

NATUS MEDICAL INC  
Form 10-Q  
May 07, 2014  
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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, 2014**

.. **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)**

**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):

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Large Accelerated filer  Accelerated filer  x  
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  x

The number of issued and outstanding shares of the registrant's Common Stock, \$0.001 par value, as of May 5, 2014 was 32,142,534.

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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)**

	<b>March 31, 2014</b>	<b>December 31, 2013</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 59,589	\$ 56,106
Accounts receivable, net of allowance for doubtful accounts of \$3,618 in 2014 and \$2,962 in 2013	79,933	82,110
Inventories	35,455	37,685
Prepaid expenses and other current assets	14,218	11,904
Deferred income tax	9,055	8,956
<b>Total current assets</b>	<b>198,250</b>	<b>196,761</b>
Property and equipment, net	21,530	23,295
Intangible assets	98,141	98,820
Goodwill	100,929	97,238
Other assets	10,441	10,324
<b>Total assets</b>	<b>\$ 429,291</b>	<b>\$ 426,438</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 26,057	\$ 29,777
Current portion of long-term debt	10,437	10,517
Accrued liabilities	25,750	26,831
Deferred revenue	11,775	12,946
<b>Total current liabilities</b>	<b>74,019</b>	<b>80,071</b>
Long-term liabilities:		
Long-term debt, net of current portion	22,500	27,500
Other liabilities	3,207	2,845
Deferred income tax	9,748	9,704
<b>Total liabilities</b>	<b>109,474</b>	<b>120,120</b>

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Stockholders' equity:

Common Stock, \$0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 32,102,547 in 2014 and 31,401,602 in 2013	302,109	292,055
Retained earnings	40,767	34,516
Accumulated other comprehensive loss	(23,059)	(20,253)
Total stockholders' equity	319,817	306,318
Total liabilities and stockholders' equity	\$ 429,291	\$ 426,438

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

**Table of Contents****NATUS MEDICAL INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME****(unaudited)****(in thousands, except per share amounts)**

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Revenue	\$ 85,624	\$ 85,834
Cost of revenue	35,733	36,601
Gross profit	49,891	49,233
Operating expenses:		
Marketing and selling	21,422	22,196
Research and development	7,508	8,212
General and administrative	12,280	13,966
Total operating expenses	41,210	44,374
Income from operations	8,681	4,859
Other income (expense), net	312	(334)
Income before provision for income tax	8,993	4,525
Provision for income tax expense	2,742	1,083
Net income	\$ 6,251	\$ 3,442
Foreign currency translation adjustment	(2,891)	(2,331)
Comprehensive income	\$ 3,360	\$ 1,111
Earnings per share:		
Basic	\$ 0.20	\$ 0.12
Diluted	\$ 0.19	\$ 0.11
Weighted average shares used in the calculation of earnings per share:		
Basic	31,062	29,570
Diluted	32,185	30,319

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





**Table of Contents****NATUS MEDICAL INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)****(in thousands)**

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
<b>Operating activities:</b>		
Net income	\$ 6,251	\$ 3,442
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,302	3,133
Provision for losses on accounts receivable	465	372
Warranty reserve	390	656
Loss on disposal of property and equipment		6
Share-based compensation	1,609	1,360
Excess tax benefit on the exercise of stock options	(2,194)	(81)
Changes in operating assets and liabilities:		
Accounts receivable	708	(787)
Inventories	1,633	64
Prepaid expenses and other assets	(1,936)	734
Accounts payable	(2,710)	(3,302)
Deferred income tax	1,844	(304)
Accrued liabilities and deferred revenue	(3,678)	(6,228)
Net cash provided by (used in) operating activities	5,684	(935)
<b>Investing activities:</b>		
Acquisition of businesses, net of cash acquired	(4,925)	(18,600)
Purchases of property and equipment	(806)	(687)
Purchase of intangible assets	(35)	(669)
Net cash used in investing activities	(5,766)	(19,956)
<b>Financing activities:</b>		
Proceeds from stock option exercises and ESPP purchases	6,300	2,115
Excess tax benefit on the exercise of stock options	2,194	81
Proceeds from short-term borrowings		22,000
Payments on borrowings	(5,079)	(2,142)
Net cash provided by financing activities	3,415	22,054
Exchange rate changes effect on cash and cash equivalents	150	134

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Net increase in cash and cash equivalents	3,483	1,297
Cash and cash equivalents, beginning of period	56,106	23,057
Cash and cash equivalents, end of period	\$ 59,589	\$ 24,354
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 186	\$ 613
Cash paid for income taxes	\$ 574	\$ 4,214
Non-cash investing activities:		
Property and equipment included in accounts payable	\$ 265	\$ 261
Inventory transferred to property and equipment	\$ 398	\$

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 ). 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, 2013.

