NATUS MEDICAL INC
Form 10-K
March 16, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2006**

OR

¨ **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	**77 0154833**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

1501 Industrial Road, San Carlos, California 94070

(Address of principal executive offices, including zip code)

(650) 802 0400

(Registrant s Telephone Number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act: None

Securities Registered Pursuant to Section 12(g) of the Act: Common Stock, $0.001 par value

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 such shorter period that the registrant was required to file such reports) and (2) has been subject to such requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K. ¨

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

Large Accelerated Filer ¨ Accelerated Filer x Non-accelerated Filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

As of June 30, 2006, the last business day of Registrant s most recently completed second fiscal quarter, there were 18,615,540 shares of Registrant s common stock outstanding, and the aggregate market value of such shares held by non-affiliates of Registrant (based upon the closing sale price of such shares on the Nasdaq National Market on June 30, 2006) was $146,282,268. Shares of Registrant s common stock held by each executive officer and director and by each entity that owns 5% or more of Registrant s outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

On March 8, 2007, the registrant had 21,469,094 shares of its common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The Registrant has incorporated by reference, into Part III of this Form 10-K, portions of its Proxy Statement for the 2007 Annual Meeting of Stockholders.

Table of Contents

NATUS MEDICAL INCORPORATED

ANNUAL REPORT ON FORM 10-K

TABLE OF CONTENTS

Table of Contents

PART I

ITEM 1. Business

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 about Natus Medical Incorporated (Natus, we, us, or our Company). These statements include, among other things, statements concerning our 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 1 include, but are not limited to, statements regarding the following: our expectations regarding the sufficiency of our cash to meet cash flow requirements, the cost of share-based compensation expense under SFAS 123R, our expectations of future profitability and the generation of positive operating cash flows, the effectiveness and advantages of our products, factors relating to demand for and economic advantages of our products, our plan to develop and acquire additional technologies, products or businesses, our expectation regarding growth in international sales, our marketing, technology enhancement, and product development strategies, our intention to enter into agreements with group purchasing organizations, our intention to introduce new products and extend existing product lines, our intention to seek strategic partners, our belief that we bring products to market efficiently, development of technologies into successful products, our estimate of the length of time for patents to issue, identity of our competition and factors for competition, our compliance with regulatory requirements and laws, and our plan to seek approval to sell our products in additional countries.

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 Management s Discussion and Analysis of Financial Condition and Results of Operations, 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.

Natus®, AABR®, AOAE®, ALGO®, Cochlea-Scan®, Echo-Screen®, Ear Couplers®, Flexicoupler®, MiniMuffs® and neoBLUE® are registered trademarks of Natus Medical Incorporated. EchoLink , Neometrics , and Accuscreen are non-registered trademarks of Natus. Solutions for Newborn Care℠ is a non-registered service mark of Natus. Bio-logic®, AuDX®, ABaer®, Ceegraph®, MASTER®, Navigator®, Sleepscan®, and Traveler® are registered trademarks of Bio-logic Systems Corp. CHAMP and Smartpack are non-registered trademarks of Bio-logic. Coherence is a non-registered trademark of Deltamed. Cool-Cap® is a registered trademark of Tiara Medical Systems, Inc. VAC-PAC® is a registered trademark of Olympic Medical Bili-Lite Pad , Bili-Lite , Billi-Bassinet , Bili-Mask , Bili-Meter , Papoose Boards , Circumstraint , Warm-Lamp , and Warmettes are non-registered trademarks of Olympic Medical.

Overview

Natus is a provider of healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care. We develop, manufacture, and market advanced neurodiagnostic and newborn care products to healthcare professionals in over 80 countries. Our 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 of brain injury in newborns, and software systems for managing and tracking disorders and diseases for public health laboratories.

Table of Contents

We have completed a number of acquisitions since 2003, consisting of either the purchase of a company, substantially all of the assets of the company, or individual products or product lines. The businesses we have acquired include Neometrics in 2003, Fischer-Zoth in 2004, and Bio-logic, Deltamed, and Olympic in 2006.

Product Families

We categorize our products into the following product families:

Newborn Hearing Screening

Diagnostic Hearing Assessment

Monitoring Systems for Neurology (Electroencphalograph or EEG)

Diagnostic Sleep Analysis (Polysomnography or PSG)

Newborn Care, including treatment for Brain Injury and Jaundice

Our principal product offerings within these product families are presented in the table below:

Table of Contents

Our Product Offerings

Newborn Hearing Screening

Overview

Hearing impairment is the most common treatable chronic disorder in newborns, affecting as many as five babies out of every 1,000 newborns. It is estimated that 20,000 hearing-impaired babies are born in the United States (U.S.) every year, and as many as 60,000 more in the rest of the developed world. Until the introduction of universal newborn hearing screening programs, screening was generally performed only on those newborns who had risk factors for hearing impairment, including a family history of hearing impairment, infection prior to birth, low birth weight, skull or facial anomalies, or bacterial meningitis. However, screening only those newborns with risk factors for hearing impairment overlooks approximately half of newborns with some level of hearing impairment.

Early identification of hearing impairment and early intervention has been shown to improve language development significantly. Babies identified as hearing impaired at birth will typically begin therapy immediately and can learn and progress at a rate comparable to children with normal hearing, regardless of the severity of hearing loss. However, undetected hearing impairment often results in the failure to learn, process spoken language, and speak. If hearing impairment is not detected prior to discharge from the hospital it is often not detected until the child is 18 months of age or older. A 1997 study conducted at the University of Colorado, Boulder evaluated the impact of hearing impairment on language and speech. All of the children evaluated in the study were born with a hearing impairment but differed by the age at which the hearing impairment was detected. The study concluded that those children whose hearing loss was detected early and who received appropriate treatment had significantly better language skills and vocabularies than those children whose hearing loss was detected later.

Newborn Hearing Screening in the United States

We estimate that today approximately 95% of the children born in the U.S. are being tested for hearing impairment prior to discharge from the hospital. In 1994, the American Academy of Pediatrics Task Force on Newborn and Infant Hearing published guidelines for universal newborn hearing screening programs. In 2000, the Joint Committee on Infant Hearing published a position statement addressing principles and guidelines for early hearing detection and intervention programs. These principles and guidelines are intended to establish the standard of care and provide that:

- At least 95% of all newborns should be screened;
- The screening method used must have the ability to detect all infants with a hearing impairment of at least 35 decibels, normal hearing level (dB nHL), a common audiological unit to measure hearing, in the better ear;
- The screening method should not refer more than 4% of all children tested for further evaluation;
- No more than 3% of children with normal hearing who are screened should receive results that indicate they have a hearing impairment, a screening error known as a false positive or false refer result; and
- No child whose hearing is impaired should receive a normal result, a screening error known as a false negative or false pass result.

Because positive results are referred to an audiologist or Ear, Nose and Throat (ENT) physician for additional testing and evaluation, limiting the number of refers stemming from false positive results reduces the cost of a newborn screening program. In addition, false positive results can cause unnecessary emotional trauma for parents.

Table of Contents

Newborn Hearing Screening Techniques

The two traditional technologies used to screen newborns and infants for hearing impairment are auditory brainstem response and otoacoustic emissions.

Auditory brainstem response (ABR). Auditory brainstem response technology is the most accurate and comprehensive method for screening and diagnosing hearing impairment. Auditory brainstem response technology is based on detecting the brain s electric impulses resultant from a specific auditory stimulus. ABR screening devices, used for newborn hearing screening, detect and analyze the brainwave response resulting from audible click stimuli presented to the infant s ears. Automated Auditory Brainstem Response (AABR) devices were developed to automatically analyze the ABR waveform resulting from the auditory stimuli with computerized detection algorithms and statistical analysis. These devices can be used by any level of hospital personnel with a minimal amount of training and will deliver a clinically valid and accurate screen. The detection algorithms indicate a PASS or REFER result that requires no interpretation, thereby reducing staffing requirements, test times, and total hearing screening program costs. A REFER test result indicates that the patient should be referred to an Audiologist or ENT for further diagnostic evaluation.

Otoacoustic emissions (OAE). OAEs are sounds created by the active biomechanical processes within the sensory cells of the cochlea. They occur both spontaneously and in response to acoustic stimuli. OAE screening uses a probe placed in the ear to deliver auditory stimuli and to measure the response of the sensory cells with a sensitive microphone. OAE screening devices have technology that allow them to discriminate between randomly occurring OAEs, OAEs created by interfering room noise present in the test environment, and the OAEs that are a response to specific test stimuli. Automated OAE screening devices are capable of filtering non-specific OAEs in order to detect and analyze the OAEs that lead to an accurate screen of the infant s hearing. While a PASS test result indicates a proper functioning cochlea, a REFER test result indicates that the OAEs are absent or small compared to normal data. A REFER test result indicates that the patient should be referred to an Audiologist or ENT for further diagnostic evaluation. OAE technology is unable to detect hearing disorders affecting the neural pathways, such as auditory neuropathy. Estimates of the incidence rate of auditory neuropathy among hearing impaired newborns vary widely, but are thought to be in the range of 5% to 15%.

Newborn Hearing Screening Product Lines

Our newborn hearing screening product lines consist of the ALGO, ABaer, AuDX, and Echo-Screen newborn hearing screeners. These hearing screening products utilize proprietary signal detection technologies to provide accurate and non-invasive hearing screening for newborns and are designed to detect hearing loss at 35 dB nHL or higher. Each of these devices is designed to generate a PASS or REFER result.

ALGO 3 and 3i Newborn Hearing Screeners. These AABR devices deliver thousands of soft audible clicks to the newborn s ears through sound cables and disposable earphones connected to the instrument. Each click elicits an identifiable brain wave, which is detected by disposable electrodes placed on the head of the child, and analyzed by the screening device. These devices use our proprietary AABR signal detection algorithm.

ABaer Newborn Hearing Screener. The ABaer, which is a PC-based newborn hearing screening device, offers a combination of automatic ABR, OAE, and diagnostic ABR technologies in one system. The automatic ABR technology utilizes our patented Point Optimized Variance Ratio (POVR) signal detection algorithm developed by the House Ear Institute. Like our ALGO newborn hearing screeners, this device delivers thousands of soft audible clicks to the newborn s ears through sound cables and disposable earphones. Each click elicits an identifiable brain wave, which is detected by disposable electrodes placed on the head of the child, and analyzed by the screening device. The ABaer OAE software is the same technology used in our AuDX product and the diagnostic ABR software is the same technology used in our Navigator diagnostic hearing assessment product.

AuDX and Echo-Screen. Our AuDX and Echo-Screen products are hand-held OAE screening devices that can be used for newborn hearing screening, as well as on patients of all ages, from children through

Table of Contents

adult. These devices record and analyze OAEs generated by the cochlea through sound cables and disposable ear probes inserted into the patient s ear canal. OAE technology is unable to detect hearing disorders affecting the neural pathways, such as auditory neuropathy.

Hearing Screening Supply Products

For infection control, accuracy, and ease of use, the supply products used with our newborn hearing screening devices are designed as single-use, disposable products. Each screening supply product is designed for a specific hearing screening technology.

ABR Screening Supply Kits. Each ABR screen is carried out with single-use earphones and electrodes, which are alcohol and latex-free. The adhesives used in these supply products are specially formulated for use on the sensitive skin of newborns. To meet the needs of our customers we offer a variety of packaging options.

OAE Supply Products. Each OAE screen is carried out with single-use probe tips that are supplied in a variety of sizes and packaging options.

Diagnostic Hearing Assessment

Overview

We design and manufacture a variety of products used to screen for or diagnose hearing loss, or to identify abnormalities affecting the peripheral and central auditory nervous systems. The technology used in most of these systems is either electrodiagnostic in nature or measures a response from the cochlea known as an otoacoustic emission.

