss as their effect is anti-dilutive or if the exercise price of such unexercised options is greater than the average market price of the stock for the period.

For the three months ended March 31, 2013, common stock equivalent shares of 749,415 were included in the weighted average shares outstanding used to calculate diluted earnings per share, while common stock equivalents of 2,028,148 were excluded from the calculation of diluted earnings per share because the exercise price of the underlying options was greater than the average market price of the stock for the period.

For the three months ended March 31, 2012, common stock equivalents of 677,535 were included in the weighted average shares outstanding used to calculate diluted earnings per share, while common stock equivalents of 2,069,593 were excluded from the calculation of diluted earnings per share because the exercise price of the underlying options was greater than the average market price of the stock for the period.

**4 - Inventories**

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Inventories consist of the following (in thousands):

	<b>March 31, 2013</b>	<b>December 31, 2012</b>
Raw materials and subassemblies	\$ 19,595	\$ 21,373
Work in process	2,998	3,085
Finished goods	20,813	19,795
Total inventories	43,406	44,253
Less: Non-current inventories	(5,378)	(3,497)
Inventories, current	\$ 38,028	\$ 40,756

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At March 31, 2013 and December 31, 2012, the Company has classified \$5.4 million and \$3.5 million of inventories, respectively, as non-current. This inventory consists primarily of service components used to repair products pursuant to warranty obligations and extended service contracts, including service components for products we are not currently selling. Management believes that these inventories will be utilized for their intended purpose.

**5 Intangible Assets**

The following table summarizes the components of gross and net intangible asset balances (in thousands):

	March 31, 2013				December 31, 2012			Net Book Value
	Gross Carrying Amount	Accumulated Impairment	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Impairment	Accumulated Amortization	
Intangible assets with definite lives:								
Technology	\$ 64,853		\$ (22,270)	\$ 42,583	\$ 62,850		\$ (21,307)	\$ 41,543
Customer related	31,575		(7,293)	24,282	26,627		(6,692)	19,935
Internally developed software	10,316		(4,259)	6,057	9,729		(4,020)	5,709
Patents	2,730		(2,191)	539	2,752		(2,171)	581
Backlog	724		(724)		724		(724)	
Definite-lived intangible assets	110,198		(36,737)	73,461	102,682		(34,914)	67,768
Intangible assets with indefinite lives:								
Tradenames	33,130	(1,560)		31,570	30,386	(1,560)		28,826
Total intangibles assets	\$ 143,328	\$ (1,560)	\$ (36,737)	\$ 105,031	\$ 133,068	\$ (1,560)	\$ (34,914)	\$ 96,594

Definite-lived intangible assets are amortized over their weighted average lives of 15 years for technology, 12 years for customer related intangibles, 7 years for internally developed software, and 14 years for patents. Intangible assets with indefinite lives are not subject to amortization.

Internally developed software consists of \$9.4 million relating to costs incurred for development of internal use computer software and \$943,000 for development of software to be sold.

Amortization expense related to intangible assets with definite lives was as follows (in thousands):

	Three Months Ended	
	March 31, 2013	March 31, 2012
Technology	\$ 963	\$ 871
Customer related	601	503
Internally developed software	239	521
Patents	20	61
Total amortization	\$ 1,823	\$ 1,956

Expected amortization expense related to amortizable intangible assets is as follows (in thousands):



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Nine months ending December 31, 2013	\$ 6,096
2014	7,834
2015	7,493
2016	6,659
2017	6,276
2018	6,105
Thereafter	32,998
Total expected amortization expense	\$ 73,461

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The carrying amount of goodwill and the changes in those balances are as follows (in thousands):

Gross Balance, December 31, 2012	\$ 112,048
Accumulated impairment losses	(20,000)
Balance net of impairment losses, December 31, 2012	92,048
Goodwill as a result of acquisitions	5,412
Foreign currency translation	(240)
Balance, March 31, 2013	\$ 97,220

**7 - Property and Equipment, net**

Property and equipment, net consist of the following (in thousands):

	March 31, 2013	December 31, 2012
Land	\$ 4,332	\$ 4,371
Buildings	11,138	11,422
Leasehold improvements	3,659	3,450
Office furniture and equipment	11,835	11,601
Computer software and hardware	10,597	10,114
Demonstration and loaned equipment	10,925	11,505
	52,486	52,463
Accumulated depreciation and amortization	(26,492)	(25,951)
Total	\$ 25,994	\$ 26,512

Depreciation and amortization expense of property and equipment was approximately \$1.1 million and \$907,000 for the three months ended March 31, 2013 and 2012, respectively.

**8 - Reserve for Product Warranties**

We provide a warranty on all medical device products that is generally one year in length. We also sell extended service agreements on our medical device products. Service for domestic customers is provided by Company-owned service centers that perform all service, repair, and calibration services. Service for international customers is provided by a combination of Company-owned facilities and third-party vendors on a contract basis.

We have accrued a warranty reserve, included in accrued liabilities on the accompanying balance sheets, for the expected future costs of servicing products during the initial warranty period. We base the liability on actual warranty costs incurred to service those products. On new products, additions to the reserve are based on a combination of factors including the percentage of service department labor applied to warranty repairs, as well as actual service department costs, and other judgments, such as the degree to which the product incorporates new technology. The reserve is reduced as costs are incurred to honor existing warranty obligations.

The details of activity in the warranty reserve are as follows (in thousands):

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	Three Months Ended	
	March 31,	
	2013	2012
Balance, beginning of period	\$ 2,260	\$ 2,157
Acquisition warranty assumed	191	
Warranty accrued for the period	656	224
Repairs for the period	(464)	(106)
Balance, end of period	\$ 2,643	\$ 2,275

The estimates we use in projecting future product warranty costs may prove to be incorrect. Any future determination that our product warranty reserves are understated could result in increases to our cost of sales and reductions in our operating profits and results of operations.

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The details of changes in stockholders equity are as follows (in thousands):

	Three Months Ended	
	March 31,	
	2013	2012
Balance, beginning of period	\$ 268,752	\$ 258,313
Net income	3,442	289
Proceeds from stock option exercises and ESPP	2,115	130
Share-based compensation expense	1,360	1,157
Tax effect of option exercises	(406)	(107)
Foreign currency translation adjustment	(2,331)	411
Balance, end of period	\$ 272,932	\$ 260,193

**10 - Share-Based Compensation**

At March 31, 2013, we have two active plans that give rise to share-based compensation, the 2011 Stock Awards Plan and the 2011 Employee Stock Purchase Plan. The terms of awards granted during the three months ended March 31, 2013 and our methods for determining grant-date fair value of the awards were consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2012.

Detail of share-based compensation expense is as follows (in thousands):

	Three Months Ended	
	March 31,	
	2013	2012
Cost of revenue	\$ 59	\$ 50
Marketing and sales	271	252
Research and development	117	105
General and administrative	913	751
Total	\$ 1,360	\$ 1,158

As of March 31, 2013, unrecognized compensation expense related to the unvested portion of our stock options and other stock awards was approximately \$10.7 million, which is expected to be recognized over a weighted average period of 2.5 years.

**Stock Options**

Activity in our stock options during the three months ended March 31, 2013 is as follows:

	Shares	Weighted Average Exercise Price	Weighted- average remaining contractual life (years)	Aggregate intrinsic value (\$ 000 s)
Outstanding, beginning of period	3,882,239	\$ 11.71		

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Granted		\$		
Exercised	(255,015)	\$	8.30	
Cancelled	(213,010)	\$	16.35	
Outstanding, end of period	3,414,214	\$	11.67	3.46 \$ 10,369
Exercisable, end of period	2,495,665	\$	11.33	2.20 \$ 8,734
Vested and expected to vest, end of period	3,289,740	\$	11.66	3.30 \$ 10,119

The intrinsic value of options exercised during the three months ended March 31, 2013 was \$1.3 million.

**Table of Contents****Restricted Stock Awards**

Activity in our restricted stock awards ( RSAs ) during the three months ended March 31, 2013 is as follows:

	Shares	Weighted- average grant date fair value	Remaining cost expected to be recognized (\$ 000 s)
Unvested, beginning of period	690,890	\$ 13.02	
Granted		\$	
Vested	(32,750)	\$ 14.94	
Forfeited	(30,640)	\$ 14.10	
Unvested, end of period	627,500	\$ 12.90	\$ 6,679

We award restricted stock awards to U.S. employees of the Company that vest 50% upon the second anniversary of the vesting start date and 25% upon each of the third and fourth anniversaries of the vesting start date. We also award RSAs to non-employee directors of the Company that vest on the first anniversary of the grant date.

At March 31, 2013 the fair market value of outstanding RSAs was \$8.4 million and the weighted average remaining recognition period of unvested RSAs was 2.3 years. At December 31, 2012 the fair market value of outstanding RSAs was \$7.7 million and the weighted average remaining recognition period was 2.6 years. The intrinsic value of RSAs equals their fair market value.

**Restricted Stock Units**

Activity in our restricted stock units ( RSUs ) during the three months ended March 31, 2013 is as follows:

	Shares	Weighted- average remaining contractual life (years)	Aggregate intrinsic value (\$ 000 s)
Outstanding, beginning of period	50,050		
Awarded	5,890		
Released			
Forfeited			
Outstanding, end of period	55,940	1.52	\$ 752

We award restricted stock units to non-U.S. employees of the Company that vest 50% upon the second anniversary of the vesting start date and 25% upon each of the third and fourth anniversaries of the vesting start date.