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, 2013 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, 2013.

Operating results for the three months ended March 31, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. 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**

Recently issued FASB guidance and Securities and Exchange Commission ( SEC ) Staff Accounting Bulletins have either been implemented, with no significant effect, or are not applicable to the Company.

**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 total cash consideration of \$21.0 million pursuant to purchase agreement. Included in the total cash consideration is an adjustment of \$2.4 million made in the first quarter of 2014 for inventory purchase commitments. 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. The acquisition strengthened the Company s existing neurology portfolio and provided new product categories. A total of \$624,000 of direct costs associated with the acquisition was expensed as incurred and reported as a component of general and administrative expenses.

The Company has accounted 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 our consolidated financial statements as of February 2, 2013, the date of the acquisition.

Valuing certain components of the acquisition required us to make significant estimates. In the first quarter of 2014, the remaining information was obtained requiring adjustments to these estimates. The final adjustments in the first quarter of 2014 resulted in an adjustment to the preliminary purchase price allocation, with an offsetting adjustment to goodwill. These adjustments were deemed immaterial and as a result our financial statements were not adjusted retrospectively.

Approximately \$7.0 million has been allocated to goodwill. Goodwill is calculated as the difference between the acquisition date fair value of the consideration transferred and the values assigned to the assets acquired and liabilities assumed and represent 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).

**Table of Contents****Pro forma financial information**

The following unaudited pro forma information combining results of operations of the Company for the three months ended March 31, 2014 and 2013 are presented as if the acquisition of Grass had occurred on January 1, 2013:

**Unaudited Pro forma Financial Information****(in thousands)**

	<b>Three Months Ended March 31, 2013</b>
Revenue	\$ 86,839
Income from operations	\$ 5,239

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.

For purposes of preparing the unaudited pro forma financial information for the period January 1, 2013 through March 31, 2013, Grass' statement of operations for the period from January 1, 2013 to February 1, 2013 was combined with our consolidated statement of operations and comprehensive income (loss) for the three months ended March 31, 2013.

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 \$624,000 related to the direct acquisition costs that were recorded in the unaudited pro forma financial information in the three months ended March 31, 2013.

**Hearing Screening as a Service**

In the first quarter of 2014, the company entered into two asset purchase agreements for companies in the newborn hearing screening services market for a total consideration of \$3.6 million. The first, Tender Touch Infant Hearing ( Tender Touch ), was acquired on January 16, 2014, and the second, Hearing Health Consultants LLC ( HHC ), was acquired on March 10, 2014. Both acquisitions support the Company's objective to enter this market that complements

our hearing business.

### **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, 2014, common stock equivalents of 1,123,806 shares were included in the weighted average shares outstanding used to calculate diluted earnings per share, while common stock equivalents of 229,990 shares 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.

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**Table of Contents****4 - Inventories**

Inventories consist of the following (in thousands):

	March 31, 2014	December 31, 2013
Raw materials and subassemblies	\$ 21,381	\$ 24,312
Work in process	2,053	2,584
Finished goods	19,731	17,861
Total inventories	43,165	44,757
Less: Non-current inventories	(7,710)	(7,072)
Inventories, current	\$ 35,455	\$ 37,685

At March 31, 2014 and December 31, 2013, the Company has classified \$7.7 million and \$7.1 million respectively, of inventories, as non-current other assets. 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, 2014			December 31, 2013				
	Gross Carrying Amount	Accumulated Impairment	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Impairment	Accumulated Amortization	Net Book Value
Intangible assets with definite lives:								
Technology	\$ 65,746		\$ (26,965)	\$ 38,781	\$ 65,904		\$ (25,519)	\$ 40,385
Customer related	32,278		(10,293)	21,985	31,231		(9,763)	21,468
Internally developed software	11,917		(5,395)	6,522	11,069		(5,107)	5,962
Patents	2,723		(2,121)	602	2,724		(2,094)	630
Backlog	722		(722)		722		(722)	
Definite-lived intangible assets	113,386		(45,496)	67,890	111,650		(43,205)	68,445
Intangible assets with indefinite lives:								

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Tradenames	33,311	(3,060)		30,251	33,435	(3,060)		30,375
Total Intangibles	\$ 146,697	\$ (3,060)	\$ (45,496)	\$ 98,141	\$ 145,085	\$ (3,060)	\$ (43,205)	\$ 98,820

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 \$10.4 million relating to costs incurred for development of internal use computer software and \$1.5 million for development of software to be sold.