Electrodiagnostic systems record electrical activity generated in the central nervous system. An electrodiagnostic testing device delivers acoustic stimuli to the ears while electrodes placed on the scalp record the brain s electrical response. The most common auditory test performed with electrodiagnostic equipment is the auditory brainstem response (ABR) test. This test, which records brainwaves that correspond to responses from the inner ear and brainstem, is used to screen for and define hearing loss characteristics, particularly for patients who cannot reliably respond to standard behavioral tests of hearing, either verbally or through motor response. A technician with minimal training can operate an instrument that performs an automated ABR screening test. More advanced ABR testing techniques that either define the nature of the hearing loss or that screen for other auditory abnormalities such as an acoustic tumor, require the expertise of a trained clinician, usually an audiologist or an ENT physician, an understanding of the technology being used, and the ability to interpret complex waveforms that represent the brain s electrical activity.

Diagnostic Hearing Assessment Product Lines

Our diagnostic hearing assessment products consist of the Navigator Pro system, the Scout Sport portable diagnostic device, the HINT PRO, the AuDX PRO, and our Cochlea-Scan.

Navigator PRO. Our Navigator PRO for hearing assessment consists of a base system that is augmented by discrete software applications that are marketed as enhancements to the system. The Navigator Pro System is a PC-based, configurable device that utilizes Evoked Potentials, which are electrical signals recorded from the central nervous system that appear in response to repetitive stimuli, such as a clicking noise. The evoked potentials are used to record and display human physiological data associated with auditory and hearing-related disorders. The Navigator Pro System can be used for patients of all ages, from children to adults, including infants and geriatric patients. The device can be configured with additional proprietary software programs for various applications. These additional software programs include: Stacked ABR, CHAMP, MASTER, AEP, VEMP, BioMAP, and Scout.

Table of Contents

Scout SPORT. The Scout SPORT is a PC-based OAE system. The ultra portable Scout Sport can be carried from one computer to another to test in different locations. For office-based environments, the Scout Sport can be used with a dedicated notebook computer to create an independent portable system.

HINT PRO. Our *Hearing in Noise Test* application uses test sentences, procedures, and headphone norms developed by the House Ear Institute. The system features computerized administration, scoring, report generation, and data storage. The HINT measures the patient s ability to recognize and repeat short sentences presented in quiet or in noise. The speech and noise sources can be spatially separated to measure binaural directional hearing and spatial unmasking. The patient s sentence recognition threshold is measured in quiet and in three noise conditions.

AuDX PRO. The AuDX Pro is a hand-held OAE screening device with a large color display that can be used for patients of all ages, newborns through geriatrics. The AuDX records and analyzes OAEs generated by the cochlea through sound cables and disposable ear probes inserted into the patient s ear canal. A REFER test result indicates that the patient should be referred to an Audiologist or ENT for further diagnostic evaluation. OAE technology is unable to detect hearing disorders affecting the neural pathways, such as auditory neuropathy.

Cochlea-Scan. The Cochlea-scan is an easy to use handheld device to assess hearing loss. It utilizes Distortion Product Otoacoustic Emissions (DPOAE) technology, which allows the user to quantify hearing loss using physiologic measures instead of relying upon a patient s behavioral response.

Centor. The Centor is a portable Audio-Evoked Potentials (AEP) product that records auditory evoked responses (AERs) in order to perform objective diagnoses as well as hearing-loss screening for adults and neonates. The system records AERs with standard or automatic protocols, such as Auditory Brainstem Response (ABR), Middle Latency Audio-Evoked Potentials (MLAEP), ElectroCochleoGraphy (EcochG), Vestibular Evoked Myogenic Potentials (VEMP), as well as pure tone or vocal stimulation.

Diagnostic Hearing Supply Products

For infection control, accuracy, and ease of use, most supply products used with our diagnostic hearing devices and systems are designed as single-use, disposable products. Each screening supply product is designed for a specific diagnostic hearing technology, and is similar in nature to our previously described OAE supply products for use in newborn hearing screening.

Monitoring Systems for Neurology (Electroencephalograph or EEG)

Overview

We design, manufacture, and market a full line of computerized instruments used to help diagnose the presence of seizure disorders, look for causes of confusion, and evaluate head injuries, tumors, infections, degenerative diseases, and metabolic disturbances that affect the brain. This type of testing is also done to diagnose brain death in comatose patients. These systems and instruments work by detecting, amplifying, and recording the brain s electrical impulses (EEGs). Routine EEG recording is done by placing electrodes on a patient s scalp over various areas of the brain to record and detect patterns of activity and specific types of electrical events. EEG technologists perform the tests, and neurologists review and interpret the results.

Routine outpatient EEG testing is performed both in private physicians offices and hospital EEG laboratories, providing physicians with a clinical assessment of a patient s condition. For patients with seizures that do not respond to conventional therapeutic approaches, long-term inpatient testing of EEGs and behavior is used to determine if surgical solutions are appropriate.

Table of Contents

Diagnostic EEG Monitoring Product Lines

Our diagnostic EEG monitoring product lines for neurology consist of our Ceegraph VISION and Coherence software running on aftermarket computer workstations, and the Netlink EEG, Netlink LTM, and Netlink Traveler amplifiers. These devices are typically used in concert, as part of an EEG system by the Neurology department of a hospital to assist in the diagnosis of assorted neurological conditions.

Ceegraph VISION. The Ceegraph VISION line of computerized EEG systems includes a broad range of products, from software licenses and ambulatory monitoring systems to advanced laboratory systems with multiple capabilities for EEG, ICU monitoring, long-term epilepsy monitoring of up to 128 channels, and powerful physician review stations with advanced quantitative EEG analysis capabilities.

Coherence. The Coherence line of computerized EEG systems is suitable for routine EEG, long-term epilepsy monitoring, ambulatory EEG and sleep studies. The Coherence system has a leading position in pediatric departments and high-end epilepsy monitoring installations in Europe.

Netlink EEG. A proprietary amplifier that interfaces the patient and computer and incorporates recent advances in amplifier and ergonomic design. Recent innovations in electronics technology and advanced internet-protocol data transmission enable Netlink EEG to provide recordings of up to 32 channels of digital data using Ethernet communication. Its custom cart allows the instrument to be moved and easily adjusted to the configuration needed.

Netlink LTM. Designed for use in long-term epilepsy monitoring applications, laboratories using the Netlink LTM amplifier can place amplifiers and recording PCs anywhere in the facility using standard Ethernet communications. Automated spike and seizure detection software options, provided by third parties, assist in the identification of clinical events indicative of epilepsy. These options utilize patented algorithms to detect seizure onset and state-dependent seizures.

Netlink Traveler. A solid-state, battery-operated ambulatory recorder for seizure monitoring that records continuous information from up to 32 channels and saves data on removable flash card media. Data can be reviewed and analyzed immediately using Ceegraph VISION with automatic spike and seizure programs.

Several additional options are available to enhance our EEG products, some of which are: a digital video option, which provides synchronized video recording of a patient s behavior while recording electrical activity from the brain; our patented SmartPack software option, which is an innovative data compression process that reduces the size of data files by as much as 60%, and our Universal Reader which is a physician s review station that permits fast and easy data analysis in a graphical format.

Diagnostic Sleep Analysis (Polysomnography or PSG)

Overview

Increasing public awareness of sleep disorders has made sleep medicine a rapidly growing specialty. The analysis of respiratory patterns, brain electrical activity and other physiological data has proven critical for the diagnosis and treatment of sleep-related diseases such as apnea, insomnia, and narcolepsy. We offer a broad range of products for the contemporary sleep laboratory, including fully configured laboratory systems, portable systems, and ambulatory recorders for home monitoring. Our Sleepscan systems provide flexible report generation capabilities, expert analysis modules, and many advanced features.

Diagnostic Sleep Analysis Product Lines

Our diagnostic PSG monitoring product lines for polysomnography consist of our Sleepscan VISION computer workstation and our Coherence Digital Polygraph product, which are both used with our Sleepscan Netlink headbox as a system for overnight sleep studies to assist in the diagnosis of several sleep disorders.

Sleepscan VISION. A sleep study entails whole-night recordings of brain electrical activity, muscle movement, airflow, respiratory effort, oxygen levels, electrocardiogram (ECG), and other parameters.

Table of Contents

These recordings result in over 1,000 pages of data that are reviewed, analyzed, and scored by a specialist, and summarized in a report. Our Sleepscan system stores all of this information digitally and provides time-saving features and software for acquiring and analyzing the data. It enables users to specify rules and personal preferences to be used during analysis, summarizing the results graphically and incorporating them in a detailed report. The Sleepscan VISION s customized analysis includes color-coded sleep stages and flow loop analysis.

Coherence Digital Polygraph. The Coherence Digital Polygraph, marketed primarily in Europe, allows the physician to perform automatic or manual scoring and event detection. User definable report templates, long-term frequency and amplitude trending, as well as wavelet event detection provide analysis and reporting tools. These systems utilize a Pulse Transit Time device for the detection of respiratory events and arousals.

Sleepscan Netlink. Our Sleepscan Netlink data acquisition system incorporates recent developments in superior amplifiers for sleep analysis. In addition to exceptional signal quality, the Netlink headbox includes a built-in oximeter, and allows the user to start and stop a study or perform electrode impedance testing either at the patient s bedside or from the monitoring room.

We also market a broad line of disposable products and accessories for the polysomnography laboratory. The Airflow Pressure Transducer uses pressure changes as an indicator of patient airflow levels, as contrasted to other monitoring devices that use temperature to indicate these levels. This product detects shallow breathing in situations where temperature related transducers might remain substantially unchanged. This method has been documented in industry publications to produce the signature waveform used in identifying a respiratory disorder known as Upper Airway Resistance Syndrome.

Newborn Care Products

Natus manufactures a wide variety of products used in the medical care of newborns. These product lines include products to diagnose and treat newborn brain injury, as well as a line of phototherapy lights to treat newborn jaundice. The Company also sells a variety of newborn care products to meet the needs of clinicians in the nursery and Neonatal Intensive Care Unit.

Newborn Brain Injury

Overview

For many years, newborn infants admitted to the neonatal intensive care unit of a hospital have routinely been monitored for heart activity, temperature, respiration, oxygen saturation, and blood pressure. Only recently has it also been considered important to monitor brain activity using continuous electroencephalopgraphy (EEG). A cerebral function monitor, utilizing amplitude-integrated EEGs (aEEGs), is a device for monitoring background neurological activity.

Neurological Assessment and Treatment Options

Early diagnosis of brain injury in newborns, when combined with early intervention, has been shown to reduce the severity of these brain injuries and in some cases, save the patient s life. These brain injuries, which can occur in as many as three out of every 1,000 newborns, are caused by conditions such as hypoxic ischemic encephalopathy (HIE), subclinical seizures, or neurological disorders. Diagnosing these conditions shortly after birth is imperative, as patients who undergo therapy within six hours after birth show a greater potential for improved outcomes.

Clinical studies have also shown that recent advancements in two primary technologies can have a marked and positive impact upon newborn brain injury. These technologies are amplitude-integrated EEG and servo-controlled patient cooling.

Table of Contents

Newborn Brain Injury Product Line

Olympic CFM-6000 System. The Cerebral Function Monitor (CFM) provides the Neurologist with the technology to diagnose neurological disorders or brain injury in the newborn. The device continuously monitors and records brain activity, aiding in the detection and treatment of HIE and seizures. The device also monitors the effects of drugs and other therapies on brain activity and improves the accuracy of newborn neurological examinations. The Olympic CFM-6000 helps determine the need for further neurological examination or transport to a trauma-center. The CFM is used with single-use disposable electrodes attached to the head of the newborn to acquire an aEEG signal that is then filtered, compressed, and displayed graphically on the device or as a hardcopy printout.