At March 31, 2013 the aggregate intrinsic value of outstanding RSUs was \$752,000 and the weighted average remaining recognition period for unvested RSUs was 2.7 years. At December 31, 2012 the aggregate intrinsic value of outstanding RSUs was \$559,000 and the weighted average remaining recognition period for unvested RSUs was 2.8 years.

**11 - Other income (expense), net**

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

	<b>Three Months Ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
Investment income	\$ 31	\$ 4
Interest expense	(477)	(8)
Foreign currency exchange gain (loss)	(198)	261
Other	310	(77)
<b>Total other income (expense), net</b>	<b>\$ (334)</b>	<b>\$ 180</b>

## 12 - Income Taxes

### Provision for Income Tax Expense

We recorded provisions for income tax of \$1.1 million and \$319,000 for the three months ended March 31, 2013 and 2012, respectively.

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Our effective tax rate was 23.9% and 52.5% for the three months ended March 31, 2013 and 2012, respectively.

Our effective tax rate for the three months ended March 31, 2013 differed from statutory tax rates primarily because of profits taxed in foreign jurisdictions with lower tax rates than the statutory rate and tax benefits of approximately \$340,000 derived from the recognition of the 2012 federal research and development tax credit by enactment of the American Taxpayer Relief Act of 2012 in January 2013.

Our effective tax rate for the three months ended March 31, 2012 differed from statutory tax rates primarily due to discrete items coupled with losses in some foreign jurisdictions for which we did not record a tax benefit.

There was an insignificant increase of unrecognized tax benefits for the three months ended March 31, 2013. Within the next twelve months it is possible our uncertain tax benefit may change within a range of approximately zero to \$600,000. This change may impact the future effective tax rate and is a result of a lapse of statute of limitations, provided that no taxing authority conducts a new examination.

Our tax returns remain open to examination as follows: U.S. Federal, 2009 through 2012, U.S. States 2008 through 2012 and significant foreign jurisdictions, 2009 through 2012.

**13 - Restructuring Reserves**

In January 2011, we adopted a reorganization plan that was designed to improve efficiencies in the operations of Medix, which we acquired in October 2010. During the three months ended September 30, 2011 we also initiated similar restructuring activities in Embla, which we acquired in September 2011. These restructuring activities were completed as of March 31, 2013.

In July 2012, we initiated an integration and reorganization plan related to the acquisition of Nicolet that is designed to eliminate redundant costs, improve efficiencies in operations, and to move to an indirect sales model in certain countries in Europe, where Nicolet had previously sold under a direct sales model. As a result of the Nicolet acquisition, we also initiated additional restructuring activities in Xltek. Substantially all of the costs associated with the integration and reorganization plan are associated with employee severance costs. Substantially all of the staff reductions were completed by March 31, 2013.

In January 2013, we adopted reorganization plans that are designed to continue to improve efficiencies in our operating units in Europe and Medix.

The balance of the restructuring reserve is included in accrued liabilities on the accompanying balance sheets. Employee termination benefits expensed are included as a part of general and administrative expenses.

Activity in the restructuring reserves for these plans for the three months ended March 31, 2013 is as follows (in thousands):

	2011 Plans	July 2012 Plan	2013 Plans	Totals
Balances at December 31, 2012	\$ 83	\$ 2,662	\$	\$ 2,745
Expensed	4	211	615	830
Cash payments	(71)	(1,138)	(384)	(1,593)
Accrual reversal	(16)	(1,201)		(1,217)
Balances at March 31, 2013	\$	\$ 534	\$ 231	\$ 765

**14 - Debt and Credit Arrangements**

At March 31, 2013 the Company had a \$60 million revolving credit facility with Wells Fargo Bank, National Association ( Wells Fargo ). The revolving credit facility contains covenants, including covenants relating to liquidity and other financial measurements, and provides for events of default, including failure to pay any interest when due, failure to perform or observe covenants, bankruptcy or insolvency events, and the occurrence of a material adverse effect, and restricts our ability to pay dividends. We have granted Wells Fargo a security interest in substantially all of our assets. The revolving credit facility was increased from \$50 million to \$60 million in January 2013 to fund the acquisition of Grass. The maximum amount of borrowing under the facility will revert to \$50 million on June 30, 2013. We have no other significant credit



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facilities.

During the first quarter 2013 we borrowed \$22 million under the credit facility in the form of revolving debt, principally to fund the Grass acquisition and to provide for other working capital needs.

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Long-term debt is comprised of the following (2013 and 2012 columns in thousands):

	March 31, 2013	December 31, 2012
Term loan \$25 million, interest at LIBOR plus 1.5%, due June 30, 2015 with term loan principle repayable in quarterly installments of \$2.1 million	\$ 18,751	\$ 20,834
Term loan \$2.9 million Canadian ( CAD ), interest at cost of funds plus 2.5%, due September 15, 2014 with principle repayable in monthly installments of \$16,000 until August 15, 2014 and one final payment of \$392,000 collateralized by a first lien on company owned land and building	663	726
<b>Total</b>	<b>19,414</b>	<b>21,560</b>
Less current portion of long-term debt	(8,522)	(8,526)
<b>Total long-term debt</b>	<b>\$ 10,892</b>	<b>\$ 13,034</b>

Maturities of long-term debt as of March 31, 2013 are as follows (in thousands):

Nine months ended December 31, 2013	\$ 6,393
2014	8,853
2015	4,168
<b>Total</b>	<b>\$ 19,414</b>

Short-term borrowings at March 31, 2013 consist of \$24 million revolving debt associated with acquisitions and \$9.3 million for working capital requirements, with interest at LIBOR plus 1.5%.

At March 31, 2013 and December 31, 2012, the carrying value of total debt approximates fair market value. The fair value of the Company's debt is considered a Level 3 measurement.

**15 - Segment, Customer and Geographic Information**

We operate in one reportable segment in which we provide healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments.

Our end-user customer base includes hospitals, clinics, laboratories, physicians, nurses, audiologists, and governmental agencies. Most of our international sales are to distributors who resell our products to end users or sub-distributors.

Revenue and long-lived asset information by geographic region is as follows (in thousands):

	Three Months Ended March 31,	
	2013	2012
Revenue:		
United States	\$ 48,351	\$ 30,338
Foreign countries	37,483	29,070
<b>Totals</b>	<b>\$ 85,834</b>	<b>\$ 59,408</b>

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	<b>March 31, 2013</b>	<b>December 31, 2012</b>
<b>Long-lived assets:</b>		
United States	\$ 10,033	\$ 9,813
Foreign countries	15,961	16,699
 Totals	 \$ 25,994	 \$ 26,512

Long-lived assets consist principally of property and equipment, net of accumulated depreciation and amortization. During the three months ended March 31, 2013 and 2012, no single customer or foreign country contributed to more than 10% of revenue.

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During the three months ended March 31, 2013 and 2012, respectively, revenue from devices and systems was \$50 million and \$35.8 million, while revenue from supplies and services was \$35.8 million and \$23.6 million, respectively, and revenue from services was less than 10% of revenue.

**16 - Fair Value Measurements**

ASC 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Fair value is defined under ASC 820 as the exit price associated with the sale of an asset or transfer of a liability in an orderly transaction between market participants at the measurement date. ASC 820 establishes the following three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value:

*Level 1* - Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

*Level 2* - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

*Level 3* - Unobservable inputs that are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

The fair value of our assets and liabilities subject to fair value measurements are as follows (in thousands):

	Fair Value as of 3/31/13	Fair Value Measurements as of 3/31/13 Using Fair Value Hierarchy		
		Level 1	Level 2	Level 3
Bank money market investments	\$ 1,148		\$ 1,148	
Total	\$ 1,148		\$ 1,148	

	Fair Value as of 12/31/12	Fair Value Measurements as of 12/31/12 Using Fair Value Hierarchy		
		Level 1	Level 2	Level 3
Bank money market investments	\$ 1,148		\$ 1,148	
Total	\$ 1,148		\$ 1,148	

The carrying amount of the Company's long term debt approximates fair value based on Level 3 inputs since the debt carries a variable interest rate that is tied to the current LIBOR rate plus a spread.

For the year ended December 31, 2012, we recorded a charge of \$560,000 related to impairment of trade names. We measure these non-financial assets at fair value on a nonrecurring basis subsequent to their initial recognition. The fair value of these non-financial assets was measured using Level 3 inputs. See Note 5 - *Intangible Assets*.

**17 Immaterial Corrections to Prior Period Financial Statements**

Certain amounts previously reported in the condensed consolidated statements of operations and comprehensive income and condensed statements of cash flows for the three month period ended March 31, 2012 have been restated to reflect the correction of immaterial errors as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. The errors were related primarily to purchase accounting adjustments. In addition, certain other errors related to the liability associated with product trade-ins, currency loss on translation of foreign debt, amortization of intangible assets, the tax benefit associated with the release of accruals for uncertain tax positions were identified

and corrected. The errors are not material individually or in the aggregate.