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2014</b>	<b>2013</b>
Technology	\$ 1,096	\$ 963
Customer Related	647	601
Internally developed software	288	239
Patents	30	20
<b>Total amortization</b>	<b>\$ 2,061</b>	<b>\$ 1,823</b>



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

Nine months ending December 31, 2014	\$ 5,965
2015	7,736
2016	6,863
2017	6,502
2018	6,236
2019	5,333
Thereafter	29,255
Total expected amortization expense	\$ 67,890

**6 Goodwill**

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

As of December 31, 2013	\$ 97,238
Acquisitions/Purchase Accounting Adjustments	4,001
Foreign currency translation	(310)
As of March 31, 2014	\$ 100,929

**7 - Property and Equipment, net**

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

	<b>March 31, 2014</b>	<b>December 31, 2013</b>
Land	\$ 4,023	\$ 4,152
Buildings	9,490	10,269
Leasehold improvements	2,795	2,789
Office furniture and equipment	10,920	10,719
Computer software and hardware	9,869	9,362
Demonstration and loaned equipment	9,557	10,320
	46,654	47,611
Accumulated depreciation and amortization	(25,124)	(24,316)
<b>Total</b>	<b>\$ 21,530</b>	<b>\$ 23,295</b>

Depreciation and amortization expense of property and equipment was approximately \$1.2 million for the three months ended March 31, 2014, and was approximately \$1.1 million for the three months ended March 31, 2013.

## **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 that are generally over one year in length. 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 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.

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

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Balance, beginning of period	\$ 3,143	\$ 2,260
Acquisition warranty assumed		191
Warranty accrued for the period	390	656
Repairs for the period	(522)	(464)
Balance, end of period	\$ 3,011	\$ 2,643

**9 - Share-Based Compensation**

At March 31, 2014, 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, 2014 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, 2013.

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

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Cost of revenue	\$ 28	\$ 59
Marketing and sales	235	271
Research and development	146	117
General and administrative	1,199	913
Total	\$ 1,609	\$ 1,360

As of March 31, 2014, unrecognized compensation expense related to the unvested portion of our stock options and other stock awards was approximately \$16.5 million, which is expected to be recognized over a weighted average period of 2.8 years.

**10 - Income Taxes****Provision for Income Tax Expense**

We recorded provisions for income tax of \$2.7 million and \$1.1 million for the three months ended March 31, 2014 and 2013, respectively. Our effective tax rate was 30.5% and 23.9% for the three month period ended March 31, 2014 and 2013, respectively.

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Our effective tax rate for the three months ended March 31, 2014 differed from statutory tax rates primarily because of profits taxed in foreign jurisdictions with lower tax rates than the statutory rate. Several temporary tax provisions including research and development tax credits and tax relief provisions to foreign income were expired on December 31 2013 as a part of the America Taxpayer Relief of 2012, which resulted in a higher effective tax rate for the three months ended March 31, 2014 compared with the effective tax rate for the three months ended ended March 31, 2013.

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.

We recorded a tax expense of \$114,000 for new unrecognized tax benefits for the three months ended March 31, 2014. Included in the balance of unrecognized tax benefits on March 31, 2014 is \$585,000 related to the tax positions for which it is reasonably possible that the total amount could change during the next twelve months,

Our tax returns remain open to examination as follows: U.S. Federal, 2010 through 2013, U.S. States 2009 through 2013 and significant foreign jurisdictions, 2009 through 2013.

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The Company has historically incurred an ongoing level of restructuring-type activities to maintain a competitive cost structure, including manufacturing and workforce optimization resulting from acquisitions.

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 the three months ended March 31, 2014 is as follows (in thousands):

Balance at December 31, 2013	\$ 335
Expensed	8
Cash payments	(215)
Balance at March 31, 2014	128

**12 - Debt and Credit Arrangements**

At March 31, 2014 the Company had a \$75 million credit facility consisting of a \$25 million revolving credit line and a \$50 million 5-year term loan with Wells Fargo Bank, National Association ( Wells Fargo ). The \$25 million credit line is fully available under the credit agreement. The 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 are in compliance with all covenants as of March 31, 2014. We have granted Wells Fargo a security interest in substantially all of our assets. We have no other significant credit facilities.