Olympic Cool-Cap System. The Olympic Cool-Cap is the only FDA approved device for administering selective head cooling as a treatment for moderate to severe hypoxic ischemic encephalopathy. A four-year clinical trial for the Cool-Cap was completed in 2006, and the FDA gave approval for the product in December 2006. The clinical trial validated the benefit of direct brain cooling in reducing the severity of brain injury resulting from newborn HIE. Both the device and the proprietary software conform to the clinical trial protocol and are designed to assist the clinician in safely administering the treatment, thereby preventing or significantly reducing the severity of neurological injury associated with HIE

Newborn Brain Injury Supply Products. The Olympic Cool-Cap brain cooling system uses a single-patient, disposable, cooling cap to continuously circulate sterile water to the patient during the 72-hour treatment period.

Jaundice Management Products

Overview

The American Academy of Pediatrics estimates that each year 60% of the approximately four million newborns in the U.S. become jaundiced. According to the Journal of the American Medical Association, neonatal jaundice is the single largest cause for hospital readmission of newborns in the U.S., and accounts for 50% of readmissions. Because of the serious consequences of hyperbilirubinemia, the American Academy of Pediatrics recommends that all newborns be closely monitored for jaundice and has called for the physician to determine the presence or absence of an abnormal rate of hemolysis to establish the appropriate treatment for the newborn.

In 2004, the American Academy of Pediatrics issued new guidelines for the treatment of jaundice in newborns. The guidelines recommend phototherapy as the standard of care for the treatment of hyperbilirubinemia in infants born at 35 weeks or more of gestation. The guidelines further highlight the need for intense phototherapy, and specifically recommend the use of the blue light treatment incorporated into our neoBLUE products.

We currently offer the following products that meet guidelines of the American Academy of Pediatrics for the treatment of newborn jaundice:

neoBLUE Product Family. This product line consists of our neoBLUE, neoBLUE Mini, and neoBLUE Cozy devices, which utilize Light Emitting Diodes (LEDs) to generate a high-intensity, narrow spectrum of blue light that is clinically proven to be most effective in the treatment of newborn jaundice. The neoBLUE phototherapy devices emit significantly less ultraviolet light and heat than conventional phototherapy devices, reducing the risk of skin damage and dehydration for infants undergoing treatment. Because of the high intensity of these lights, the treatment time associated with phototherapy is reduced.

Bili-Lite Product Family. These devices utilize fluorescent light bulbs for the treatment of hyperbilirubinemia. The Bili-Bassinet provides intensive phototherapy from both under and over the baby for maximum surface area coverage. The Bili-Lite pad is a product designed for home-based phototherapy; because of its design, it does not require the use of eye shields, making it easier to use by parents.

Table of Contents

Other Newborn Care Product Lines

Medical Devices. These products include devices such as: photometers, patient warming lamps, pediatric scales, blanket warming cabinets, exam lights, transilluminators, oxygen hoods, heat shields, and our newborn circumstraint.

Disposable Supplies. These products include disposable supplies such as: neonatal noise attenuators, phototherapy eye masks, restraining boards, and x-ray shields for newborn gonads.

Newborn Screening Data Management Product Line. Revenue from installation and upgrades of our Neometrics newborn screening data management systems is classified as devices and systems revenue, as more fully described below. Revenue from maintenance contracts on these systems is classified as supplies and services revenue, as more fully described below.

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 such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care, including jaundice, brain injury, and metabolic testing. We develop, manufacture, and market advanced neurodiagnostic and newborn care products to healthcare professionals in over 80 countries. Our 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 of brain injury in newborns, and software systems for managing and tracking disorders and diseases for public health laboratories.

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 16 Segment, Customer and Geographic Information* of our 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 related Supplies and Services, which are generally recurring. The sources of revenue for these broad categories are described above. Revenue from Devices and Systems, and Supplies and Services, as a percent of total revenue for the years ending December 31, 2006, 2005 and 2004 is as follows:

	Devices and Systems	Supplies and Services	Total
2006	58%	42%	100%
2005	46%	54%	100%
2004	39%	61%	100%

In the table above, the two categories include revenue from freight of 2%, 1%, and 1% of total revenue in 2006, 2005 and 2004.

In 2006, 2005 and 2004, sales to no single end-user customer comprised more than 10% of our revenue, and revenue from services was less than 10% of our revenue.

Table of Contents

Marketing and Sales

Marketing

Our marketing strategy differentiates our products by their level of quality, performance, and customer benefit. We educate customers and potential customers worldwide about our products through several traditional methods, such as, but not limited to:

Trade conference exhibits;

Direct presentations to healthcare professionals;

Publications in professional journals and trade magazines;

The Internet via our website, *www.natus.com;*

Print and direct mail advertising campaigns; and

Sponsorship of and participation in clinical education seminars.

Educational efforts directed at government agencies and key physicians and clinicians about the benefits of universal screening in terms of patient outcomes and long-term treatment costs are a key element of our marketing strategy.

Domestic Sales

We sell our products in the United States primarily through a direct sales organization. This direct sales organization is a significant benefit to the Company, allowing us to maintain a higher level of customer service and satisfaction than would otherwise be possible by another distribution method. Revenue from our direct sales channels as a percent of total revenue was 64%, 84% and 79% in 2006, 2005 and 2004, respectively. The reduction of revenue sold through our direct sales channels as a percent of total revenue in 2006 resulted from sales of our line of diagnostic hearing products, which are sold through distributors. We gained this product line through our acquisition of Bio-logic in January 2006. We also sell certain products under private label arrangements. Domestic revenue resulting from sales through these non-direct sales channels was 11% of total revenue in 2006 and an immaterial percentage in 2005 and 2004.

International Sales

We sell our products outside the U.S. primarily through a distributor sales channel, which consists of distributors selling Natus products into more than 80 countries as of December 31, 2006. We sell products to our distributors under substantially the same terms as sales through our direct sales channels. Terms of sales to international distributors are EXW, reflecting that goods are shipped ex works, in which title and risk of loss are assumed by the distributor at the shipping point. Distributors are generally given exclusive rights in their territories to purchase products from Natus and resell to end users or sub-distributors. Our distributors typically perform marketing, sales, and technical support functions in their respective markets. Each distributor may sell Natus products to their customer directly, via other distributors or resellers, or both. We actively train our distributors in product marketing, selling, and technical service techniques.

Through our acquisition of Deltamed in September 2006, we now sell some of our products in France and Germany through a direct sales organization. We previously had direct sales organizations in Japan and the United Kingdom (U.K.). However, in 2004 we ceased selling through a direct sales force in Japan and began to sell through a distributor, and in February 2006 we ceased selling through a direct sales force in the U.K. and began to sell through a distributor.

Revenue from international sales was approximately 29%, 36% and 27% of our total revenue in 2006, 2005 and 2004, respectively.

Table of Contents

Seasonality in Revenue

We typically experience seasonality in our revenue. Our revenue typically drops from our fiscal fourth quarter to our fiscal first quarter. This seasonality results from the purchasing habits of our customers, who are primarily hospital based, and the manner in which our direct sales force is compensated, as their compensation is based on annual sales plans that are tied to our December year end.

Group Purchasing Organizations

More than 90% of the hospitals in the U.S. are members of group purchasing organizations (GPO s), which negotiate volume purchase prices for member hospitals, group practices, and other clinics. Direct purchases by members of group purchasing organizations accounted for approximately 31%, 28% and 46% of our revenue in 2006, 2005 and 2004, respectively. Direct purchases by members of one GPO, Novation, accounted for approximately 12%, 15% and 20% of our revenue in 2006, 2005 and 2004, respectively. Our revenue recognition policies related to sales to GPO members are described in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, contained in this report.

Third-Party Reimbursement

In the U.S., health care providers generally rely on third-party payors, including private health insurance plans, federal Medicare, state Medicaid, and managed care organizations, to reimburse all or part of the cost of the procedures they perform. Third-party payors can affect the pricing or the relative attractiveness of our products by regulating the maximum amount of reimbursement these payors provide for services. In general, reimbursement for newborn screening is included in the lump-sum payment for the newborn s birth and hospitalization. For this reason, we are not able to measure a reimbursement success rate for our screening products.

Customer Service and Support

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

Manufacturing

Other companies manufacture a significant portion of the components used in our products; however, we perform final assembly, testing, and packaging of most of the devices ourselves to control quality and manufacturing efficiency. We also use contract vendors to manufacture some of our disposable supply and medical device products. We perform regular quality audits of these vendors.

We purchase materials and components from qualified suppliers that are subject to our quality specifications and inspections. We conduct quality audits of our key suppliers, several of which are experienced in the supply of components to manufacturers of finished medical devices, or supplies for use with medical devices. Most of our purchased components are available from more than one supplier.

Our manufacturing, service, and repair facilities are subject to periodic inspection by federal, state, and foreign regulatory authorities. Our quality assurance system is subject to regulation by the FDA and other state government agencies. We are required to conduct our product design, testing, manufacturing, and control activities in conformance with the FDA s quality system regulations and to maintain our documentation of these activities in a prescribed manner. We have passed all quality system regulations inspections of our facilities conducted by the FDA and respective states. In addition, our production facilities have received ISO 13485 certification. ISO 13485 certification standards for quality operations have been developed to ensure that medical

Table of Contents

device companies meet the standards of quality on a worldwide basis. We have also received the EC Certificate pursuant to the European Union Medical Device Directive 93/42/EEC, which allowed us to place a CE mark on our products after assembling appropriate documentation.

Research and Development

We are committed to introducing new products and supporting current product offerings in our markets through a combination of internal as well as external efforts that are consistent with our corporate strategy.

Internal product development capabilities. We believe that product development capabilities are essential to provide our customers with new product offerings. We plan to leverage our core technologies by introducing product line extensions as well as new product offerings.

Partnerships that complement our expertise. We continue to seek strategic partners in order to develop products that may not otherwise be available to us. By taking advantage of our core competencies, we believe that we can bring products to market in an efficient manner, and leverage our distribution channels.

New opportunities through technology acquisition. We continue to evaluate new, emerging, and complementary technologies in order to identify new product opportunities. With our knowledge of our current markets we believe that we can effectively develop technologies into successful new products.

Our research and development expenses were $10.6 million or 11.8% of total revenue in 2006, $4.3 million or 10.0% of total revenue in 2005, and $3.7 million or 10.1% of total revenue in 2004.

Proprietary Rights

We protect our intellectual property through a combination of patent, copyright, trade secret, and trademark laws. We attempt to protect our intellectual property rights by filing patent applications for new features and products we develop. We enter into confidentiality or license agreements with our employees, consultants, and corporate partners, and seek to control access to our intellectual property, distribution channels, documentation, and other proprietary information. However, we believe that these measures afford only limited protection.

The intellectual rights to some of the original patents for technology incorporated into our products are now in the public domain. However, we do not consider these patents, or any currently viable patent or related group of patents to be of such importance that their expiration or termination would materially affect our business.

We capitalize the cost of purchased technology and intellectual property, as well as certain costs incurred in obtaining patent rights, and amortize these costs over the estimated economic lives of the related assets.

Competition

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

We derive a significant portion of our revenue from the sale of disposable supplies that are used with our medical devices. In the U.S., we sell our supply products in a mature market. Because these products can generate high margins, we expect that our products, particularly our hearing screening supply products, could face increasing competition, including competitors offering lower prices, which could have an adverse affect on our revenue and margins.

Table of Contents

We believe the principal factors that will draw clinicians and other buyers to our products, include:

- Level of specificity, sensitivity, and reliability of the product;
- Time required to obtain results with the product, such as to test for or treat a clinical condition;
- Relative ease of use of the product;
- Depth and breadth of the products features;
- Quality of customer support for the product;
- Frequency of product updates;
- Extent of third-party reimbursement of the cost of the product or procedure;
- Extent to which the products conform to standards of care guidelines; and
- Price of the product.