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A summary of the effects of the correction of these errors on our condensed consolidated financial statements for the three month period ended March 31, 2012 is presented in the table below (in thousands):

	<b>Three Months Ended March 31, 2012</b>	
	<b>As Previously Reported</b>	<b>As Corrected</b>
<b>Condensed Consolidated Statements of Operations and Comprehensive Income</b>		
Revenue	\$ 59,510	\$ 59,408
Cost of revenue	26,042	26,086
Gross profit	33,468	33,322
Income from operations	161	428
Income before provision for income tax	329	608
Net income	358	289
<b>Condensed Consolidated Statements of Cash Flows</b>		
Net income	\$ 358	\$ 289
Depreciation and amortization	2,939	2,846
Change in operating assets and liabilities		
Inventories	3,881	3,953
Deferred income tax	(569)	86
Accrued liabilities and deferred revenue	211	(342)
Net cash provided by operating activities	6,118	6,130
Exchange rate changes effect on cash and cash equivalents	(283)	(295)

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**ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations  
Registered Trademarks and Tradenames**

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**Overview**

The following Management’s Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) supplements the MD&A in the Annual Report on Form 10-K for the year ended December 31, 2012 of Natus Medical Incorporated. Management’s discussion and analysis should be read in conjunction with our condensed consolidated financial statements and accompanying footnotes, the discussion of certain risks and uncertainties contained in Part II, Item 1A of this report, our Annual Report filed on Form 10K for the year ended December 31, 2012 and the cautionary information regarding forward-looking statements at the end of this section. MD&A includes the following sections:

Our Business. A general description of our business;

2013 First Quarter Overview. A summary of key information concerning the financial results for the three months ended March 31, 2013;

Application of Critical Accounting Policies. A discussion of the accounting policies that are most important to the portrayal of our financial condition and results of operations and that require significant estimates, assumptions, and judgments;

Results of Operations. An analysis of our results of operations for the periods presented in the financial statements;

Liquidity and Capital Resources. An analysis of capital resources, sources and uses of cash, investing and financing activities, off-balance sheet arrangements, contractual obligations and interest rate hedging;

Recent Accounting Pronouncements. See Note 1 to our Condensed Consolidated Financial Statements for a discussion of new accounting pronouncements that affect us; and

Cautionary Information Regarding Forward-Looking Statements. Cautionary information about forward-looking statements.

**Our Business**

Natus is a leading provider of healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments in newborn care, hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and balance and mobility disorders. Product offerings include computerized neurodiagnostic systems for audiology, neurology, polysomnography, and neonatology, as well as newborn care products such as hearing screening systems, phototherapy devices for the treatment of newborn jaundice, head-cooling products for the treatment

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of brain injury in newborns, incubators to control the newborn's environment, and software systems for managing and tracking disorders and diseases for public health laboratories.



**Table of Contents****End Markets**

Our products address two primary end markets:

**Neurology** Includes products for diagnostic electroencephalography (EEG), electromyography (EMG), intra-operative monitoring (IOM), diagnostic sleep analysis, or polysomnography (PSG), newborn brain monitoring, and assessment of balance and mobility disorders.

**Newborn Care** Includes thermoregulation devices and products for the treatment of brain injury and jaundice in newborns and products for newborn hearing screening and diagnostic hearing assessment.

**Segment and Geographic Information**

We operate in one reportable segment in which we provide healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments.

Our end-user customer base includes hospitals, clinics, laboratories, physicians, nurses, audiologists, and governmental agencies. Most of our international sales are to distributors who resell our products to end-users or sub-distributors.

Information regarding our sales and long-lived assets in the U.S. and in countries outside the U.S. is contained in Note 15 *Segment, Customer and Geographic Information* of our condensed consolidated financial statements included in this report.

**Revenue by Product Category**

We generate our revenue either from sales of Devices and Systems, which are generally non-recurring, and from related Supplies and Services, which are generally recurring. The products that are attributable to these categories are described in our Annual Report on Form 10-K for the year ended December 31, 2012. Revenue from Devices and Systems and Supplies and Services, as a percent of total revenue for the three months ended March 31, 2013 and 2012 is as follows:

	Three Months Ended March 31,	
	2013	2012
Devices and Systems	58%	60%
Supplies and Services	42%	40%
<b>Total</b>	<b>100%</b>	<b>100%</b>

During the three months ended March 31, 2013 and 2012, no single customer or foreign country contributed to more than 10% of revenue, and revenue from services was less than 10% of revenue.

**2013 First Quarter Overview**

Our business and operating results are driven in part by worldwide economic conditions. Our sales are significantly dependent on both capital spending by hospitals in the United States and healthcare spending by ministries of health within the European Union.

On February 2, 2013, we completed an asset purchase of the Grass Technologies Product Group ( Grass ) from Astro-Med Inc. and on July 2, 2012, we acquired the Nicolet neurodiagnostic business ( Nicolet ) from CareFusion.

Our consolidated revenue increased \$26.4 million in the first quarter ended March 31, 2013 to \$85.8 million compared to \$59.4 million in the first quarter of the previous year. Grass contributed to \$2.3 million of revenue and Nicolet contributed to \$25.9 million of revenue in the first

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quarter of 2013. We experienced revenue increases across business units in the United States and declines across other business units in Canada, Europe, and South America.

Net income was \$3.4 million or \$0.11 per diluted share in the three months ended March 31, 2013, compared with net income of \$289,000 or \$0.01 per diluted share in the same period in 2012. An increase from 56.1% to 57.4% in gross profit percentage for the first quarter of 2013 compared to same period in 2012 resulted primarily from improved margins associated with product mix as well as pricing changes.

**Table of Contents****Application of Critical Accounting Policies**

We prepare our financial statements in accordance with accounting principles generally accepted in the United States 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, or judgments could have a material effect 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

Inventory is carried at the lower of cost or market value

Carrying value of intangible assets and goodwill

Liability for product warranties

Share-based compensation

These critical accounting policies are described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2012, under Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*. There have been no changes to these policies during the three months ended March 31, 2013.

**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.

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2013</b>	<b>2012</b>
Revenue	100%	100%
Cost of revenue	42.6	43.9
<b>Gross profit</b>	<b>57.4</b>	<b>56.1</b>
Operating expenses:		
Marketing and selling	25.9	28.0
Research and development	9.6	11.4
General and administrative	16.2	16.0
Total operating expenses	51.7	55.4
<b>Income from operations</b>	<b>5.7</b>	<b>0.7</b>
Other income (expense), net	(0.4)	0.3

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Income before provision for income tax	5.3	1.0
Provision for income tax	1.3	(0.5)
Net income	4.0%	0.5%

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As the operations of Grass and Nicolet have been reflected in our consolidated results since their acquisition dates of February 2013 and July 2012, where significant, we have noted the impact of these acquisitions on our results of operations for the three months ended March 31, 2013, as compared to the same period in 2012.

The following discussion reflects the effects of the corrections disclosed in note 17 to the condensed consolidated financial statements.

### **Three Months Ended March 31, 2013 and 2012**

#### **Revenues**

Our consolidated revenue increased by \$26.4 million or 44% to \$85.8 million for the three months ended March 31, 2013, compared to \$59.4 million in the comparable 2012 period. The increase was attributable to our recent acquisitions. Grass, acquired in February 2013 contributed \$2.3 million of revenue in the first quarter of 2013. Nicolet, acquired in July 2012 contributed \$25.9 million of revenue in the first quarter of 2013. Revenue from our products other than Grass and Nicolet decreased by \$1.8 million in 2013, compared to 2012, due in large part to our emphasizing the sale of the newly acquired products that serve the same markets as certain legacy products coupled with the lack of a large international order similar to the \$2.3 million order from the Republic of Iraq Ministry of Health that we fulfilled in the first quarter of 2012.

Revenue from our neurology products increased \$27.3 million or 96% to \$55.7 million in the first quarter of 2013, compared to \$28.4 million in the same period in 2012. Revenue from our neurology products, other than Grass and Nicolet products, decreased by \$900,000 for the three months ended March 31, 2013 compared to 2012. This decline was attributable to weak economic conditions in Europe and to our emphasizing the sales of our newly acquired neurology products. Revenue from our newborn care products decreased by \$900,000, or 3% to \$30.1 million in the first quarter of 2013 compared to \$31 million in the same period in 2012. This decline was primarily attributed to lower sales of newborn care devices and systems partially offset by an increase in newborn care supplies and services.

Revenue from neurology devices and systems was \$34.5 million for the three months ended March 31, 2013, representing an increase of 110% or \$18.1 million, from \$16.4 million reported in the first quarter of 2012. Grass and Nicolet contributed to \$15.2 million of the increase in neurology devices and systems while revenue from our neurology products other than Grass and Nicolet increased by \$2.9 million in the first quarter of 2013 compared to the first quarter of 2012, primarily attributable to an increase in EEG and sleep systems revenue. Revenue from newborn care and other devices and systems was \$15.5 million for the three months ended March 31, 2013, representing a decrease of 20% or \$3.8 million, from \$19.4 million reported in the first quarter of 2012. This decline in newborn care devices and systems revenue was due to lower sales of newborn incubators, balance monitoring and distributed product revenue.

Revenue from devices and systems was 58% of consolidated revenue in the first quarter of 2013 compared to 60% of total revenue in the first quarter of 2012.

Revenue from neurology supplies and services was \$21.2 million for the three months ended March 31, 2013 representing an increase of 77% or \$9.2 million, from \$12 million reported in the first quarter of 2012. Grass and Nicolet contributed to \$12.2 million of the increase in neurology supplies and services. Neurology supplies and services revenue other than Grass and Nicolet, decreased by \$3 million in the first quarter of 2013 compared to the first quarter of 2012. This decline was primarily attributable to a decrease in sleep supplies. Revenue from newborn care supplies and services was \$14.6 million for the three months ended March 31, 2013, representing an increase of 25% or \$2.9 million from \$11.7 million reported in the first quarter of 2012. This increase was comprised primarily of incubator supplies revenue.