During the first quarter 2013 we borrowed \$22 million under the credit facility principally to fund the Grass acquisition and to provide for other working capital needs. We had no additional borrowings.

The credit facility was increased to \$75 million in June 2013 and the term was extended to five years. As part of the amended credit facility in June 2013, we converted \$31.2 million of short-term revolving debt to a term loan, increasing the term loan from \$18.8 million as of March 31, 2013 to \$50 million as of June 30, 2013.

During the fourth quarter of 2013 and the first quarter of 2014 additional principal payments of \$7.5 million and \$5.0 million were made respectively. As a result of these additional principal payments the final payment on this term loan is scheduled to be made on or about June 30, 2017.

Long-term debt is comprised of the following (2014 and 2013 columns in thousands):

	March 31, 2014	December 31, 2013
Term loan \$50 million, interest at LIBOR plus 1.75%, due September 30, 2018 with term loan principle repayable in quarterly installments of \$2.5 million	\$ 32,500	\$ 37,500

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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 \$404,000 collateralized by a first lien on company owned land and building

	437	517
<b>Total</b>	<b>32,937</b>	<b>38,017</b>
Less: current portion of long-term debt	(10,437)	(10,517)
<b>Total long-term debt</b>	<b>\$ 22,500</b>	<b>\$ 27,500</b>

Maturities of long-term debt as of March 31, 2014 are as follows (in thousands):

Nine months ended December 31, 2014	\$ 7,937
2015	10,000
2016	10,000
2017	5,000
<b>Total</b>	<b>\$ 32,937</b>

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At March 31, 2014 and December 31, 2013, the carrying value of total debt approximates fair market value. The fair value of the Company's debt is considered a Level 2 measurement.

**13 - 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 is as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
<b>Consolidated Revenue:</b>		
United States	\$ 48,346	\$ 48,364
Foreign countries	37,278	37,470
<b>Totals</b>	<b>\$ 85,624</b>	<b>\$ 85,834</b>

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
<b>Revenue by End Market:</b>		
<b>Neurology Products</b>		
Devices and Systems	\$ 36,116	\$ 34,707
Supplies	14,226	15,447
Services	6,144	5,553
<b>Total Neurology Revenue</b>	<b>56,486</b>	<b>55,707</b>
<b>Newborn Care Products</b>		
Devices and Systems	14,924	17,250
Supplies	12,276	11,464
Services	1,938	1,413
<b>Total Newborn Care Revenue</b>	<b>29,138</b>	<b>30,127</b>
<b>Total Revenue</b>	<b>\$ 85,624</b>	<b>\$ 85,834</b>

	<b>March 31, 2014</b>	<b>December 31, 2013</b>
Property and equipment, net:		
United States	\$ 9,265	\$ 9,619
Canada	5,868	6,060
Argentina	3,941	4,932
Other foreign countries	2,456	2,684
Totals	\$ 21,530	\$ 23,295

During the three months ended March 31, 2014 and 2013, no single customer or foreign country contributed to more than 10% of revenue.



**Table of Contents****14 - 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 Company does not have any financial assets or liabilities measured at fair value on a recurring basis.

The following financial instruments are not measured at fair value on the Company's condensed consolidated balance sheet as of March 31, 2014 and December 31, 2013, but require disclosure of their fair values: cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities and debt. Except for debt, the carrying value of these financial instruments approximates fair values because of their relatively short maturity.

The carrying amount of the Company's long term debt approximates fair value based on Level 2 inputs since the debt carries a variable interest rate that is tied to the current LIBOR rate plus a spread.