We believe that our primary competitive strength relates to the functionality and reliability of our products. Different competitors may have competitive advantages in one or more of the categories listed above and they may be able to devote greater resources to the development, promotion, and sale of their products.

Government Regulation

FDA s Premarket Clearance and Approval Requirements

Unless an exemption applies, the medical devices we sell, with the exception of some disposable products in our newborn care line of products, must first receive one of the following types of FDA premarket review authorizations under the Food, Drug, and Cosmetics Act, as amended:

- Clearance via Section 510(k); or
- Premarket approval via Section 515 if the FDA has determined that the medical device in question poses a greater risk of injury.

The FDA s 510(k) clearance process usually takes from three to 12 months, but can take longer. The process of obtaining premarket approval via Section 515 is much more costly, lengthy, and uncertain. Premarket approval generally takes from one to three years, but can take longer. We cannot be sure that the FDA will ever grant either 510(k) clearance or premarket approval for any product we propose to market.

The FDA decides whether a device must undergo either the 510(k) clearance or premarket approval process based upon statutory criteria. These criteria include the level of risk that the agency perceives to be associated with the device and a determination of whether the product is a type of

device that is substantially equivalent to devices that are already legally marketed. The FDA places devices deemed to pose relatively less risk in either class I or class II, which requires the manufacturer to submit a premarket notification requesting 510(k) clearance, unless an exemption applies. The premarket notification must demonstrate that the proposed device is substantially equivalent in intended use and in safety and effectiveness to an existing legally marketed device that is a class I, class II, pre-amendment class III device, or any of those for which the FDA has not yet called for submission of a premarket approval.

The FDA places devices deemed to pose the greatest risk, such as life-sustaining, life-supporting or implantable devices, or devices deemed to be not substantially equivalent to a predicate device, in its Class III classification. The FDA requires these devices to undergo the premarket approval process via Section 515 in which the manufacturer must prove the safety and effectiveness of the device. A premarket approval application must provide extensive pre-clinical and clinical trial data.

Table of Contents

The FDA may require results of clinical trials in support of a 510(k) submission and generally requires clinical trial results for a premarket approval application. In order to conduct a clinical trial on a significant-risk device, the FDA requires manufacturers to apply for and obtain, in advance, an investigational-device exemption. The investigational-device exemption application must be supported by appropriate data, such as animal and laboratory testing results. If the FDA and the Institutional Review Boards at the clinical trial sites approve the investigational-device exemption application for a significant-risk device, the manufacturer may begin the clinical trial. An investigational-device exemption approval provides for a specified clinical protocol, including the number of patients and study sites. If the manufacturer deems the product a non-significant risk device, the product will be eligible for more abbreviated investigational-device exemption requirements. If the Institutional Review Boards at the clinical trial sites concur with the non-significant risk determination, the manufacturer may begin the clinical trial.

We received approval for our Olympic Cool-Cap product as a Class III device from the FDA through the premarket approval process. Most of our other products in our newborn hearing screening, diagnostic hearing, EEG monitoring, polysomnography, and newborn care product lines have been approved by the FDA as Class II devices. Some of our disposable products, such as our Nascor neonatal headshields and oxygen delivery systems have received FDA approval as Class I devices. The FDA to date has not regulated data management software, including our Neometrics newborn screening data management system.

FDA Regulation

Numerous FDA regulatory requirements apply to our marketed devices. These requirements include:

- FDA quality system regulations which require manufacturers to create, implement, and follow design, testing, control, documentation, and other quality assurance procedures;
- Medical device reporting regulations, which require that manufacturers report to the FDA certain types of adverse and other events involving their products; and
- FDA general prohibitions against promoting products for unapproved uses.

Class II and Class III devices may also be subject to special controls applied to them, such as performance standards, post-market surveillance, patient registries, and FDA guidelines that may not apply to class I devices. We believe we are in compliance with the applicable FDA guidelines, but we could be required to change our compliance activities or be subject to other special controls if the FDA changes its existing regulations or adopts new requirements.

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

- Fines, injunctions, and civil penalties;
- Recall or seizure of our products;
- Issuance of public notices or warnings;
- Imposition of operating restrictions, partial suspension, or total shutdown of production;

Refusal of our requests for 510(k) clearance or pre-market approval of new products;

Withdrawal of 510(k) clearance or pre-market approval already granted; or

Criminal prosecution.

The FDA also has the authority to require us to repair, replace, or refund of the cost of any medical device manufactured or distributed by us.

Table of Contents

Other U.S. Regulations

We also must comply with numerous additional federal, state, and local laws relating to matters such as safe working conditions, manufacturing practices, environmental protection, biohazards, fire hazard control, and hazardous substance disposal. We believe we are currently in compliance with applicable safety, quality, environmental-protection, biohazard, and hazardous-substance-disposal regulations.

Foreign Regulation

In the foreign countries in which we sell or plan to sell our FDA-regulated products, these products are also regulated as medical devices, and are subject to regulatory requirements by foreign governmental agencies similar to those of the FDA. Our manufacturing facilities are audited and have been certified to be ISO900l/EN46001 compliant, which allows us to sell our products in Europe. Our manufacturing facilities are subject to CE Mark and ISO 9001 inspection by TÜV Rheinland. We plan to seek approval to sell our products in additional countries. The time and cost required to obtain market authorization from other countries and the requirements for licensing a product in another country may differ significantly from FDA requirements.

Employees

On December 31, 2006, we had approximately 360 full time employees worldwide. None of our employees are represented by a labor union. We have not experienced any work stoppages and consider our relations with our employees to be good.

Executive Officers

The following table lists our executive officers and their ages as of March 1, 2007:

Name	Age	Position(s)
James B. Hawkins	51	President, Chief Executive Officer, and Director
Steven J. Murphy	55	Vice President Finance and Chief Financial Officer
William L. Mince	55	Vice President Operations
Kenneth M. Traverso	46	Vice President Marketing and Sales
D. Christopher Chung, M.D.	43	Vice President Medical Affairs, R&D, and Engineering

James B. Hawkins has served as President and Chief Executive Officer, and as a member of the Board of Directors, since joining Natus in April 2004. Mr. Hawkins has over 25 years of combined medical device and financial management experience. Prior to joining Natus, he was President and Chief Executive Officer of Invivo Corporation (Nasdaq:SAFE) for 19 years. Invivo Corporation, maker of multi-parameter vital sign monitoring equipment used in hospitals, was acquired in early 2004 by Intermagnetics General Corporation (Nasdaq:IMGC). He earned a Bachelor of Commerce degree, specialized in Management from Santa Clara University and a Masters of Business Administration Finance degree from San Francisco State University.

Steven J. Murphy has served as Chief Financial Officer since February 2006, Vice President Finance since June 2003, and joined Natus in September 2002 as Director of Finance. From February 2002 through September 2002, Mr. Murphy was interim Controller at Travel Nurse International, a temporary staffing firm that was acquired by Medical Staffing Network in December 2002. From October 1998 through January 2002, Mr. Murphy was Controller of AdvisorTech Corporation, an international software development company providing IT-based solutions in the field of investments, where he was responsible for financial reporting of domestic, Asian and European operations with significant reporting responsibilities to the board of directors and investor groups. From 1996 to 1998 he was Vice President Finance of RWS Group, LLC, an international service company providing management of language-related projects. Mr. Murphy holds a Bachelor of Science degree in Business Administration from California State University, Chico. Mr. Murphy is a certified public accountant.

William L. Mince has served as our Vice President Operations since joining Natus in October 2002. From November 2000 to September 2002, Mr. Mince served as President and Founder of My Own Jukebox, an Internet

Table of Contents

retail company. From July 1998 to October 2000, Mr. Mince was a consultant with the majority of his time spent as Senior Vice President Network Solutions for Premier Retail Network, a media broadcasting company. From July 1997 to June 1998, Mr. Mince served as President and Chief Operating Officer of Ophthalmic Imaging Systems, a publicly-held medical device company. From July 1994 to June 1997, Mr. Mince was Vice President Operations with Premier Retail Network. From May 1988 to June 1994, Mr. Mince was Director of Operations for Nellcor, a medical device company. Mr. Mince holds a Bachelor of Science degree in Business Administration from the University of Redlands and a Masters of Business Administration degree from National University.

Kenneth M. Traverso has served as our Vice President Marketing and Sales since April 2002. From September 2000 to April 2002, he served as our Vice President Sales. From October 1999 to July 2000, Mr. Traverso served as President of DinnerNow.com Inc., an internet aggregator for the restaurant industry. From January 1998 to September 1999, Mr. Traverso served as Vice President Sales, Western Region of Alere Medical, an outpatient chronic disease management company. From May 1995 to January 1998, Mr. Traverso served as Vice President Marketing and Sales of AbTox, Inc., a low temperature sterilization company. From August 1990 to May 1995, Mr. Traverso served in various capacities at Natus, including Vice President Sales. From September 1984 to July 1990 Mr. Traverso served various positions at Nellcor, a medical device company, including Regional Sales Manager, Western Region. Mr. Traverso holds a Bachelor of Science degree in Administration & Marketing from San Francisco State University.

D. Christopher Chung, M.D., has served as our Vice President R&D and Engineering since June 2003, and has served as our Vice President Medical Affairs since February 2003. Dr. Chung also served as our Medical Director from October 2000 to February 2003. From August 2000 to present, Dr. Chung has also served as a Pediatric Hospitalist at the California Pacific Medical Center in San Francisco. From June 1997 to June 2000, Dr. Chung trained as a pediatric resident at Boston Children s Hospital and Harvard Medical School. From May 1986 to July 1993, Dr. Chung worked as an Engineer at Nellcor, a medical device company. Dr. Chung holds a Bachelor of Arts degree in Computer Mathematics from the University of Pennsylvania and a Doctor of Medicine degree from the Medical College of Pennsylvania-Hahnemann University School of Medicine. He is board certified in Pediatrics and is a Fellow of the American Academy of Pediatrics.

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

We acquired intellectual property assets and technology patents from Pemstar Pacific Consultants during 2002; we acquired the assets of Neometrics Inc. and affiliated entities during 2003; and we acquired Fischer-Zoth in 2004. In January 2006 we completed the acquisition of Bio-logic. In September and October 2006 we completed the acquisitions Deltamed and Olympic Medical, and certain assets from Nascor.

We expect to continue to pursue opportunities to acquire other businesses in future periods. 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 to our acquisitions, including one-time charges associated with restructurings or in-process research and development assets. 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.

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 the acquisition. Our corporate headquarters are located in San Carlos,

Table of Contents

California. Bio-logic s primary offices are located in Illinois, Olympic Medical s operations are in Washington, Neometrics operations are located in New York, Deltamed s operations are in France, and Fischer-Zoth s operations are in Germany. The geographical distance between our various facilities may further adversely affect our ability to manage these operations. 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 the acquisition that we anticipate. We may encounter the following difficulties, costs, and delays involved in integrating and managing these operations, and the operations of companies we may acquire:

- Failure to realize expected synergies;
- Inability to effectively integrate acquired products into our business;
- Failure to successfully manage relationships with customers and other important business partners;
- 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;
- Challenges encountered in managing larger, more geographically dispersed operations;
- The loss of key employees;
- Assumption of unknown liabilities;
- Failure to understand and compete effectively in markets and with products or technologies with which we have limited previous experience;
- Impairment charges incurred to write down the carrying amount of intangible assets, including goodwill, generated as a result of the acquisition;
- 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 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.

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

At December 31, 2006, we had 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 judgments. 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. Any future determination that these assets are carried at greater than their fair value could result in additional charges, which could significantly impact our operating results.