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Revenue from supplies and services was 42% of consolidated revenue in the first quarter of 2013 compared to 40% of total revenue in the first quarter of 2012.

No single customer accounted for more than 10% of our revenue in either the first quarter of 2013 or 2012. Revenue from domestic sales increased 59% to \$48.4 million for the three months ended March 31, 2013 from \$30.4 million in the first quarter of 2012. Revenue from international sales increased 29% to \$37.5 million for the three months ended March 31, 2013 compared to \$29.1 million in the first quarter of 2012. Revenue from domestic sales was 56% of total revenue for the three months ended March 31, 2013 compared to 51% of total revenue in the first quarter of 2012, and revenue from international sales was 44% of total revenue in the first quarter of 2013 compared to 49% of total revenue in the first quarter of 2012.

***Cost of Revenue***

Our cost of revenue increased \$10.5 million or 40% to \$36.6 million for the three months ended March 31, 2013 from \$26.1 million in the first quarter of 2012. Grass and Nicolet contributed \$11.2 million to our cost of revenue. Gross profit increased \$15.9 million, or 48%, to \$49.2 million in the first quarter of 2013 from \$33.3 million in the first quarter of 2012 as a result of our increased sales. Gross profit as a percentage of revenue was 57.4% for the three months ended 2013 and 56.1% for the three months ending March 31, 2012 as a result of product mix, primarily as a result of a higher percentage of sales of neurology products which generally carry higher margins than our other products.

***Operating Costs***

Total operating costs increased \$11.5 million or 35% to \$44.4 million for the three months ended March 31, 2013, from \$32.9 million in the first quarter of 2012. The operating expense of Grass and Nicolet contributed to \$10.1 million in operating costs. The newly enacted medical device tax in 2013 accounted for \$1.3 million of the increase in operating costs.

Our marketing and selling expenses increased \$5.6 million or 33% to \$22.2 million in the first quarter of 2013, from \$16.6 million in the first quarter of 2012. Marketing and selling expenses as a percent of total revenue decreased to 25.9% in the first quarter of 2013 from 28% in the first quarter of 2012. The marketing and selling expenses of Grass and Nicolet and were \$5.4 million. The remaining increase in marketing and selling expenses was primarily related to payroll related costs associated with higher revenue.

Our research and development expenses increased \$1.5 million or 22% to \$8.2 million for the three months ended March 31, 2013 from \$6.7 million for the three months ended March 31, 2012. Research and development expenses as a percent of total revenue decreased to 9.6% in the first quarter of 2013 from 11.4% in the first quarter of 2012. The research and development expenses of Grass and Nicolet were \$1.9 million for the three months ended March 31, 2013, partially offset by lower employee compensation costs resulting from cost cutting activities initiated in 2012 in our other operations.

Our general and administrative expenses increased \$4.5 million or 47% to \$14 million for the three months ended March 31, 2013 from \$9.5 million for the three months ended March 31, 2012. General and administrative expenses as a percent of revenue increased to 16.2% in the first quarter of 2013 from 16% in the first quarter of 2012. The general and administrative expense of Grass and Nicolet was \$2.7 million. The newly enacted medical device tax in 2013 accounted for \$1.3 million of the increase in general and administrative expenses.

***Other Income (Expense), net***

Other income (expense), net consists of investment income, interest expense, net currency exchange gains and losses, and other miscellaneous income and expense. We reported other income (expense), net of \$(334,000) for the three months ended March 31, 2013, compared to \$180,000 for the three months ended March 31, 2012. We reported \$198,000 of foreign currency exchange losses in the first quarter of 2013 versus \$261,000 of foreign exchange gains in the first quarter of 2012. Interest expense was \$477,000 for the three months ended March 31, 2013 compared to \$8,000 for the three months ended March 31, 2012 due primarily to borrowings to fund the Nicolet and Grass acquisitions.

***Provision for Income Tax***

We recorded a provision for income tax of \$1.1 million and \$319,000 for the three months ended March 31, 2013 and 2012, respectively. Our effective tax rate was 23.9% and 52.5% for the three months ended March 31, 2013 and 2012, respectively. Our effective tax rate for the three months ended March 31, 2013 differed from statutory tax rates primarily because of profits taxed in foreign jurisdictions with lower tax rates than the statutory rate and tax benefits of approximately \$340,000 derived from the recognition of the 2012 federal research and development tax credit by enactment of the American Taxpayer Relief Act of 2012 in January 2013. For the three months ended March 31, 2012, our effective rate differed from statutory tax rates primarily due to discrete items coupled with losses in some foreign jurisdictions for which we did not

record a tax benefit.

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### **Liquidity and Capital Resources**

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

As of March 31, 2013, we had cash and cash equivalents of \$24.4 million, stockholders' equity of \$272.9 million, and working capital of \$57.1 million, compared with cash and cash equivalents of \$23.1 million, stockholders' equity of \$268.8 million, and working capital of \$70.3 million as of December 31, 2012. The decrease in working capital resulted primarily from \$18 million of short-term borrowings associated with the acquisition of Grass.

As of March 31, 2013, we had cash and cash equivalents outside the U.S. in certain of our foreign operations of approximately \$11.1 million. We currently intend to permanently reinvest the cash held by our foreign subsidiaries. If, however, a portion of these funds were needed for and distributed to our operations in the United States, we would be subject to additional U.S. income taxes and foreign withholding taxes. The amount of taxes due would depend on the amount and manner of repatriation, as well as the location from where the funds are repatriated.

At March 31, 2013 we had a \$60 million revolving credit facility with Wells Fargo Bank, National Association (Wells Fargo). The revolving credit facility contains covenants, including covenants relating to liquidity and other financial measurements, and provides for events of default, including failure to pay any interest when due, failure to perform or observe covenants, bankruptcy or insolvency events, and the occurrence of a material adverse effect, and restricts our ability to pay dividends. We have granted Wells Fargo a security interest in substantially all of our assets. The revolving credit facility was increased from \$50 million to \$60 million in January 2013 to fund the acquisition of Grass. The maximum amount of borrowing under the facility will revert to \$50 million on June 30, 2013.

In February 2013, we acquired through an asset purchase for a cash price of \$18.6 million the Grass Technology Product Group from Astro-Med Inc. We funded this acquisition with a combination of cash-on-hand and an \$18.0 million borrowing under the Wells Fargo credit facility.

We believe that our current cash and cash equivalents and any cash generated from operations will be sufficient to meet our ongoing operating requirements for the foreseeable future. In addition to the Grass and Nicolet acquisitions, we acquired Embla in 2011 and Medix in 2010, and completed two acquisitions in 2009, four acquisitions in 2008, one in 2007, and three in 2006. We intend to continue to acquire additional technologies, products, or businesses and these acquisitions could be significant. These actions would likely affect our future capital requirements and the adequacy of our available funds. In order to finance future acquisitions, we may be required to raise additional funds through public or private financings, strategic relationships or other arrangements. Any equity financing may be dilutive to stockholders, and debt financing, if available, may involve restrictive covenants and increase our cost of capital.

Cash provided by operations decreased by \$7.1 million to (\$935,000) for the three months ended March 31, 2013 compared to an increase of \$6.1 million for the same period in 2012. The sum of our net income and certain non-cash expense items, such as reserves, depreciation and amortization, and share based compensation was approximately \$8.9 million in the first quarter of 2013 period, compared to \$4.9 million in the first quarter of 2012. The overall impact of changes in certain operating assets and liabilities on total operating cash flows resulted in a cash outflow of \$9.8 million in the three months ended March 31, 2013 compared with a cash inflow of \$1.3 million in the 2012 period. In particular, our cash flow from operations in the first three months of 2013 was negatively impacted by a \$6.2 million decrease in accrued expenses and deferred revenue, a \$3.3 million decrease in accounts payable and a \$787,000 increase in accounts receivable partially offset by higher net income.

Cash used by investing activities was \$20 million for the three months ended March 31, 2013, compared to cash used by investing activities of \$1.2 million for the same period in 2012. We used \$18.6 million to acquire businesses during the three months ended March 31, 2013 for which we had no comparable investing activity during the three months ended March 31, 2012. We used \$687,000 and \$1.2 million of cash to acquire property and equipment during the three months ended March 31, 2013 and 2012, respectively.

Cash provided by financing activities was \$22.1 million in the three months ended March 31, 2013, compared to cash used in financing activities of \$17,000 in the three months ended March 31, 2012. In February 2013 we borrowed \$18 million of cash on our credit facility to partially fund the acquisition of Grass and had additional short-term borrowings of \$4 million as of March 31, 2013. We received cash from sales of our stock pursuant to exercise of stock options and contributions to our employee stock purchase plan in the amount of \$2.1 million and \$130,000 in the three months ended March 31, 2013 and 2012, respectively.





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

Extent to which we make acquisitions;

Amount and timing of revenue;

Extent to which our existing and new products gain market acceptance;

Cost and timing of product development efforts and the success of these development efforts;

Cost and timing of marketing and selling activities; and

Availability of borrowings under line of credit arrangements and the availability of other means of financing.