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

### **Registered Trademarks and Tradenames**

*Natus*<sup>®</sup>, *AABR*<sup>®</sup>, *ABaer*<sup>®</sup>, *ALGO*<sup>®</sup>, *AOAE*<sup>®</sup>, *AuDX*<sup>®</sup> *Aura*<sup>®</sup>, *Balance Manager*<sup>®</sup>, *Balance Master*<sup>®</sup>, *Balance Shape*<sup>®</sup>, *Biliband*<sup>®</sup>, *Bio-logic*<sup>®</sup>, *Bo-JECT*<sup>®</sup>, *Brain Atlas*<sup>®</sup>, *Ceegraph*<sup>®</sup>, *CHAMP*<sup>®</sup>, *Clarity System*<sup>®</sup>, *Cochlea Scan*<sup>®</sup>, *Cool Cap*<sup>®</sup>, *CoolCare*<sup>®</sup>, *Comet*<sup>®</sup>, *Dantec*<sup>®</sup>, *Ear Couplers*<sup>®</sup>, *Ear Muffin*<sup>®</sup>, *EC2*<sup>®</sup>, *Echo Screen*<sup>®</sup>, *Embla US*<sup>®</sup>, *Embletta*<sup>®</sup>, *Enterprise*<sup>®</sup>, *EquiTest*<sup>®</sup>, *Fass*<sup>®</sup>, *Fischer-Zoth*<sup>®</sup>, *Flexicoupler*<sup>®</sup>, *Grass*<sup>®</sup>, *Grass Technologies*<sup>®</sup>, *Gumdrop*<sup>®</sup>, *Halo Ear Muffin*<sup>®</sup>, *Hawaii Medical*<sup>®</sup>, *Keypoint*<sup>®</sup>, *Keypoint AU*<sup>®</sup>, *Keypoint EU*<sup>®</sup>, *Keypoint JP*<sup>®</sup>, *MASTER*<sup>®</sup>, *Medelec*<sup>®</sup>, *Medix*<sup>®</sup>, *Medix I.C.S.A.*<sup>®</sup>, *Navigator*<sup>®</sup>, *Neatnick*<sup>®</sup>, *neoBLUE*<sup>®</sup>, *Neurocom*<sup>®</sup>, *Neuromax*<sup>®</sup>, *Neurotrac*<sup>®</sup>, *NeuroWorks*<sup>®</sup>, *Nicolet*<sup>®</sup>, *NicoletElite*<sup>®</sup>, *Oxydome*<sup>®</sup>, *Panorama*<sup>®</sup>, *Pocket*<sup>®</sup>, *Polyview*<sup>®</sup>, *REMBRANDT*<sup>®</sup>, *REMlogic*<sup>®</sup>, *Sandman*<sup>®</sup>, *Scout*<sup>®</sup>, *Sleeprite*<sup>®</sup>, *Sleepscan*<sup>®</sup>, *Sleeptrek*<sup>®</sup>, *Smart Scale*<sup>®</sup>, *Sonamed*<sup>®</sup>, *Sonara*<sup>®</sup>, *Sonara TEK*<sup>®</sup>, *Stellate Notta*<sup>®</sup>, *STETHODOP*<sup>®</sup>, *SZAC*<sup>®</sup>, *TECA*<sup>®</sup>, *Tootsweet*<sup>®</sup>, *Traveler*<sup>®</sup>, *Treetip*<sup>®</sup>, *Twin*<sup>®</sup>, *VAC PAC*<sup>®</sup>, *VERSALAB*<sup>®</sup>, *Warmette*<sup>®</sup>, *Xact Trace*<sup>®</sup>, *Xitek*<sup>®</sup> are registered trademarks of Natus Medical Incorporated and its subsidiaries. *Accuscreen*, *Bili Lite Pad*, *Bili-Lite*, *Biomark*, *Circumstraint*, *Coherence*, *Deltamed*, *inVision*, *Medix MediLED*, *MiniMuffs*, *NatalC*, *Neometrics* and *Smartpack* are non-registered trademarks of Natus and its subsidiaries. *Solutions for Newborn CareSM* is a non-registered service mark of Natus.

**Overview**

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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, 2013 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 10-K for the year ended December 31, 2013 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;

**2014 First Quarter Overview.** A summary of key information concerning the financial results for the three months ended March 31, 2014;

**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;

## **Table of Contents**

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.

We have completed a number of acquisitions since 2003, consisting of either the purchase of a company, substantially all of the assets of a company, or individual products or product lines. Our most recent significant acquisition was Grass in 2013. We expect to continue to pursue opportunities to acquire other businesses in the future.

## ***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, which we have presented as the aggregation of our neurology and newborn care product families. Within this reportable segment we are organized on the basis of the healthcare products and services we provide which are used for the screening, detection, treatment, monitoring and tracking of common medical ailments in newborn care, hearing impairment, neurological dysfunction, epilepsy, sleep disorders.

Our end-user customer base includes hospitals, clinics, laboratories, physicians, nurses, audiologists, and governmental agencies. Most of our international sales are to distributors, who in turn, 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 13 Segment, Customer and Geographic Information* of our Consolidated Financial Statements included in this report and is incorporated in this section by this reference.