Our acquisitions have included in-process research and development assets (IPR&D assets) for which we hope to generate future cash flows; our results of operations could be adversely affected if we are unable to bring these assets to market

Through our acquisitions of other businesses, we have acquired IPR&D assets from which we hope to generate future cash flows. There is inherent risk in bringing these IPR&D assets to market and we may be

Table of Contents

unable to realize the full value we have assigned to them. We may be unable to complete the development of these IPR&D assets within a timely manner, or we may encounter technological difficulties that prevent us from completing their development. If we are unable to derive future revenue from our IPR&D assets, our results of operations could be adversely impacted.

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.

In the past, we have relied on sales of our newborn screening products for the majority of our revenue, and these products will continue to contribute to a substantial portion of our revenue; a decline in sales of these products could cause our revenue to fall

We expect that the revenue from our newborn hearing screening products will continue to account for a substantial portion of our revenue for at least the next year. Any factors adversely affecting the pricing of our newborn hearing screening devices and related supplies, or demand for our newborn hearing screening products, including physician acceptance or the selection of competing products, could cause our revenue to decline and our business to suffer.

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 new products or technologies

Clinicians, hospitals, and government agencies are unlikely to purchase our products if clinicians are not adequately reimbursed for the procedures conducted with our devices or supplies. Unless a sufficient amount of 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 refuse adequate reimbursement unless the patient has demonstrable risk factors. If health care providers cannot obtain sufficient reimbursement from third-party payors for our products or the screenings conducted with our products, 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 health care payment systems. Reimbursement, funding, and health care 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.

Table of Contents

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

It is critical to the success of our sales efforts that we educate a sufficient number of clinicians, hospital administrators, and government agencies about our products and the costs and benefits of their use. The commercial success of our products depends upon clinician, government agency and other third-party payor confidence in the economic and clinical benefits of our products as well as their comfort with the efficacy, reliability, sensitivity and specificity of our products. We believe that 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 more 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;

Performance, quality, price, and total cost of ownership 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 payors;

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

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

Increased sales through group purchasing organizations and sales to high volume purchasers may reduce our average selling prices, which would reduce our revenue and gross profits

We have entered, and may in the future enter, into agreements with customers who purchase high volumes of our products. Our agreements with these customers may contain discounts from our normal selling prices and other special pricing considerations, which could cause our revenue and profits to decline. In addition, we have entered into agreements to sell our products to members of group purchasing organizations, or 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 31%, 28%, and 46% of our total revenue during 2006, 2005, and 2004, respectively, and sales to members of one GPO, Novation LLC, accounted for approximately 12%, 15%, and 20% of our total revenue in 2006, 2005, and 2004, respectively. Other 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 revenue and profits could decline.

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

20

Table of Contents

any new equipment from us or upgrade to any of our newer equipment products. 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 affect on our revenue and margins.

We believe that our primary competitive strengths relate to the functionality and reliability of our products, our recognized brands, and our developed sales channels. 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 and acquire additional products and technologies for the screening, detection, treatment, monitoring and tracking of common medical ailments. Developing and acquiring 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 business could be harmed if our competitors establish cooperative relationships with large medical device vendors or rapidly acquire market share through industry consolidation

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

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 plan to expand our international sales and marketing efforts to increase sales of our products in foreign countries. During the past five years we significantly expanded our distributor network outside the U.S. 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.;

Table of Contents

Political and economic instability, including instability related to war and terrorist attacks in the U.S. and abroad;

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

Decreased health care spending by foreign governments that would reduce international demand for our produces;

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

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; and

Attitudes by clinicians, and cost reimbursement policies, towards use of disposable supplies that are potentially unfavorable to our business.

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 revenue may be adversely impacted

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 the phase-in period generally spans 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 governments do not require universal newborn hearing screening prior to hospital discharge, or if physicians or hospitals are slow to comply with those guidelines, or if governments provide for a lengthy phase-in period for compliance.

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. Our reliance on international distributors has increased because of our decisions in 2004 and 2005 to close our Japanese and U.K. sales subsidiaries and sell through distributors in those countries, and because of our acquisition of Fischer-Zoth, which sells its products through distributors in Europe and Asia. We may also sell Deltamed products through distributors in countries outside of France and Germany. 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.

22

Table of Contents

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. These payments could be equal to a year or more of gross profit on sales of our products that the distributor would have earned. Any required payments would adversely affect our operating results.

Our operating results may suffer because of our exposure to foreign currency exchange rate fluctuations and may require us to engage in foreign currency hedging

Substantially all of our sales contracts to our U.S. based customers provide for payment in U.S. dollars. In addition, sales to most of our international distributors provide for payment in U.S. dollars. However, substantially all of the revenue and expenses of our foreign subsidiaries are denominated in the applicable foreign currency. To date we have not undertaken any foreign currency hedging transactions and, as a result, 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 the translation of assets denominated in foreign currencies.

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. For example, during 2002, we experienced delays on the part of a supplier to provide us with volume production of our Flexicoupler supplies, and in 2005, we relied on a single supplier of cables used in our ALGO hearing screening devices to help us complete a field replacement program of those cables. If these or other 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. Hiring research and development, engineering, sales, marketing and customer service personnel in our industry is very competitive due to the limited number of people available with the necessary technical skills and understanding of our product technologies. We may be unable to attract and retain personnel necessary for the development of our business.

Table of Contents

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 Food and Drug Administration, or the FDA, and by similar regulatory agencies in many other countries in which we do business. 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 s Section 510(k) clearance process usually takes from three to 12 months, but can take longer. The process of obtaining premarket approval via Section 515 is much more costly, lengthy and uncertain. Premarket approval generally takes from one to three years, but can take even longer. The FDA may not grant either Section 510(k) clearance or premarket approval for any product we propose to market. Furthermore, if the FDA concludes that future products using our technology do not meet the requirements to obtain Section 510(k) clearance, we would have to seek premarket approval via Section 515. The FDA may impose the more burdensome premarket approval requirement on modifications to our existing products or future products, which in either case could be costly and cause us to divert our attention and resources from the development of new products or the enhancement of existing products.

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 or we do not pass an inspection

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

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

We have received clearance from the FDA to market a new product that will potentially expose us to greater products liability exposure and FDA regulation

In December 2006 we received clearance from the FDA to market the Olympic Cool-Cap, a product designed to lower the cerebral temperature of children born with a particular medical condition. This product 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 oversight processes of the FDA and other regulatory bodies.

Table of Contents

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

We 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.

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

Every manufacturer of a finished medical device, including Natus and some of our contract manufacturers and suppliers, is required to demonstrate and maintain compliance with the FDA s quality system regulation and comparable regulations of states and other countries. The FDA enforces the quality system regulation through periodic inspections. We, or our contract manufacturers, may fail to pass future quality system regulation inspections. If we, or our contract manufacturers, fail one of these inspections in the future, our operations could be disrupted and our manufacturing and sales delayed significantly until we demonstrate adequate compliance. If we or our contract manufacturers fail to take adequate corrective action in a timely fashion in response to a quality system regulation inspection, the FDA could shut down our or our contract manufacturers manufacturing operations or require us, among other things, to recall our products, either of which would harm our business.

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

The medical technology industry has, in the past, been characterized by a substantial amount of litigation and related administrative proceedings regarding patents and intellectual property rights. We expect that medical screening and diagnostic products may become increasingly subject to third-party infringement claims as the number of competitors in our industry segment grows and the functionality of products in different industry segments 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 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

25

Table of Contents

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

Since our inception, we have incurred significant net losses, including net losses for the years 2004 and 2003, and we may incur net losses in the future. As of December 31, 2006, we had an accumulated deficit of approximately $31.7 million. Additionally, our revenue and operating results have varied significantly from quarter to quarter in the past and may continue to fluctuate in the future. The following are among the factors that could cause our revenue, operating results and margins to fluctuate significantly from quarter to quarter:

- Budgeting cycle of our customers, particularly government entities;
- Size and timing of specific sales, such as large purchases of our devices and systems or our supplies and services by government agencies or hospital systems;
- Trade-in allowances or other concessions in connection with the introduction of new products or improvements to existing products;
- Length and unpredictability of our sales cycle; and
- Market changes caused by rapidly evolving technology.

In addition, 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 current and prospective customers, many of which are government agencies. We may also experience declining sales in the third fiscal quarter due to summer holiday and vacation schedules. We anticipate that we will continue to experience these seasonal fluctuations, which may lead to fluctuations in our quarterly operating results. We believe that you should not rely on our results of operations for interim periods as an indication of our expected results in any future period.

We anticipate that it will become increasingly difficult for us to manage our expenses as we:

- Continue to invest in research and development to enhance our product lines, including products and technologies we have gained through our acquisitions;
- Develop additional applications for our current technology;

Increase our marketing and selling activities, particularly outside the U.S.; and

Develop additional infrastructure and hire required management and other employees to keep pace with our growth.

As a result of these factors, we may need to generate proportionately higher revenue to maintain profitability. We cannot be certain that we will be able to sustain profitability in the future.

Table of Contents

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

As of December 31, 2006, we had total federal net operating loss carryforwards of approximately $11.2 million and credit carryforwards of approximately $1.0 million available to reduce future taxable income. These net operating loss and credit carryforwards, if not utilized to offset taxable income in future periods, will expire in various amounts beginning in 2008. In addition, the net operating loss and credit carryforwards are subject to examination by the Internal Revenue Service (IRS), and are thus subject to adjustment or disallowance resulting from any such IRS examination. If we are unable to fully utilize our net operating loss carryforwards, our future tax payments could be higher and our financial condition may suffer.

ITEM 1B. Unresolved Staff Comments.
Not applicable.

ITEM 2. Properties
The corporate headquarters of the Company are located in San Carlos, California, in facilities covering 39,200 square feet pursuant to a lease that expires in June 2010.

The Company also utilizes the following properties:

- 26,000 square feet in Mundelein, Illinois, in a facility owned by the Company that is utilized substantially for the operations of Bio-logic;
- 65,000 square feet in Seattle, Washington, of which 12,000 square feet are currently sub-let, pursuant to a lease that expires in December 2011, that is utilized substantially for the operations of Olympic Medical;
- 2,900 square feet in Hauppauge, New York, pursuant to a lease that expires in October 2007, that is utilized substantially for the operations of Neometrics;
- 3,800 square feet in Munich, and 3,000 square feet in Usingen, both in Germany, pursuant to leases that expire in 2007 and 2008 that are utilized substantially for the operations of Fischer-Zoth; and
- 2,700 square feet in Paris, and 7,500 square feet in Bordeaux, both in France, pursuant to leases that expire in November 2009 and March 2009, respectively, that are utilized substantially for the operations of Deltamed.

ITEM 3. 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 has reviewed these matters and believes that the resolution of them will not have a significant adverse effect on our financial condition.

ITEM 4. Submission of Matters to a Vote of Security Holders
No stockholder votes took place during the fourth quarter of the year ended December 31, 2006.

27

Table of Contents

PART II

ITEM 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock has been traded on the Nasdaq Global Market under the symbol BABY since our initial public offering in July 2001. The following table sets forth, for the periods indicated, the high and low closing sales price per share of our common stock, as reported on the Nasdaq Global Market.

	High	Low
Fiscal Year Ended December 31, 2006:		
Fourth Quarter	$ 17.50	$ 13.33
Third Quarter	13.93	9.89
Second Quarter	20.50	9.89
First Quarter	21.57	14.56
Fiscal Year Ended December 31, 2005:		
Fourth Quarter	$ 18.72	$ 11.30
Third Quarter	13.46	9.91
Second Quarter	11.44	7.40
First Quarter	9.30	6.52

As of March 1, 2007, there were 21,469,094 shares of our common stock issued and outstanding and held by approximately 55 stockholders of record. We estimate that there are approximately 8,693 beneficial owners of our common stock.

Dividends

We have never declared or paid cash dividends on our capital stock. We currently expect to retain future earnings, if any, for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future.