## **Commitments and Contingencies**

In the normal course of business, we enter into obligations and commitments that require future contractual payments. The commitments result primarily from firm, noncancellable purchase orders placed with contract vendors that manufacture some of the components used in our medical devices and related disposable supply products, as well as commitments for leased office, manufacturing, and warehouse facilities. The only material change to the table of contractual obligations presented in Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, of our Annual Report on Form 10-K for the year ended December 31, 2012 has been the result of \$22 million of debt incurred from borrowings against the revolving credit facility as of March 31, 2013.

Under our bylaws, we have agreed to indemnify our officers and directors for certain events or occurrences arising as a result of the officer or director's serving in such capacity. We have a directors and officers' liability insurance policy that limits our exposure and enables us to recover a portion of any future amounts paid resulting from the indemnification of our officers and directors. In addition, we enter into indemnification agreements with other parties in the ordinary course of business. In some cases we have obtained liability insurance providing coverage that limits our exposure for these other indemnified matters. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. We believe the estimated fair value of these indemnification agreements is minimal and have not recorded a liability for these agreements.

## **Recent Accounting Pronouncements**

See Note 1 to our Condensed Consolidated Financial Statements for a discussion of new accounting pronouncements that affect us.

## **Cautionary Information Regarding Forward Looking Statements**

*This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 about Natus Medical Incorporated. 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 belief that the recovery from the worldwide economic downturn has continued, our expectation regarding expansion of our international operations, our expectations regarding our new products, the sufficiency of our current cash, cash equivalents, and short-term investment balances, and any cash generated from operations to meet our ongoing operating and capital requirements for the foreseeable future, the use of debt to fund acquisitions, our expectations of earnout arrangements related to acquisitions, and our intent to acquire additional technologies, products, or businesses.*

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*Forward-looking statements are not guarantees of future performance and are subject to substantial risks and uncertainties that could cause the actual results predicted in the forward-looking statements as well as our future financial condition and results of operations to differ materially from our historical results or currently anticipated results. Investors should carefully review the information contained under the caption "Risk Factors" contained in Part II, Item 1A of this report for a description of risks and uncertainties. All forward-looking statements are based on information available to us on the date hereof, and we assume no obligation to update forward-looking statements.*

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**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

We develop products in the U.S., Canada, Argentina, and Europe and sell those products into more than 100 countries throughout the world. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Most of our sales in Europe and Asia are denominated in U.S. Dollars and Euros and with the acquisitions of Xitek in 2007, Medix in 2010 and Nicolet in 2012, a small portion of our sales are now denominated in Canadian dollars, Argentine pesos and British pounds. As our sales in currencies other than the U.S. Dollar increase, our exposure to foreign currency fluctuations may increase.

In addition, changes in exchange rates also may affect the end-user prices of our products compared to those of our foreign competitors, who may be selling their products based on local currency pricing. These factors may make our products less competitive in some countries.

If the U.S. Dollar uniformly increased or decreased in strength by 10% relative to the currencies in which our sales were denominated, our net income would have correspondingly increased or decreased by an immaterial amount for the three months ended March 31, 2013. Our interest income is sensitive to changes in the general level of interest rates in the U.S. However, because current market conditions have resulted in historically low rates of return on our investments, a hypothetical decrease of 10% in market interest rates would not result in a material decrease in interest income earned on our investments held as of March 31, 2013.

When feasible, we invest excess cash in bank money-market funds or discrete short-term investments. The fair value of short-term investments and cash equivalents ( investments ) is sensitive to changes in the general level of interest rates in the U.S., and the fair value of these investments will fall if market interest rates increase. However, since we generally have the ability to hold the investments to maturity, these declines in fair value may never be realized. If market interest rates were to increase by 10% from levels at March 31, 2013, the fair value of our investments would decline by an immaterial amount.

All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of March 31, 2013. 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**

*Evaluation of Disclosure Controls and Procedures*

Our management, under the supervision of our Chief Executive Officer and Chief Financial Officer and with the participation of our disclosure committee, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of March 31, 2013. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that 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 SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of March 31, 2013 at the reasonable assurance level due to a material weakness that we identified as of December 31, 2012 that has not been remediated. The material weakness relates to our controls over the implementation of a single-platform enterprise resource planning ( ERP ) application for our operations in North America exclusive of Nicolet. In particular, we did not perform adequate user acceptance testing prior to implementing this application to identify processes that were later discovered to not operate as designed. This resulted in an inadequate segregation of duties and inadequate controls over approval of certain journal entries based on the roles assigned to users of the ERP. In addition, given the system implementation issues, we were not able to timely prepare account analyses and reconciliations.

These factors prevented us from completing our financial close and preparation of financial statements on a timely basis, which, in turn, made us unable to file our financial statements by the due date required by the applicable rules and regulations established by the Securities and Exchange Commission.

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### **Management's Remediation Activities**

To remediate the material weakness in our internal control over financial reporting described above, we are developing and implementing new control procedures regarding our ongoing implementation of the ERP application, including the following: (i) devoting additional resources to fixing processes associated with the financial close that were not operating as designed, (ii) revising user roles to provide adequate separation of duties, appropriate approval levels, and review of manual transaction details, and (iii) developing detailed reports to facilitate accurate account analyses and timely reconciliation of accounts. However, the material weakness will not be considered remediated until the applicable remedial controls operate for a sufficient period of time and management has concluded, through testing, that the controls are operating effectively.

### **Changes in Internal Control over Financial Reporting**

Other than the actions taken as described above under Management's Remediation Activities, there were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### **Inherent Limitations on Effectiveness of Controls**

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, even if determined effective and no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives to prevent or detect misstatements. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply judgment in evaluating the benefits of possible controls and procedures relative to their costs. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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**PART II. OTHER INFORMATION**

**ITEM 1. Legal Proceedings**

We may from time to time become a party to various legal proceedings or claims that arise in the ordinary course of business. Our management reviews these matters if and when they arise and believes that the resolution of any such matters currently known will not have a material effect on our results of operations or financial position.

**ITEM 1A. Risk Factors**

**We have completed a number of acquisitions and expect to complete additional acquisitions in the future. There are numerous risks associated with acquisitions and we may not achieve the expected benefit of any of our acquisitions**

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

Our significant acquisitions are as follows: Neometrics in 2003; Fischer-Zoth in 2004; Bio-logic, Deltamed, and Olympic in 2006; Xltex in 2007; Sonamed, Schwarzer Neurology, and Neurocom in 2008; Hawaii Medical and Alpine Biomed in 2009, Medix in 2010, Embla in 2011, Nicolet in 2012, and Grass in 2013.

We expect to continue to pursue opportunities to acquire other businesses in the future. The acquisitions that we have completed may not result in improved operating results for us, or in our achieving a financial condition superior to that which we would have achieved had we not completed them. Our results of operations may be adversely impacted by costs associated with our acquisitions, including one-time charges associated with restructurings. Further, our acquisitions could fail to produce the benefits that we anticipate, or could have other adverse effects that we currently do not foresee. In addition, some of the assumptions that we have relied upon, such as achievement of operating synergies, may not be realized. In this event, one or more of the acquisitions could result in reduced earnings of Natus as compared to the earnings that would have been achieved by Natus if the acquisition had not occurred.

We have assumed contingent obligations associated with earnout provisions in some of our acquisitions. We believe these provisions help us to negotiate mutually agreeable purchase terms between us and the sellers. However, a disagreement between us and a seller about the terms of an earnout provision could result in our paying more for an acquisition than we intended. For example, such disagreements arose in connection with our acquisitions of Alpine Biomed and Schwarzer Neurology. Although we resolved these disputes under terms that were not unfavorable to us, we cannot be assured of such outcomes in the future.

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We used a significant portion of our existing cash resources, in addition to borrowing under our credit facility, to complete the recent acquisitions of the Nicolet business from CareFusion and Grass Technologies. This usage of cash will have an adverse impact on our liquidity, and will force us to place more reliance on cash flow from operations for our liquidity. If our cash flow from operations is not sufficient for our needs, our business could be adversely impacted.

If our cash flow from operations is not sufficient for our needs, our business could be adversely affected. If we are required to seek additional external financing to support our need for cash to fund future acquisitions, we may not have access to financing on terms that are acceptable to us, or at all. Alternatively, we may feel compelled to access additional financing on terms that are dilutive to existing holders of our common stock or that include covenants that restrict our business, or both. If the recent lack of liquidity in credit markets persists into the future, our ability to obtain debt financing for future acquisitions may be impaired.

If we fail to successfully manage the combined operations of Natus and the businesses we have acquired, we may not realize the potential benefits of our acquisitions. Our corporate headquarters are located in San Carlos, California. We also have the following operating divisions: Olympic in Washington; Neurocom in Oregon; Bio-logic in Illinois; Embla and Neometrics in New York; Nicolet in Wisconsin; Grass in Rhode Island; Xltek in Canada; Medix in Argentina; Alpine Biomed in Denmark; Fischer-Zoth, Schwarzer Neurology, IT-Med, and Alpine Biomed Germany (collectively Natus Europe ) in Germany; and Deltamed and Alpine Biomed France (collectively Natus France ) in France. If we fail to manage these disparate operations effectively, our results of operations could be harmed, employee morale could decline, key employees could leave, and customers could cancel existing orders or choose not to place new ones. In addition, we may not achieve the synergies or other benefits of these and future acquisitions that we anticipate. We may encounter the following additional difficulties and delays involved in integrating and managing these operations, and the operations of companies we may acquire:

Failure of customers to continue using the products and services of the combined company;

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

Assumption of unknown liabilities;

Failure to understand products or technologies with which we have limited previous experience;

Failure to compete effectively in new markets;

Decreased liquidity, restrictive bank covenants, and incremental financing costs associated with debt we may incur to complete future acquisitions; and

Diversion of the attention of management from other ongoing business concerns.