***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, 2013. Revenue from Devices and Systems, Supplies and Services, as a percent of total revenue for the three months ended March 31, 2014 and 2013 is as follows:

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2014</b>	<b>2013</b>
Devices and Systems	60%	61%
Supplies	31%	31%
Services	9%	8%
Total	100%	100%

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During the three months ended March 31, 2014 and 2013, no single customer or foreign country contributed to more than 10% of revenue.

### **2014 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.

Our consolidated revenue decreased \$0.2 million in the first quarter ended March 31, 2014 to \$85.6 million compared to \$85.8 million in the first quarter of the previous year. We experienced revenue increases across business units in Canada and Denmark, and declines across other business units in Europe, South America and the United States.

Net income was \$6.3 million or \$0.19 per diluted share in the three months ended March 31, 2014, compared with net income of \$3.4 million or \$0.12 per share in the same period in 2013. An increase from 57.4% to 58.2% in gross profit percentage for the first quarter of 2014 compared to same period in 2013 resulted primarily from improved margins associated with more favorable product mix.

### **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 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, 2013, 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, 2014.

**Results of Operations**

The following table sets forth, for the periods indicated selected consolidated statements of income 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 March 31,</b>	
	<b>2014</b>	<b>2013</b>
Revenue	100%	100%
Cost of revenue	41.7	42.6
Gross profit	58.3	57.4
Operating expenses:		
Marketing and selling	25.0	25.9
Research and development	8.8	9.6
General and administrative	14.3	16.2
Total operating expenses	48.1	51.7
Income from operations	10.1	5.7
Other income (expense), net	0.4	(0.4)
Income before provision for income tax (benefit)	10.5	5.3
Provision for income tax expense	3.2	1.3
Net income	7.3%	4.0%

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As the operations of Grass since its acquisition date of February 2013 have been reflected in our consolidated results, where significant, we have noted the impact of this acquisition on our results of operations for the three months ended March 31, 2014, as compared to the same period in 2013.

**Three Months Ended March 31, 2014 and 2013**

**Revenues**

Our consolidated revenue decreased \$0.2 million in the first quarter ended March 31, 2014 to \$85.6 million compared to \$85.8 million in the first quarter of the previous year. Grass contributed \$1.6 million of incremental revenue in the first quarter of 2014.

Revenue from our neurology products increased \$0.7 million or 1.3 % to \$56.4 million in the first quarter of 2014, compared to \$55.7 million in the same period in 2013. This increase was attributable to higher demand for polysomnography systems. Revenue from our newborn care products decreased by \$1.0 million, or 3.3% to \$29.1 million in the first quarter of 2014 compared to \$30.1 million in the same period in 2013. This decrease was primarily attributed to lower international demand for phototherapy products.

Revenue from neurology devices and systems was \$36.1 million for the three months ended March 31, 2014, representing an increase of 3.9% or \$1.4 million, from \$34.7 million reported in the first quarter of 2013. Grass contributed to \$1.0 million of incremental revenue in neurology devices and systems while revenue from our neurology products other than Grass increased by \$0.4 million in the first quarter of 2014 compared to the first quarter of 2013, primarily driven by an increase in demand for polysomnography systems. Revenue from newborn care devices and systems was \$14.9 million for the three months ended March 31, 2014, representing a decrease of 13.5% or \$2.3 million, from \$17.3 million reported in the first quarter of 2013. This decrease in newborn care devices and systems revenue was driven by lower international demand for phototherapy products.

Revenue from devices and systems was 60% of consolidated revenue in the first quarter of 2014 compared to 61% of consolidated revenue in the first quarter of 2013.

Revenue from neurology supplies was \$14.2 million for the three months ended March 31, 2014 representing a decrease of 7.9% or \$1.2 million, from \$15.4 million reported in the first quarter of 2013. Grass contributed \$0.5 million of incremental revenue to neurology supplies. Neurology supplies revenue other than Grass decreased \$1.7 million in the first quarter of 2014 compared to the first quarter of 2013. This decrease was primarily attributable to a decrease in neurodiagnostic supplies. Revenue from newborn care supplies was \$12.3 million for the three months ended March 31, 2014, representing an increase of 7.1% or \$0.8 million from \$11.5 million reported in the first quarter of 2013. This increase is primarily due to a increase in demand for ALGO hearing supplies.

Revenue from supplies was 31% of consolidated revenue in the first quarter of 2014 and 2013.