Securities Authorized for Issuance Under Equity Compensation Plans

Additional information required by this item regarding equity compensation plans is incorporated by reference to the information set forth in Item 12 of this report on Form 10-K.

Table of Contents

Stock Performance Graph

The following information of Part II Item 5 is being furnished and shall not be deemed to be soliciting material or to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities of that Section, nor will it be deemed incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent that it shall be expressly set forth by specific reference in such filing.

The following graph shows a comparison, from January 1, 2002 through December 31, 2006, of cumulative total return for our common stock, the Nasdaq Composite Index and the Standard & Poor s 500 Health Care Equipment Index. Such returns are based on historical results and are not intended to suggest future performance. Data for the Nasdaq Composite Index and the Standard & Poor s 500 Health Care Equipment Index assume reinvestment of dividends.

Use of Proceeds

In January 2006, we used all of the remaining proceeds from our initial public offering in our acquisition of Bio-logic. We used approximately $46 million of our own funds to complete that acquisition, including $7.1 million we received in a private placement of our stock in October 2005.

Table of Contents

ITEM 6. Selected Consolidated Financial Data

Our selected consolidated financial data is presented below as of December 31, 2006, 2005, 2004, 2003 and 2002 and for each of the years in the five-year period ended December 31, 2006, and is derived from the consolidated financial statements of Natus Medical Incorporated and its subsidiaries. The consolidated financial statements as of December 31, 2006 and 2005 and for each of the years in the three-year period ended December 31, 2006 are included elsewhere in this report. The selected consolidated balance sheet data as of December 31, 2004, 2003 and 2002 and the consolidated statements of operations data for the years ended December 31, 2003 and 2002 are derived from our consolidated financial statements, which are not included in this report. The selected consolidated financial data set forth below is qualified in its entirety by, and should be read in conjunction with, the Consolidated Financial Statements and Notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this report.

	Year ended December 31,				
	2006[a]	2005	2004[a]	2003[a]	2002
	(in thousands, except per share data)				
Consolidated Statement of Operations Data:					
Revenue	$ 89,915	$ 43,045	$ 36,506	$ 31,006	$ 27,013
Cost of revenue	33,665	16,092	15,015	12,786	12,122
Gross profit	56,250	26,953	21,491	18,220	14,891
Operating expenses:					
Marketing and selling	21,944	11,396	11,305	12,775	13,673
Research and development	10,604	4,318	3,672	3,682	4,752
General and administrative	11,004	5,806	6,626	4,984	5,018
Acquired in-process research and development	9,800[b]		470		
Restructuring			776		234
Total operating expense	53,352	21,520	22,849	21,441	23,677
Income (loss) from operations	2,898	5,433	(1,358)	(3,221)	(8,786)
Other income, net	225	1,228	310	597	1,296
Income (loss) before provision for income taxes	3,123	6,661	(1,048)	(2,624)	(7,490)
Provision for income tax (benefit) expense	4,050	509	297	4	(38)
Income (loss) from continuing operations	(927)	6,152	(1,345)	(2,628)	(7,452)
Discontinued operations			(1,062)	(116)	
Net income (loss)	$ (927)	$ 6,152	$ (2,407)	$ (2,744)	$ (7,452)
Earnings (loss) per share:					
Basic	$ (0.05)	$ 0.35	$ (0.14)	$ (0.17)	$ (0.46)
Diluted	$ (0.05)	$ 0.33	$ (0.14)	$ (0.17)	$ (0.46)
Weighted average shares used in the calculation of net income (loss) per share:					
Basic	19,548	17,429	16,837	16,411	16,056
Diluted	19,548	18,693	16,837	16,411	16,056

	December 31,				
	2006	2005	2004	2003	2002
	(in thousands)				
Balance Sheet Data:					
Cash, cash equivalents, and short-term investments	$ 15,392	$ 52,209	$ 35,743	$ 37,635	$ 44,918

Working capital	30,803	57,495	40,826	44,720	50,883
Total assets	124,163	77,395	59,257	57,020	59,340
Total stockholders equity	101,026	68,965	52,728	52,632	54,687

[a] Results of operations of Neometrics, Fischer-Zoth, Bio-logic, Deltamed, and Olympic are included from their acquisition dates of July 2003, September 2004, January 2006, September 2006, and October 2006, respectively.

[b] Acquired in-process research and development charges in 2006 are associated with our acquisitions of Bio-logic and Olympic, and in 2004 with our acquisition of Fischer-Zoth.

Table of Contents

ITEM 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following Management Discussion and Analysis of Financial Condition and Results of Operations (MD&A) should be read in conjunction with the Company s financial statements and the accompanying footnotes. MD&A includes the following sections:

Our Business. A general description of our business.

Year 2006 Overview. A summary of key information concerning the financial results for 2006 and changes from 2005.

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 critical judgments and estimates.

Results of Operations. An analysis of our results of operations for the three years 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. A recap of recently issued accounting pronouncements that may have an impact on our results of operations, financial position or cash flows.

Cautionary Information Regarding Forward-Looking Statements. Cautionary information about forward-looking statements and a description of certain risks and uncertainties that could cause our actual results to differ materially from our historical results or our current expectations about future periods.

Business

Natus provides healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care. We develop, manufacture, and market advanced neurodiagnostic and newborn care products to healthcare professionals. Our 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 of brain injury in newborns, and software systems for managing and tracking disorders and diseases for public health laboratories.

We design our products to deliver accurate results in a rapid and reliable manner. In addition, our products address guidelines for standard medical practices as adopted by various medical-industry associations such as the American Academy of Pediatrics (AAP) and the Joint Committee on Infant Hearing (JCIH).

Our principal product families and product lines consist of:

Newborn Hearing Screening. ALGO, ABaer, AuDX, and Echo-Screen;

Diagnostic Hearing Assessment. Navigator, AuDX Pro, Scout, and Cochlea-Scan;

Diagnostic EEG Monitoring. Ceegraph VISION, Coherence, and CFM 6000;

Diagnostic Sleep Analysis. Sleepscan VISION and Coherence;

Newborn Care and Other. Cool-Cap, NeoBLUE, Bili-Lites, Smart Scales, Neometrics MSDS, Pasteurmatic washer and pasteurizer, Bio-Clean Sterile Dryer, and VAC-PAC.

Our revenue is generated almost exclusively from the sale of devices and systems, which are generally non-recurring, and related supplies and services, which are generally recurring. The sources of our revenue from devices and systems, and related supplies and services, are covered in Item 1 to this Annual Report on Form 10-K.

Table of Contents

We sell our products in the United States primarily through a direct sales organization. Through our acquisition of Bio-logic in January 2006, we now offer our line of diagnostic hearing products in the U.S. primarily through distributors; we also sell certain products under private label arrangements. We sell our products outside the U.S. primarily through a distributor sales channel, which consists of distributors selling Natus products into more than 80 countries as of December 31, 2006. Through our acquisition of Deltamed in September 2006, we sell some of our products in France and Germany through a direct sales organization. We previously had direct sales organizations in Japan and the United Kingdom (U.K.). However, in 2004 we ceased selling through a direct sales force in Japan and began to sell through a distributor, and in February 2006 we ceased selling through a direct sales force in the U.K. and began to sell through a distributor. Revenue from direct sales in our international markets represents less than 10% of total revenue.

We intend to continue expansion of our international operations because we believe international markets represent a significant growth opportunity. International sales made to distributors are characterized by lower gross profits due to the discount from our list prices that the distributors receive. International sales contributed to 29% of our revenue during 2006, compared to 36% of our revenue during 2005. The reduction in international sales as a percent of total sales in 2006 compared to 2005 was attributable to our acquisition of Bio-logic, as their international sales comprise a lower percentage of their total sales than Natus. We anticipate that international revenue will increase as a percent of revenue in the future.

We estimate that approximately 95% of the children born in the U.S. are currently being tested for hearing prior to discharge from the hospital. As such, the U.S. market is a mature and competitive market. We derive a significant portion of our revenue from the sale of disposable supplies that are used with our screening devices. Because these products can generate high margins, we may face increasing competition. We believe that our primary competitive advantage relates to the functionality and reliability of our products and that other suppliers may compete against us by offering lower prices.

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

Year 2006 Overview

In January we acquired Bio-logic Systems Corp (Bio-logic) for $69.3 million pursuant to an Agreement and Plan of Merger dated as of October 16, 2005. We used $12.8 million of Bio-logic cash to fund the acquisition. Bio-logic, which traded on the Nasdaq National Market under the ticker BLSC, reported revenue of $30.5 million and net income of $1.9 million, for the year ended February 28, 2005.

In January we initiated an integration plan (the Plan) related to the acquisition of Bio-logic. Under the Plan, we reduced our combined workforce by 23 employees or 10% of our workforce. The objectives of the Plan were to eliminate redundant costs and improve efficiency. Total employee severance costs related to the staff reductions were $3.0 million, including costs related to change of control provisions in the employment contracts of the chief executive officer, chief operating officer, and two vice-presidents of Bio-logic totaling $2.7 million.

During the first quarter 2006 we began marketing the latest extension of our product line for the treatment of newborn jaundice. The neoBLUE cozy provides a light treatment source from underneath the baby, utilizing the same blue light emitting diodes (LEDs) used in our line of neoBLUE overhead phototherapy lights.

In March we partnered with Welch Allyn, Inc., a leading manufacturer of frontline medical products and solutions, to market an innovative hearing loss detection solution that will improve clinical efficiencies by allowing pediatricians to objectively screen for hearing loss in infants, toddlers, preschool, and school age children.

Table of Contents

In August we issued 2,645,000 shares of our stock in a registered offering priced at $11.66 per share, raising $29.3 million after deducting costs associated with the offering. In September we completed the sale of an undeveloped parcel of land we obtained through our acquisition of Bio-logic. The sale of land had no impact on our results of operations; however, we netted approximately $2.5 million cash through the sale.

In September we acquired Deltamed S.A. (Deltamed) for cash of $4.1 million cash and in October we acquired Olympic Medical Corp (Olympic) for $19.3 million including the immediate satisfaction of $2.7 million dollars of Olympic obligations associated with the acquisition. Olympic has approximately 100 employees and recorded sales of $16.9 million during calendar year 2005.

In December we received premarket approval from the FDA to market our Olympic Cool-Cap, a Class III medical device. The Cool-Cap system, which is the only FDA-approved device for the treatment of hypoxic ischemic encephalopathy (HIE) in term newborns, provides selective head cooling to prevent or reduce the severity of neurologic injury associated with HIE.

We adopted Financial Accounting Standards Board (FASB), Statement on Financial Accounting Standards (SFAS) No. 123R on January 1, 2006. During 2006 we expensed $1.4 million of share-based compensation expense, which increased our net loss per share by $0.04.

Application of Critical Accounting Policies

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

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

Revenue recognition

We recognize revenue, net of discounts, from sales of medical devices and supplies, including sales to distributors, when a purchase order has been received, when title transfers, when the selling price is fixed or determinable, and when collection of the resulting receivable is reasonably assured. Revenue from sales of certain EEG and PSG systems is recognized in accordance with FASB Statement of Position No. 97-2, *Software Revenue Recognition*, wherein revenue is recognized when there is persuasive evidence of an arrangement, delivery has occurred, the sales price is fixed or determinable, and collection is reasonably assured. Set-up and training revenue related to system sales is not recognized until the service is completed. When contractual arrangements contain multiple elements, revenue is allocated to each element based on its relative fair value determined using prices charged when elements are sold separately. Terms of sale for most domestic sales are FOB origin, reflecting that title and risk of loss are assumed by the purchaser at the shipping point, however, terms of sale for some neurology and sleep-diagnostic systems are FOB destination, reflecting that title and risk of loss are assumed by the purchaser upon delivery. Terms of sales to international distributors are EXW, reflecting that goods are shipped ex works, in which title and risk of loss are assumed by the distributor at the shipping point.