Our reported operating results may suffer because of impairment charges incurred to write down the carrying amount of intangible assets, including goodwill, generated as a result of the acquisitions.

### **Our growth in recent years has depended substantially on the completion of acquisitions and we may not be able to complete acquisitions of this nature or of a relative size in the future to support a similar level of growth**

The acquisitions that we have completed have been the primary source of our growth in revenue in recent years. We expend considerable effort in seeking to identify attractive acquisition candidates and, upon doing so, to convince the potential target to consider a sale to us and, ultimately, to negotiate mutually agreeable acquisition terms. If we are not successful in these efforts in the future, our growth rate will not increase at a rate corresponding to that which we have achieved in recent years. Further, as we grow larger it will be necessary to complete the acquisition of larger companies and product lines to support a growth similar to that which we have achieved in the past. The market for

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attractive acquisitions is competitive and others with greater financial resources than we have may be better positioned than we are to acquire desirable targets. Further, we may not be able to negotiate acquisition terms with target companies that will allow us to achieve positive financial returns from the transaction.



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### **We did not file with the SEC a timely amended Current Report on Form 8-K with respect to our Nicolet acquisition and we did not file our Annual Report on Form 10-K for 2012 on a timely basis, which could adversely affect our ability to complete a registered offering of our securities**

As a result of our acquisition of Nicolet in July 2012 we were required to file with the Securities and Exchange Commission an amended Current Report on Form 8-K containing certain audited financial statements of the acquired business. We did not complete the preparation and filing of the required financial statements until subsequent to the due date. As a result of this delay and our failure to file our Annual Report on Form 10-K for 2012 on a timely basis, we may be ineligible for a period of 12 months following the due date of this Annual Report on Form 10-K utilize a Registration Statement on Form S-3 to register securities. Were we to seek to issue securities in a public offering during this 12 month period it could be more costly and time consuming for us to do so as a result of the inability to use this abbreviated form of registration statement.

### **Adverse economic conditions in markets in which we operate may harm our business**

Unfavorable changes in U.S. and international economic environments may adversely affect our business and financial results. Economic conditions in the countries in which we operate and sell products worsened and global financial markets subsequently experienced significant volatility and declines throughout much of 2009. Although these conditions have improved somewhat, unfavorable conditions continue to impact the U.S. and European economies. We are unable to foresee when, or if, these factors might return to historical levels. During challenging economic times, and in tight credit markets, our customers may delay or reduce capital expenditures. This could result in reductions in sales of our products, longer sales cycles, difficulties in collection of accounts receivable, slower adoption of new technologies, and increased price competition, all of which could impact our results of operations and financial condition. In addition, we expect these factors will cause us to be more cautious in evaluating potential acquisition opportunities, which could hinder our ability to grow through acquisition while these conditions persist.

### **We have initiated changes to our information systems that could disrupt our business and our financial results**

We plan to continuously improve our information systems to support the form, functionality, and scale of our business. These types of transitions frequently prove disruptive to the underlying business of an enterprise and may cause us to incur higher costs than we anticipate. Failure to manage a smooth transition to the new systems and the ongoing operations and support of the new systems could materially harm our business operations.

For example, we are currently in the process of implementing the rollout of a world-wide, single-platform enterprise resource planning ( ERP ) application including customer relationship management, product lifecycle management, demand management, consolidation and financial statement generation, and business intelligence. In 2012 we implemented this application in our North American operations, exclusive of the operations of Nicolet. We faced unexpected challenges in preparing our financial statements on a timely basis for the third and fourth quarters of 2012 that were resolved only by devoting additional resources to the close. We may experience difficulties in the implementation of the ERP in our operations outside of North America, which we plan to do in 2013, and we may fail to gain the efficiencies the implementation is designed to produce within the anticipated timeframe. The implementation could also be disruptive to our operations, including the ability to timely ship and track product orders to customers, project inventory requirements, manage our supply chain and otherwise adequately service our customers. Until we have completed this world wide implementation, we will be dependent on multiple platforms.

### **If we do not remediate a material weakness in our internal control over financial reporting, the accuracy and timeliness of our financial reporting may be adversely affected**

Under Section 404 of the Sarbanes-Oxley Act of 2002 and rules promulgated by the SEC, companies are required to conduct a comprehensive evaluation of their internal control over financial reporting. As part of this process, we are required to document and test our internal control over financial reporting; our management is required to assess and issue a report concerning our internal control over financial reporting; and our independent registered public accounting firm is required to attest to and report on the effectiveness of our internal control over financial reporting. Management's assessment of our internal control over financial reporting as of December 31, 2012, identified a control deficiency related to our implementation of the ERP application mentioned above that we and our independent registered public accounting firm regard as a material weakness. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our financial statements will not be prevented or detected and corrected on a timely basis. This material weakness is more fully described in Item 9A. Controls and Procedures - Management's Report on Internal Control Over Financial Reporting. As further discussed in Item 9A, we are developing and implementing new control procedures regarding the roll out of the ERP outside of the U.S., and we are taking steps to remediate this material weakness as it relates to the implementation in the U.S. We will need to monitor and evaluate these procedures to ensure that they are operating effectively. We may be at risk for future material weaknesses, particularly if these new procedures do not operate effectively. The existence of this material weakness and of any other ineffective

controls over our financial reporting could result in one or all of the following:

Restatement of previously filed financial statements;

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Failure to meet our reporting obligations;

Inability to efficiently raise capital through an equity offering;

Loss of investor confidence; and

Negative impact on the trading price of our common stock.

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

Our balance sheet includes significant intangible assets, including goodwill and other acquired intangible assets. The determination of related estimated useful lives and whether these assets are impaired involves significant judgment. Our ability to accurately predict future cash flows related to these intangible assets might be hindered by events over which we have no control. Due to the highly competitive nature of the medical device industry, new technologies could impair the value of our intangible assets if they create market conditions that adversely affect the competitiveness of our products. Further, declines in our market capitalization may be an indicator that our intangible assets or goodwill carrying values exceed their fair values which could lead to potential impairment charges that could impact our operating results. For example, in 2011 we recorded a \$20 million goodwill impairment charge related to our European reporting unit.

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

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

**If health care providers are not adequately reimbursed for procedures conducted with our devices or supplies, or if reimbursement policies change adversely, we may not be successful marketing and selling our products or technologies**

Clinicians, hospitals, and government agencies are unlikely to purchase our products if they are not adequately reimbursed for the procedures conducted with our devices or supplies. Unless a sufficient amount of conclusive, peer-reviewed clinical data about our products has been published, third-party payors, including insurance companies and government agencies, may refuse to provide reimbursement. Furthermore, even if reimbursement is provided, it may not be adequate to fully compensate the clinicians or hospitals. Some third-party payors may impose restrictions on the procedures for which they will provide reimbursement. If health care providers cannot obtain sufficient reimbursement from third-party payors for our products or the screenings conducted with our products, we may not achieve significant market acceptance of our products. Acceptance of our products in international markets will depend upon the availability of adequate reimbursement or funding within prevailing healthcare payment systems. Reimbursement, funding, and healthcare payment systems vary significantly by country. We may not obtain approvals for reimbursement in a timely manner or at all.

Adverse changes in reimbursement policies in general could harm our business. We are unable to predict changes in the reimbursement methods used by third-party health care payors, particularly those in countries and regions outside the U.S. For example, some payors are moving toward a managed care system in which providers contract to provide comprehensive health care for a fixed cost per person. In a managed care system, the cost of our products may not be incorporated into the overall payment for patient care or there may not be adequate reimbursement for our products separate from reimbursement for other procedures.

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**Healthcare reforms, changes in healthcare policies, and changes to third-party reimbursements for our products may affect demand for our products**

In March 2010 the U. S. government signed into law the *Patient Protection and Affordable Care Act* and the *Health Care & Education Reconciliation Act*. These laws are intended to, among other things, curb rising healthcare costs, including those that could significantly affect reimbursement for our products. The policies supporting these laws include: basing reimbursement policies and rates on clinical outcomes; the comparative effectiveness and costs of different treatment technologies and modalities; imposing price controls; and other measures. Future significant changes in the healthcare systems in the United States or elsewhere could also have a negative impact on the demand for our current and future products. These include changes that may reduce reimbursement rates for our products and changes that may be proposed or implemented by the U.S. Presidential administration or Congress.

There are numerous steps required to implement these laws. Because of the unsettled nature of these reforms, we cannot predict what additional healthcare reforms will be implemented at the federal or state level, or the effect that any future legislation or regulation will have on our business. There is also considerable uncertainty of the impact of these reforms on the medical device market as a whole. If we fail to react effectively to the implementation of health care reform, our business may be adversely affected.