Revenue from neurology services was \$6.1 million for the three months ended March 31, 2014 representing an increase of 10.6% or \$0.6 million, from \$5.5 million reported in the first quarter of 2013. Revenue from newborn care services was \$1.9 million for the three months ended March 31, 2014, representing an increase of 37.1% or \$0.5 million from \$1.4 million reported in the first quarter of 2013. This increase was comprised primarily of growth in newborn care hearing screening data management services.

Revenue from services was 9% of consolidated revenue in the first quarter of 2014 compared to 8% in the same period in 2013.

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No single customer accounted for more than 10% of our revenue in the first quarter of either 2014 or 2013. Revenue from domestic sales was \$48.4 million for the three months ended March 31, 2014 and March 31, 2013. Revenue from international sales decreased 0.4% to \$37.3 million for the three months ended March 31, 2014 compared to \$37.5



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million in the first quarter of 2013. Revenue from domestic sales was 56.5% of total revenue for the three months ended March 31, 2014 and 56.3% for the three months ended March 31, 2013. Revenue from international sales was 43.5% of total revenue in the first quarter of 2014 and 2013.

***Cost of Revenue and Gross Profit***

Our cost of revenue decreased \$0.8 million or 2.1% to \$35.8 million for the three months ended March 31, 2014 from \$36.6 million in the first quarter of 2013. Gross contributed an incremental increase of \$0.8 million to our cost of revenue, which was coupled with cost of revenue declines across North America driven by favorable product mix. Gross profit increased \$0.7 million, or 1.3% to \$49.9 million in the first quarter of 2014 from \$49.2 million in the first quarter of 2013. Gross profit as a percentage of revenue was 58.3% for the three months ended March 31, 2014 and 57.4% for the three months ended March 31, 2013. The increase in gross profit as a percentage of revenue was the result of improved margins associated with product mix.

***Operating Costs***

Total operating costs decreased \$3.2 million or 7.1% to \$41.2 million for the three months ended March 31, 2014, from \$44.4 million in the first quarter of 2013. The operating costs of Grass contributed to \$0.1 million in incremental operating costs.

Our marketing and selling expenses decreased \$0.8 million or 3.5% to \$21.4 million in the first quarter of 2014, from \$22.2 million in the first quarter of 2013. Marketing and selling expenses as a percent of total revenue were 25.0% for the three months ended March 31, 2014 and 25.9% for the same period in 2013. The decrease in marketing and selling expenses is the result of cost cutting initiatives.

Our research and development expenses decreased \$0.7 million or 8.6% to \$7.5 million for the three months ended March 31, 2014 from \$8.2 million for the three months ended March 31, 2013. Research and development expenses as a percent of total revenue decreased to 8.8% in the first quarter of 2014 from 9.6% in the first quarter of 2013. The decrease in research and development expenses is due to lower employee compensation costs resulting from restructuring activities initiated in mid 2013.

Our general and administrative expenses decreased \$1.7 million or 12.1% to \$12.3 million for the three months ended March 31, 2014 from \$14.0 million for the three months ended March 31, 2013. General and administrative expenses as a percent of revenue decreased to 14.3% in the first quarter of 2014 from 16.3% in the first quarter of 2013. The medical device tax enacted in 2013 accounted for \$0.7 million of general and administrative expenses for the three months ended March 31, 2014. The overall decrease in general and administrative expenses for the period was driven by a reduction in spending on outside services.

***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 of \$0.3 million for the three months ended March 31, 2014, compared to other expense of \$0.3 million for the three months ended March 31, 2013. We reported \$0.1 million of foreign currency exchange gains in the first quarter of 2014 versus \$0.2 million of foreign exchange losses in the first quarter of 2013. Interest expense was \$0.3 million for the three months ended March 31, 2014 compared to \$0.5 million for the three months ended March 31, 2013. The overall decrease in interest expense was driven by favorable interest rate fluctuation.

***Provision for Income Tax***

We recorded a provision for income tax of \$2.7 million and \$1.1 million for the three months ended March 31, 2014 and 2013, respectively. Our effective tax rate was 30.5% and 23.9% for the three months ended March 31, 2014 and 2013, respectively. For the three months ended March 31, 2014, our effective tax rate differed from statutory tax rates primarily because of profits taxed in foreign jurisdictions with lower tax rates. Several temporary tax provisions including research and development tax credits and tax relief provision to foreign income were expired on December 31 2013 as a part of the America Taxpayer Relief of 2012 resulted a higher effective tax rate ended March 31, 2014 than the effective tax rate ended March 31, 2013. For the three months ended March 31, 2013, our effective tax rate 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.