Revenue from extended service and maintenance agreements, for both medical devices and data management systems, is recognized ratably over the service period. Advance payments from customers are recorded as deferred revenue and recognized as revenue as otherwise described above. We generally do not provide rights of return on products. We accept trade-ins of our own and competitive medical devices. Trade-ins are recorded as a reduction of the replacement medical device sale. Provisions are made for initial standard warranty obligations of one year, and post-sale training and customer support at the time the related revenue is recognized.

Table of Contents

More than 90% of the hospitals in the U.S. are members of GPOs, which negotiate volume purchase prices for member hospitals, group practices, and other clinics. We have entered into agreements with several GPOs that typically contain preferential terms for the GPO and its members, including provisions for some, if not all, of the following:

- Negotiated pricing for all group members;
- Volume discounts and other preferential terms on their member s direct purchases from us;
- Promotion of Natus products by the GPO to its members;
- Payment of marketing fees by Natus to the GPO, usually based on purchasing experience of group members; and
- Non-recourse cancellation provisions.

We do not sell our products to GPOs. Hospitals, group practices and other clinics that are members of a GPO purchase products directly from us under the terms negotiated by the GPO. Negotiated pricing and discounts are recognized as a reduction of the selling price of our products. Revenue from sales to GPO members is otherwise consistent with our general revenue recognition policies as previously described.

Allowance for doubtful accounts

We must exercise judgment when assessing the sufficiency of our allowance for estimated uncollectible accounts receivable. Our estimates are based on our historical collection experience within the markets in which we operate, assessment of our average accounts receivable aging days, and any other specific information of which we may be aware, such as bankruptcy filings or liquidity problems of our customers. Any future determination that our allowance for estimated uncollectible accounts receivable is not properly stated could result in a change in our operating expense and results of operations.

Inventory is carried at the lower of cost or market value

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

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

Carrying value of intangible assets

We amortize intangible assets with finite lives over their useful lives; any future changes that would limit their useful lives or any determination that these assets are carried at amounts greater than their fair value could result in additional charges. We carry goodwill and any other intangible assets with indefinite lives at original cost but do not amortize them. Any future determination that these assets are carried at amounts greater than their fair value could result in additional charges, which could significantly impact our operating results.

We test our definite-lived intangible assets for impairment whenever changes in circumstances indicate the carrying value of these assets may be impaired. Impairment indicators include, but are not limited to, net book value as compared to market capitalization, significant negative industry and economic trends, and significant

34

Table of Contents

underperformance relative to historical and projected future operating results. Impairment is considered to have occurred when the estimated undiscounted future cash flows related to the asset are less than its carrying value. Estimates of future cash flows involve consideration of many factors including the marketability of new products, product acceptance and lifecycle, competition, appropriate discount rates, and operating margins.

We test our goodwill and indefinite-lived intangible assets for impairment at least annually as of October 1st of each year; this assessment is also performed whenever there is a change in circumstances that indicates the carrying value of these assets may be impaired. The determination of whether any potential impairment of goodwill exists is based upon a comparison of the fair value of a reporting unit to the basis of the underlying net assets of such reporting unit. To determine the fair value of our reporting units, we utilize subjective valuations based upon discounted cash flow analysis. The discounted cash flow analysis is dependent upon a number of factors including estimates of forecasted revenue and costs, and appropriate discount rates.

Liability for product warranties

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

Share-based compensation

On January 1, 2006, we adopted the provision of SFAS 123R, *Share-Based Payment*, using the modified prospective approach. With the adoption of SFAS 123R, the Company is required to record the fair value of share-based compensation awards as expenses in the consolidated statement of operations. In order to determine the fair value of stock options on the date of grant, the Company applies the Black-Scholes option-pricing model. Inherent in this model are assumptions related to expected dividend yield, risk-free interest rate, expected stock-price volatility, expected term, and forfeiture rate. While the risk-free interest rate and dividend yield are less subjective assumptions, typically based on factual data derived from public sources, the expected stock-price volatility, expected life, and forfeiture rate assumptions require a greater level of judgment which makes them critical accounting estimates. Following is a summary of the criteria the Company considers when making these estimates:

Expected volatility is based exclusively on historical volatility data of the Company s common stock, measured by reference to the average of the high and low price of the stock on the same day of each week.

The expected term of stock options granted is based exclusively on historical data and represents the period of time that stock options granted are expected to be outstanding. The expected term is calculated for and applied to one group of stock options, as the Company does not currently expect substantially different exercise or post-vesting termination behavior among its employee population. The Company uses the simplified method for calculating expected term allowed by SAB No. 107.

Share-based compensation expense is based on awards ultimately expected to vest. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company bases its pre-vesting forfeiture rate on weighted average historical forfeiture rates. Under the provisions of SFAS 123R, the Company will record additional expense if the actual forfeiture rate is lower than estimated, and will record a recovery of prior expense if the actual forfeiture is higher than estimated.

Table of Contents

Results of Operations

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

	Percent of Revenue Years Ended December 31,		
	2006	2005	2004
Revenue	100.0%	100.0%	100.0%
Cost of revenue	37.4	37.6	41.1
Gross profit	62.6	62.4	58.9
Operating expenses:			
Marketing and selling	24.4	27.5	30.9
Research and development	11.8	10.6	10.1
General and administrative	12.3	13.4	18.2
Acquired in-process research and development	10.9		1.3
Restructuring			2.1
Total operating expenses	59.4	51.5	62.6
Income (loss) from operations	3.2	10.9	(3.7)
Other income, net	.3	2.6	.8
Income (loss) before provision for income taxes	3.5	13.5	(2.9)
Income tax provision	4.5	1.4	.8
Income (loss) from continuing operations	(1.0)	12.1	(3.7)
Discontinued operations			(2.9)
Net income (loss)	(1.0)%	12.1%	(6.6)%

Comparison of 2006 and 2005

Acquisitions

In order to more fully understand the comparison of the results of operations for the year ended December 31, 2006 to the years ended December 31, 2005 and 2004, it is important to note that we acquired Bio-logic in January 2006, which had a material impact on our financial position and results of operations during 2006. The acquisitions of Deltamed in September 2006, and Olympic in October 2006 did not have as significant of an impact on our results of operations for the year ended December 31, 2006, primarily because these acquisitions were completed late in the year.

Operating Results

We analyze our revenue from two perspectives. Because our acquisitions have been significant, we measure the contribution of the businesses we acquired in 2006 to consolidated revenue for the year. We also analyze our revenue as coming from two sources: sales of devices and systems, and sales of related supplies and services. We report freight revenue separate from these two sources.

Our revenue increased 109%, or $46.9 million, to $89.9 million in 2006, from $43.0 million in 2005. Bio-logic contributed to $38.2 million of our 2006 revenue, which amount represents an 18% increase over Bio-logic s stand-alone revenue of $32.3 million for the twelve months ended December 31, 2005. Deltamed and Olympic contributed to $6.1 million of our revenue in 2006.

36

Table of Contents

Revenue from devices and systems was $51.6 million in 2006, representing an increase of 166% or $32.1 million, from $19.4 million reported in 2005. Revenue from supplies and services was $36.9 million in 2006, representing an increase of 59% or $13.8 million, from $23.2 million in 2005.

Revenue from devices and systems was 57% of total revenue in 2006, compared to 45% in 2005, and revenue from supplies and services was 41% of total revenue in 2006 compared to 54% of revenue in 2005. The changes in the percentages from 2005 to 2006 resulted primarily from the contribution of Bio-logic. Freight revenue of $1.4 million in 2006 represented 2% of total revenue, while freight revenue of $488,000 in 2005 represented 1% of total revenue.

No customer accounted for more than 10% of our revenue in either 2006 or 2005. Revenue from domestic sales increased 133% to $64.0 million in 2006, from $27.5 million in 2005. Revenue from international sales increased 67% to $25.9 million in 2006, compared to $15.6 million in 2005. Revenue from domestic sales was 71% of total revenue in 2006, compared to 64% in 2005, and revenue from international sales was 29% of total revenue in 2006 compared to 36% of revenue in 2005. The changes in the percentages from 2006 to 2005 resulted primarily from the contribution of Bio-logic and Deltamed.

Our cost of revenue increased $17.6 million, or 109%, to $33.7 million in 2006, from $16.1 million in 2005. The increase was primarily due to our increased sales, and also includes $116,000 of share based compensation expense in 2006 for which there was no corresponding charge in 2005. Gross profit increased $29.3 million, or 109%, to $56.3 million in 2006 from $27.0 million in 2005, primarily due to our increased sales. Gross profit as a percentage of revenue was 62.6% in both 2006 and 2005. Sales of Olympic products reduced consolidated gross profit by 0.4% in 2006.

Total operating costs increased 148% to $53.4 million in 2006, from $21.5 million in 2005. The operations of Bio-logic, Deltamed, and Olympic contributed to $19.4 million of the increase, while charges for in-process research and development contributed an additional $9.8 million; we had no such costs in 2005. Our operating costs other than the charges for in-process research and development declined as a percentage of revenue in 2006 relative to 2005. We also recorded $1.3 million of employee share-based compensation expense in 2006 for which there was no cost in 2005.

Our marketing and selling expenses increased $10.5 million, or 92.6%, to $21.9 million in 2006 from $11.4 million in 2005. The marketing and selling expenses of Bio-logic, Deltamed, and Olympic were $10.7 million in 2006. We recorded $483,000 of employee share-based compensation expense in marketing and selling expenses in 2006 for which there was no cost in 2005.

Our research and development expenses increased $6.3 million, or 146%, to $10.6 million in 2006 from $4.3 million in 2005. The research and development expenses of Bio-logic, Deltamed, and Olympic were $6.2 million. We recorded $111,000 of employee share-based compensation expense in research and development expenses in 2006 for which there was no cost in 2005.

Our general and administrative expenses increased $5.2 million, or 90%, to $11.0 million in 2006 from $5.8 million in 2005. General and administrative expenses of Bio-logic, Deltamed, and Olympic were $2.6 million. Our general and administrative costs other than those associated with our acquisitions increased by $2.6 million. Outside consulting costs increased by $1.1 million, primarily due to incremental legal, auditing, and tax consulting fees associated with the increase in the size of the Company resulting from our acquisitions. In addition we recorded $695,000 of employee share-based compensation expense in general and administrative expenses in 2006 for which there was no cost in 2005.

During 2006, we recorded charges for acquired in-process research development of $5.9 million associated with our acquisition of Bio-Logic in January 2006 and $3.9 million associated with our acquisition of Olympic in October 2006. We had no such costs in 2005.

Table of Contents

Other income (expense) net consists of investment income and net capital gains and losses from our investment portfolio, interest expense, net currency exchange gains and losses, and other miscellaneous income and expenses. We reported a net other income of $225,000 in 2006, compared to $1.2 million in 2005. The reduction in net other income resulted primarily from the decrease in our investment portfolio and an increase in interest expense related to a bank obligation outstanding during ten months of 2006 both of which were related to our acquisition of Bio-logic in January 2006. Our net foreign currency gains and losses were not material in 2006 or 2005. Unrealized translation gains and losses from our consolidated foreign subsidiaries are not included in net income, but are reported as a component of other comprehensive income.

We recorded income tax expense of $4.1 million in 2006, compared to $509,000 recorded in 2005. The charge for acquired in-process research and development associated with the acquisition of Bio-logic does not represent a deductible expense for purposes of calculating our effective tax rate. Our effective tax rate for 2006 without giving effect to non-deductible in-process research and development was 44.9%. Our effective tax rate in 2005 was 7.6%. Our effective tax rate increased in 2006 because we released the valuation allowance against our deferred tax assets through purchase accounting associated with the acquisition of Bio-logic. At December 31, 2006 we had federal and state net operating loss carryforwards of approximately $11.2 million and $3.2 million, respectively, and federal and state credit carryforwards of $881,000 and $587,000, respectively, available to offset future taxable income. Our tax loss and credit carryforwards do not offset taxable income for purposes of the Federal corporate alternative minimum tax, for which there is an effective tax rate of 2.0% on our U.S. operating income. Income tax expense related to our international operations is based on the statutory rates in those jurisdictions.