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

It is critical to the success of our sales efforts that we educate a sufficient number of clinicians, hospital administrators, and government agencies about our products and the costs and benefits of their use. The commercial success of our products depends upon clinician, government agency, and other third-party payer confidence in the economic and clinical benefits of our products as well as their comfort with the efficacy, reliability, sensitivity and specificity of our products. We believe that clinicians will not use our products unless they determine, based on published peer-reviewed journal articles and experience, that our products provide an accurate and cost-effective alternative to other means of testing or treatment. Our customers may choose to use competitive products, which may be less expensive or may provide faster results than our devices. Clinicians are traditionally slow to adopt new products, testing practices and clinical treatments, partly because of perceived liability risks and the uncertainty of third-party reimbursement. If clinicians, government agencies and hospital administrators do not adopt our products, we may not maintain profitability. Factors that may adversely affect the medical community's acceptance of our products include:

Publication of clinical study results that demonstrate a lack of efficacy or cost-effectiveness of our products;

Changing governmental and physician group guidelines;

Actual or perceived performance, quality, price, and total cost of ownership deficiencies of our products relative to other competitive products;

Our ability to maintain and enhance our existing relationships and to form new relationships with leading physicians, physician organizations, hospitals, state laboratory personnel, and third-party payers;

Changes in state and third-party payer reimbursement policies for our products; and

Repeal of laws requiring universal newborn hearing screening and metabolic screening.

**Sales through group purchasing organizations and sales to high volume purchasers may reduce our average selling prices, which could reduce our operating margins**

We have entered, and expect in the future to enter into agreements with customers who purchase high volumes of our products. Our agreements with these customers may contain discounts from our normal selling prices and other special pricing considerations, which could cause our

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operating margins to decline. In addition, we have entered into agreements to sell our products to members of GPOs, which negotiate volume purchase prices for medical devices and supplies for member hospitals, group practices and other clinics. While we make sales directly to GPO members, the GPO members receive volume discounts from our normal selling price and may receive other special pricing considerations from us. Sales to members of all GPOs accounted for approximately 10%, 12% and 18% of our total revenue during 2012, 2011 and 2010, respectively. Others of our existing customers may be members of GPOs with which we do not have agreements. Our sales efforts through GPOs may conflict with our direct sales efforts to our existing customers. If we enter into agreements with new GPOs and some of our existing customers begin purchasing our products through those GPOs, our operating margins could decline.

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### **Demand for some of our products depends on the capital spending policies of our customers, and changes in these policies could harm our business**

A majority of customers for our products are hospitals, physician offices, and clinics. Many factors, including public policy spending provisions, available resources, and economic cycles have a significant effect on the capital spending policies of these entities and therefore the amount that they can spend on our equipment products. If budget resources limit the capital spending of our customers, they will be unlikely to either purchase any new equipment from us or upgrade to any of our newer equipment products. Lack of liquidity in credit markets and uncertainty about future economic conditions can have an adverse effect on the spending patterns of our customers. These factors can have a significant adverse effect on the demand for our products.

### **Our markets are very competitive and in the United States we sell certain of our products in a mature market**

We face competition from other companies in all of our product lines. Our competitors range from small privately held companies to multinational corporations and their product offerings vary in scope and breadth. We do not believe that any single competitor is dominant in any of our product lines.

The markets for certain of our products in the U.S., including the newborn hearing screening and EEG monitoring markets, are mature and we are unlikely to see significant growth for such products in the U.S. In the U.S. we derive a significant portion of our revenue from the sale of disposable supplies that are used with our hearing screening devices. Because these disposable supply products can generate high margins, we expect that our products, particularly our hearing screening disposable supply products, could face increasing competition, including competitors offering lower prices, which could have an adverse effect on our revenue and margins.

Our competitors may have certain competitive advantages, which include the ability to devote greater resources to the development, promotion, and sale of their products. Consequently, we may need to increase our efforts, and related expenses for research and development, marketing, and selling to maintain or improve our position.

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

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

We intend to develop additional products and technologies, including enhancements of existing products, for the screening, detection, treatment, monitoring and tracking of common medical ailments. Developing new products and improving our existing products to meet the needs of current and future customers requires significant investments in research and development. If we fail to successfully sell new products, update our existing products, or timely react to changes in technology, our operating results may decline as our existing products reach the end of their commercial life cycles.

### **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**

We have expanded our international operations through acquisitions and plan to expand our international sales and marketing efforts to increase sales of our products in foreign countries. We may not realize corresponding growth in revenue from growth in international unit sales, due to the lower average selling prices we receive on sales outside of the U.S. Even if we are able to successfully expand our international selling efforts, we cannot be certain that we will be able to create or increase demand for our products outside of the U.S. Our international operations are subject to other risks, which include:

Impact of possible recessions in economies outside the U.S.;

Political and economic instability, including instability related to war and terrorist attacks;

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Contractual provisions governed by foreign law, such as local law rights to sales commissions by terminated distributors;

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Decreased healthcare spending by foreign governments that would reduce international demand for our products;

Continued strengthening of the U.S. dollar relative to foreign currencies that could make our products less competitive because approximately half of our international sales are denominated in U.S. dollars;

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.

Complying with U.S. regulations that apply to international operations, including trade laws, the U.S. Foreign Corrupt Practices Act, and anti-boycott laws, as well as international laws such as the U.K. Bribery Act;

Loss of business through government tenders that are held annually in many cases; and

Potentially negative consequences from changes in tax laws, including legislative changes concerning taxation of income earned outside of the U.S.

In particular, our international sales could be adversely affected by a strengthening of the U.S. dollar relative to other foreign currencies, which makes our products more costly to international customers for sales denominated in U.S. dollars.

**Our operating results may suffer because of our exposure to foreign currency exchange rate fluctuations**

Substantially all of our sales contracts with our U.S. based customers provide for payment in U.S. dollars. With the exception of our Canadian operations, substantially all of the revenue and expenses of our foreign subsidiaries are denominated in the applicable foreign currency. To date we have executed only limited foreign currency contracts to hedge these currency risks. Our future revenue and expenses may be subject to volatility due to exchange rate fluctuations that could result in foreign exchange gains and losses associated with foreign currency transactions and the translation of assets and liabilities denominated in foreign currencies.

Substantially all our sales from our U.S. operations to our international distributors provide for payment in U.S. dollars. A strengthening of the U.S. dollar relative to other foreign currencies could increase the effective cost of our products to our international distributors as their functional currency is typically not the U.S. dollar. This could have a potential adverse effect on our ability to increase or maintain average selling prices of our products to our foreign-based customers.

**If guidelines mandating universal newborn hearing screening do not continue to develop in foreign countries and governments do not mandate testing of all newborns as we anticipate, or if those guidelines have a long phase-in period, our sales of newborn hearing screening products may not achieve the revenue growth we have achieved in the past**



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We estimate that approximately 95% of the children born in the U.S. are currently being tested for hearing impairment prior to discharge from the hospital. To date, there has been only limited adoption of newborn hearing screening prior to hospital discharge by foreign governments, and when newborn hearing screening programs are enacted by foreign governments there can be a phase-in period spanning several years. The widespread adoption of 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 hearing screening as well as the use of our products to perform the screening and monitoring. Our revenue from our newborn hearing screening product lines may not grow if foreign governments do not require universal newborn hearing screening prior to hospital discharge, if physicians or hospitals are slow to comply with those guidelines, or if governments provide for a lengthy phase-in period for compliance.

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

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

We may be subject to foreign laws governing our relationships with our international distributors. These laws may require us to make payments to our distributors if we terminate our relationship for any reason, including for cause. Some countries require termination payments under local law or legislation that may supersede our contractual relationship with the distributor. Any required payments would adversely affect our operating results.

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

We contract with third parties for the supply of some of the components used in our products and the production of our disposable products. Some of our suppliers are not obligated to continue to supply us. We have relatively few sources of supply for some of the components used in our products and in some cases we rely entirely on sole-source suppliers. In addition, the lead-time involved in the manufacturing of some of these components can be lengthy and unpredictable. If our suppliers become unwilling or unable to supply us with components meeting our requirements, it might be difficult to establish additional or replacement suppliers in a timely manner, or at all. This would cause our product sales to be disrupted and our revenue and operating results to suffer.

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

### **We depend upon key employees in a competitive market for skilled personnel, and, without additional employees, we cannot grow or maintain profitability**

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

### **Our ability to market and sell products depends upon receipt of domestic and foreign regulatory approval of our products and manufacturing operations. Our failure to obtain or maintain regulatory approvals and compliance could negatively affect our business**

Our products and manufacturing operations are subject to extensive regulation in the United States by the FDA and by similar regulatory agencies in other countries. Our products are classified as medical devices. Medical devices are subject to extensive regulation by the FDA pursuant to regulations that are wide ranging and govern, among other things: design and development; manufacturing and testing; labeling; storage and record keeping; advertising, promotion, marketing, sales distribution and export; and surveillance and reporting of deaths or serious injuries.

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

Clearance via Section 510(k) of the Food, Drug, and Cosmetics Act of 1938, as amended; or

Premarket approval via Section 515 of the Food, Drug, and Cosmetics Act if the FDA has determined that the medical device in question poses a greater risk of injury.

The FDA will clear marketing of a medical device through the 510(k) process if it is demonstrated that the new product is substantially equivalent to other 510(k)-cleared products. The premarket approval application process is much more costly, lengthy and uncertain than the 510(k) process, and must be supported by extensive data from preclinical studies and human clinical trials. The FDA may not grant either 510(k) clearance or premarket approval for any product we propose to market. Further, any modification to a 510(k)-cleared device that could significantly affect its safety or effectiveness, or that would constitute a major change in its intended use, design or manufacture, requires a new 510(k) clearance or, possibly, approval of a premarket approval application. The FDA requires every manufacturer to make this determination in the first instance, but the FDA may review any manufacturer's decision. If the FDA requires us to seek 510(k) clearance or premarket approval for modification of a previously cleared product for which we have concluded that new clearances or approvals are unnecessary, we may be required to cease marketing or to recall the modified product until we obtain clearance or approval, and we may be subject to significant regulatory fines or penalties. Further, our products could be subject to recall if the FDA determines, for any reason, that our products are not safe or effective.