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**Table of Contents****Liquidity and Capital Resources**

As of March 31, 2014, we had cash and cash equivalents of \$59.6 million and working capital of \$124.2 million, compared with cash and cash equivalents of \$56.1 million and working capital of \$116.7 million as of December 31, 2013. The \$7.5 million increase in working capital from December 31, 2013 to March 31, 2014 resulted primarily from a \$3.5 million increase in cash and cash equivalents and a \$3.7 million reduction in accounts payable.

As of March 31, 2014, we had cash and cash equivalents outside the U.S. in certain of our foreign operations of approximately \$59.6 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, 2014 we had a \$75 million credit facility consisting of a \$25 million revolving credit line and a \$50 million 5-year term loan with Wells Fargo Bank, National Association ( Wells Fargo ). The 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. We have no other significant credit facilities.

In February 2013, we acquired the Grass Technology Product Group from Astro-Med Inc through an asset purchase for a cash price of \$18.6 million. We funded this acquisition with a combination of cash-on-hand and an \$18 million borrowing under the 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.

Cash provided by operations increased by \$6.6 million to \$5.7 million for the three months ended March 31, 2014 compared to \$0.9 million cash used by operations for the same period in 2013. The sum of our net income and certain non-cash expense items, such as reserves, depreciation and amortization, and share based compensation was approximately \$9.8 million for the three months ended March 31, 2014, compared to \$8.9 million in the 2013 period. The overall impact of changes in certain operating assets and liabilities on total operating cash flows resulted in a cash outflow of \$4.1 million in the three months ended March 31, 2014 compared with a cash inflow of \$9.8 million in the 2013 period. The increase in cash flow from operations for the three months of 2014 was largely driven by an increase of \$2.8 million in net income and an increase in our deferred taxes of \$2.1 million related to the tax effect of stock option exercises.

Cash used by investing activities was \$5.8 million for the three months ended March 31, 2014, compared to cash used by investing activities of \$20.0 million for the same period in 2013. We used \$2.5 million to acquire Tender Touch and HHC during the three months ended March 31, 2014. We also made purchase accounting adjustments for \$2.4 million related to the Grass acquisition. We used \$0.8 million and \$1.4 million of cash to acquire property and equipment and intangibles during the three months ended March 31, 2014 and 2013, respectively.

Cash provided by financing activities was \$3.4 million in the three months ended March 31, 2014, compared to \$22.1 million in the three months ended March 31, 2013. In February 2013 we borrowed \$18 million of cash on our credit facility to partially fund the acquisition of Grass. 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 \$6.3 million and \$2.1 in the three months ended March 31, 2014 and 2013, respectively.

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.

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### **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. There were no material changes 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, 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.*

*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.*

## **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 Xltek in 2007, Medix in 2010 and Nicolet in 2013, 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, 2014. 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, 2014.

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, 2014, the fair value of our investments would decline by an immaterial amount.

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All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of March 31, 2014. 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**

Under the rules of the Securities and Exchange Commission, disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in our reports that we file or submit under the Securities Exchange Act of 1934 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 that evaluation, our management, including our chief executive officer and chief financial officer, has concluded that our disclosure controls and procedures were effective at a reasonable assurance level as of March 31, 2014.

#### **Inherent Limitations Over Internal Controls**

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Natus have been detected.

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

There were no changes in the Company's internal control over financial reporting during the first quarter of 2014, which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **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**

A description of the risks associated with our business, financial condition and results of operations is set forth in Part 1, Item 1A Risk Factors of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013. There have been no material changes in our risks from such description.



**Table of Contents****ITEM 6. Exhibits**

## (a) Exhibits

<b>Exhibit No.</b>	<b>Exhibit</b>	<b>Incorporated By Reference Exhibit</b>			
		<b>Filing</b>	<b>No.</b>	<b>File No.</b>	<b>File Date</b>
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				
101	The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations and Comprehensive Income, (iii) Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements.				

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**SIGNATURES**

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

NATUS MEDICAL INCORPORATED

Dated: May 7, 2014

By: /s/ James B. Hawkins

**James B. Hawkins**

**President and Chief Executive Officer**

**(Principal Executive Officer)**

Dated: May 7, 2014

By: /s/ Jonathan A. Kennedy

**Jonathan A. Kennedy**

**Senior Vice President Finance and**

**Chief Financial Officer**

**(Principal Financial and**

**Accounting Officer)**

**Table of Contents****NATUS MEDICAL INCORPORATED****INDEX TO EXHIBITS**

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