Comparison of 2005 and 2004

Our revenue increased $6.5 million, or 18%, to $43.0 million in 2005 from $36.5 million in 2004. Revenue from devices and systems grew to $19.4 million in 2005 from $14.1 million in 2004. Approximately $2.6 million, or 49% of the increase, was attributable to sales of the Company s neoBLUE line of phototherapy lights, including the new neoBLUE mini product, which was introduced in September 2004. The balance of the increase came from sales of hearing screening devices, including $2.0 million from the Echo-Screen OAE device, which Natus gained through its acquisition of Fischer-Zoth in September 2004. partially offset by a decrease in revenue from installations of our Neometrics product line. Revenue from supplies and services increased $1.1 million, or 5%, to $23.2 million in 2005, from $22.1 million in 2004. Substantially all of our revenue increases mentioned above, and in the narrative to follow, were from increased unit sales of our products, as average selling prices remained relatively stable among most of our product lines. Revenue from supplies and services was 54% of total revenue in 2005 compared to 61% of total revenue in 2004. No end-customer accounted for more than 10% of our revenue in either 2005 or 2004.

Revenue from sales outside the U.S. was $15.6 million for 2005, up $5.6 million, or 56% from $10.0 million for 2004. Approximately 35% of the increase was attributable to sales of our Echo-Screen OAE device and approximately 22% of the increase was attributable to sales of disposable supplies used with our ALGO hearing screening products. Sales in the U.K. and Europe contributed to 65% of total international revenue in 2005, compared to 62% in 2004.

Our cost of revenue increased $1.1 million, or 7%, to $16.1 million in 2005 up from $15.0 million in 2004. Gross profit increased $5.5 million, or 25%, to $27.0 million in 2005 from $21.5 million in 2004. Gross profit as a percentage of revenue improved to 62.6% in 2005 from 58.9% in 2004. The improvement in our gross profit percentage in 2005 was attributable to reductions in manufacturing overhead as a percent of revenue, as our manufacturing overhead is largely fixed. In addition, we benefited from sales of our high-margin Echo-Screen OAE device, which we acquired in September 2004.

Total operating costs decreased by $1.3 million or 6%, to $21.5 million in 2005, compared to $22.8 million in 2004. In June 2004 we initiated an operating cost reduction plan (2004 operating cost reduction plan) that resulted in the immediate reduction of 25 employees, and we also initiated a plan to liquidate our Japanese

Table of Contents

subsidiary. The effect of the 2004 operating cost reduction plan resulted in decreases in our operating costs in 2005 compared to 2004, as more fully described below. In addition, we incurred costs in 2004 that did not recur in 2005 related to the restructuring, the write-off of acquired in-process research and development, and costs associated with the departure of our former chief executive officer. These cost savings were partially offset by operating costs of our Fischer-Zoth subsidiary, which we acquired in September 2004.

Our marketing and selling expenses increased $91,000, or 1%, to $11.4 million in 2005 from $11.3 million in 2004. We benefited from the effect of the 2004 operating cost reduction plan. Reductions in marketing salaries and other discretionary marketing expenditures of approximately $300,000 and cost reductions related to the liquidation of our Japanese subsidiary were offset by additional marketing costs associated with our Fischer-Zoth subsidiary.

Our research and development expenses increased $646,000, or 18%, to $4.3 million in 2005 from $3.7 million in 2004. Approximately 68% of the increase was attributable to research and development costs of our Fischer-Zoth subsidiary. We also incurred increased outside consulting costs related to an ongoing development project for a point-of-care device that we expect to release in 2007. Savings from the 2004 operating costs reduction plan partially offset these increases.

Our general and administrative expenses decreased $820,000, or 12%, to $5.8 million in 2005 from $6.6 million in 2004. During the 2004 period, we recorded $870,000 of costs associated with the departure of our former chief executive officer; this cost did not recur in 2005. We incurred increased costs associated with our Fischer-Zoth subsidiary of approximately $252,000, costs of complying with the Sarbanes-Oxley Act of approximately $750,000, and increased incentive-based salary costs. The effects of the 2004 operating cost reduction plan offset these cost increases.

During 2004 the Company recorded $470,000 of costs associated with an in-process research and development project related to our acquisition of Fischer-Zoth in September 2004, as well as $776,000 of restructuring costs associated with a cost reduction plan initiated in June 2004. These costs did not recur in 2005.

Other income (expense) net consists of investment income and net capital gains and losses from our investment portfolio, net currency exchange gains and losses, and other miscellaneous income and expenses. Other income (expense) net was $1.2 million in 2005, compared to $310,000 in 2004. The increase in other income (expense) net in 2005 was primarily related to higher investment income of $1.2 million in 2005, compared to $454,000 in 2004, which was primarily attributable to higher short-term interest rates in 2005. Net foreign currency gains and losses were zero in 2005 compared to net foreign currency losses of $28,000 in 2004. Our foreign currency gains and losses result primarily from fluctuations in local currency equivalents of the U.S. dollar in the U.K. and Europe. Unrealized translation gains and losses from our consolidated foreign subsidiaries are not included in net income, but are reported as a component of other comprehensive income.

We recorded income tax expense of $509,000 in 2005, an increase of 71% over $297,000 recorded in 2004. We have significant U.S. Federal net operating loss carryforwards. However, our tax loss carryforwards do not offset taxable income for purposes of the Federal corporate alternative minimum tax, for which there is an effective tax rate of 2.5% on our U.S. operating income. Income tax expense related to our international operations was also higher in the 2005 period.

Liquidity and Capital Resources

Comparison of 2006 and 2005

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 or to raise capital.

As of December 31, 2006, we had cash, cash equivalents, and short-term investments of $15.4 million, stockholders equity of $101.0 million, and working capital of $30.8 million, compared with cash, cash

Table of Contents

equivalents, and short-term investments of $52.2 million, stockholders equity of $69.0 million, and working capital of $57.5 million as of December 31, 2005. The reduction in our cash, cash equivalents and short-term investments is primarily related to our acquisitions of Bio-logic, Deltamed, and Olympic.

In January 2006 we acquired Bio-logic for $69.3 million cash, in September 2006 we acquired Deltamed for $4.1 million cash, and in October 2006, we acquired Olympic for $16.6 million cash, plus the immediate satisfaction of approximately $2.7 million of obligations associated with the acquisition.

In August 2006, we issued 2,645,000 shares of our common stock in a registered offering. The offering was priced at $11.66 per share, which was the closing price of our stock on the day prior to the offering. We raised $29.3 million, net of underwriting fees and other costs of the offering.

On November 8, 2006 we entered into a $15 million revolving credit facility and transferred the outstanding balance of an existing term credit facility to the revolving facility. We repaid the outstanding balance of the revolving credit facility later in November 2006. The proceeds of advances on the revolving credit facility can be used for working capital needs. In addition, we can use up to $10 million of the commitment for the acquisition of businesses without prior approval of Wells Fargo. The revolving credit facility carries an unused commitment fee, and 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. At December 31, 2006 we were in compliance with all covenants of the revolving credit facility and there was no outstanding balance.

Following our acquisitions of Bio-logic, Deltamed, and Olympic, our cash reserves and working capital have been significantly reduced. However, we believe that our current cash, cash equivalents, and short-term investment balances, and any cash generated from operations will be sufficient to meet our ongoing operating and capital requirements for the foreseeable future. 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. We may be required to raise additional funds through public or private financings, strategic relationships, or other arrangements. Any additional equity financing may be dilutive to stockholders, and debt financing, if available, may involve restrictive covenants and increase our cost of capital.

Net cash provided by operations was $3.2 million in 2006 compared to net cash provided by operations of $7.9 million in 2005. Cash provided by operation in 2006 was largely attributable to our net loss for the year offset by substantial non-cash charges for in-process research and development, and depreciation and amortization. Additionally, during the 2006 period, the Company assumed accrued liabilities of $2.5 million and $2.7 million, respectively, associated with the Bio-logic and Olympic acquisitions that were paid off shortly after the acquisitions were consummated. The reduction of these accrued liabilities reduced cash provided by operations by $5.2 million in 2006. Increases in accounts receivable, inventories, and accounts payable of $11.9 million, $8.3 million, and $6.3 million, respectively, were largely the result of our acquisitions.

Other than $71.8 million of the Company s cash used to acquire Bio-logic, Deltamed, the Nascor assets, and Olympic, offset by sales of short-term investments, cash used in investing activities in 2006 was $2.4 million, primarily to acquire equipment, offset by proceeds from the sale of land of $2.5 million and a reduction in deposits and other assets. In 2005, we used $480,000 for earnout payments associated with our pervious acquisitions and $931,00 for purchases equipment for the year ended December 31, 2005.

Cash provided by financing activities was $32.0 million in the year ended December 31, 2006, compared to $10.2 million in 2005. During 2006 we raised $29.3 million in a registered common stock offering, and during 2005 we raised $7.1 million in a private placement of our stock. Other sources of cash from financing activities were primarily from exercises of stock options pursuant to our stock option plans and purchases of our stock by

Table of Contents

employee pursuant to our Employee Stock Purchase Plan in the amount of $1.7 million and $3.0 in the years ended December 31, 2006 and 2005, respectively. During 2006 we also realized an excess tax benefit of $1.1 million on the exercise of employee stock options that was recorded as an increase to stockholders equity.

Comparison of 2005 and 2004

Net cash provided by operations increased by $5.1 million to $7.9 million in 2005 from $2.8 million in 2004. The increase was favorably impacted by our results of operations, as we reported net income of $6.2 million for the year, compared to a net loss of $2.4 million reported in 2004. In addition, a reduction in inventories and an increase in accrued liabilities together provided an additional $1.8 million in 2005, offset by an increase in accounts receivable of $1.6 million. Our accounts receivable increased because sales in the fourth quarter of 2005 were approximately $2.1 million greater than in 2004.

Excluding purchases and sales of short-term investments, cash used in investing activities decreased by $6.5 million, to $1.4 million in 2005, from $6.9 million in 2004. In 2005 we paid $480,000 in additional purchase consideration related to our acquisition of Fischer-Zoth, pursuant to earnout provisions of the purchase agreement. In 2004, we acquired Fischer-Zoth for $5.4 million, net of cash acquired. Investment in capital assets of $931,000 in 2005 was approximately $945,000 less than the amount invested in 2004. Our short-term investments are primarily available-for-sale securities with maturities of less than one year, and fluctuations between cash equivalents and short-term investments are often attributable to investment decisions. We exclude the impact of purchases and sales of short-term investments in our analysis of cash provided by or used in investing activities.

Related to our acquisitions of Fischer-Zoth and Neometrics are the potential for additional purchase consideration to be paid subject to these business lines achieving certain financial goals. The Company believes the additional purchase consideration to be paid in the future will not exceed $1.4 million, a portion of which is denominated in Euro. If paid, the additional purchase consideration will be paid out over periods through December 31, 2010.

Net cash provided by financing activities increased by $8.2 million, to $10.2 million in 2005, from $2.0 million in 2004. In anticipation of our acquisition of Bio-logic, we raised $7.1 million in a private placement of our common stock in October 2005 at the then current trading price for our shares. We also generated cash from financing activities in both 2005 and 2004 through purchases of our stock pursuant to our stock option plans and our employee stock purchase plan.

Future Liquidity

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

- Amount and timing of revenue;
- Extent to which our existing and new products gain market acceptance;
- Extent to which we make acquisitions;
- Cost and timing of 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.

Contractual Obligations

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