Delays in receipt of, or failure to receive, clearances or approvals, the loss of previously received clearances or approvals, or the failure to comply with existing or future regulatory requirements could adversely impact our operating results. 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 Section 510(k) clearance or premarket approval of new products;

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

Criminal prosecution.

Domestic regulation of our products and manufacturing operations, other than that which is administered by the FDA, includes the Environmental Protection Act, the Occupational Safety and Health Act, and state and local counterparts to these Acts.

**Our business would be harmed if the FDA determines that we have failed to comply with applicable regulations governing the manufacture of our products and/or we do not pass an inspection**

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We and our suppliers are required to demonstrate and maintain compliance with the FDA's Quality System Regulation. The Quality System Regulation sets forth the FDA's requirements for good manufacturing practices of medical devices and includes requirements for, among other things, the design, testing, production processes, controls, quality assurance, labeling, packaging, storage and shipping of such products. In addition, we and our suppliers must engage in extensive recordkeeping and reporting and must make available our manufacturing facility and records for periodic unscheduled inspections by federal, state and foreign agencies, including the FDA. We cannot assure you that we and our suppliers are or will continue to be in full compliance with the Quality System Regulation, and that we will not encounter any manufacturing difficulties.

Failure of our third party suppliers and manufacturers or us to comply with applicable regulations could result in sanctions being imposed on us, including, among other things, fines, injunctions, civil penalties, failure of regulatory authorities to grant marketing approval of our products, delays, suspension or withdrawal of approvals, seizures or recalls of products and manufacturing restrictions, any of which could harm our business.

### **Our Olympic Cool-Cap product is subject to greater products liability exposure and FDA regulation**

The FDA classifies medical devices into one of three classes depending on the degree of risk associated with each medical device and the extent of controls that are needed to ensure safety and effectiveness. Devices deemed to pose lower risk are placed in either Class I or Class II. Devices deemed by the FDA to pose the greatest risk, such as life-sustaining, life supporting or implantable devices, or a device deemed to not be substantially equivalent to a previously cleared 510(k) device are placed in Class III, and generally require premarket approval from the FDA before they may be marketed.

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Our Olympic Cool-Cap is a Class III minimally invasive medical device, and as such we may be subject to an increased product liability risk relative to our other Class I and Class II non-invasive products. In addition, this type of product is subject to greater FDA oversight than our other products and there is greater risk that sales of the product could be interrupted due to the premarket approval processes of the FDA and other regulatory bodies.

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

We are prohibited by the FDA from promoting or advertising our medical device products for uses not within the scope of our clearances or approvals, or from making unsupported promotional claims about the benefits of our products. If the FDA determines that our claims are outside the scope of our clearances, or are unsupported, it could require us to revise our promotional claims or take enforcement action against us. If we were subject to such an action by the FDA, our sales could be delayed, our revenue could decline, and our reputation among clinicians could be harmed. Likewise, if we acquire new products, either through the purchase of products, technology assets, or businesses, that are subsequently deemed to have inadequate supporting data, we may be required to (i) obtain adequate data, which could be costly and impede our ability to market these products, or (ii) modify the labeling on these products, which could impair their marketability, as described above.

**If we deliver products with defects, we may incur costs to repair and, possibly, recall that product and market acceptance of our products may decrease.**

The manufacturing and marketing of our products involve an inherent risk of our delivering a defective product or products that do not otherwise perform as we expect. We may incur substantial expense to repair any such products and may determine to recall such a product, even if not required to do so under applicable regulations. Any such recall would be time consuming and expensive. Product defects or recalls may adversely affect our customers' acceptance of the recalled and other of our products. As an example, in the second quarter of 2010 we discontinued selling the Sonamed Clarity newborn hearing screening product line and incurred costs associated with sales concessions awarded customers who traded in a Clarity device for one of our existing newborn hearing screening devices and the write-down of inventory. We also recorded an impairment charge to write-off the carrying value of the Sonamed and Clarity tradenames.

**If we fail to comply with healthcare regulations, we could face substantial penalties and our business, operations and financial condition could be adversely affected.**

We do not provide healthcare services, control the referral of patients for healthcare services, nor bill Medicare, Medicaid or other third-party payors; however, due to the breadth of many healthcare laws and regulations, we could be subject to healthcare fraud regulation and enforcement by both the federal government and the states in which we conduct our business. The laws that may affect our ability to operate include: (i) the federal healthcare programs Anti-Kickback Law, which prohibits, among other things, persons from knowingly and willfully soliciting, receiving, offering or paying remuneration, directly or indirectly, in exchange for or to induce either the referral of an individual for, or the purchase, order or recommendation of, any good or service for which payment may be made under federal healthcare programs such as Medicare or Medicaid, (ii) federal false claims laws which prohibit, among other things, individuals or entities from knowingly presenting, or causing to be presented, claims for payment from Medicare, Medicaid, or other third-party payors that are false or fraudulent, and which may apply to entities like us which provide coding and billing advice to customers, and/or (iii) state law equivalents of each of the above federal laws, such as anti-kickback and false claims laws which may apply to items or services reimbursed by any third-party payor, including commercial insurers, many of which differ from their federal counterparts in significant ways, thus complicating compliance efforts.

If our operations are found to be in violation of any of the laws described above or any other governmental regulations that apply to us, we may be subject to penalties, including civil and criminal penalties, damages, fines and the curtailment or restructuring of our operations. Any penalties, damages, fines, curtailment or restructuring of our operations could adversely affect our ability to operate our business and our financial results. The risk of our being found in violation of these laws is increased by the fact that their provisions are open to a variety of interpretations. Any action against us for violation of these laws, even if we successfully defend against it, could cause us to incur significant legal expenses and divert our management's attention from the operation of our business.

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

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

Result in costly litigation and damage awards;

Divert our management's attention and resources;

Cause product shipment delays or suspensions; or

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

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

We may also find it necessary to bring infringement actions against third parties to seek to protect our intellectual property rights. Litigation of this nature, even if successful, is often expensive and disruptive of our management's attention, and in any event may not lead to a successful result relative to the resources dedicated to any such litigation.

### **We license intellectual property rights from third parties and would be adversely affected if our licensors do not appropriately defend their proprietary rights or if we breach any of the agreements under which we license commercialization rights to products or technology from others**

We license rights from third parties for products and technology that are important to our business. If our licensors are unsuccessful in asserting and defending their proprietary rights, including patent rights and trade secrets, we may lose the competitive advantages we have through selling products that we license from third parties. Additionally, if it is found that our licensors infringe on the proprietary rights of others, we may be prohibited from marketing our existing products that incorporate those proprietary rights. Under our licenses, we are subject to commercialization and development, sublicensing, royalty, insurance and other obligations. If we fail to comply with any of these requirements, or otherwise breach a license agreement, the licensor may have the right to terminate the license in whole or to terminate the exclusive nature of the license.

### **Product liability suits against us could result in expensive and time consuming litigation, payment of substantial damages, and an increase in our insurance rates**

The sale and use of our products could lead to the filing of a product liability claim by someone claiming to have been injured using one of our products or claiming that one of our products failed to perform properly. A product liability claim could result in substantial damages and be costly and time consuming to defend, either of which could materially harm our business reputation or financial condition. Our product liability insurance may not protect our assets from the financial impact of defending a product liability claim. Any product liability claim brought against us, with or without merit, could increase our product liability insurance rates or prevent us from securing any coverage in the future.

### **We have experienced seasonality in the sale of our products**

We experience seasonality in our revenue. For example, our sales typically decline from our fourth fiscal quarter to our first fiscal quarter, due to patterns in the capital budgeting and purchasing cycles of our customers, many of which are government agencies, and the compensation arrangements of our direct sales employees, as those arrangements are tied to calendar-year sales plans. 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

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fluctuations, which may lead to fluctuations in our quarterly operating results. We believe that you should not rely on our results of operations for interim periods as an indication of our expected results in any future period.

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## (a) Exhibits

Exhibit No.	Exhibit	Incorporated By Reference		
		Filing	Exhibit No.	File No. File Date
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002			
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002			
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002			
101.INS*	XBRL Instance Document			
101.SCH*	XBRL Taxonomy Extension Schema Document			
101.CAL*	XBRL Taxonomy Extension Label Calculation Linkbase Document			
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document			
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document			
101.DEF*	XBRL Taxonomy Extension Definition Document			

\* Pursuant to Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Annual Report on Form 10-K shall not be deemed to be filed for purposes of section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be deemed part of a registration statement, prospectus or other document filed under the Securities Act or Exchange Act, except as may be expressly set forth by specific reference in such filings.



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**SIGNATURES**

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

Dated: May 21, 2013

NATUS MEDICAL INCORPORATED

By: /s/ James B. Hawkins

**James B. Hawkins**

**Chief Executive Officer**

**(Principal Executive Officer)**

Dated: May 21, 2013

By: /s/ Jonathan Kennedy

**Jonathan Kennedy**

**Senior Vice President Finance and**

**Chief Financial Officer**

**(Principal Financial and**

**Accounting Officer)**

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