

NATUS MEDICAL INC  
Form 10-Q  
August 05, 2015  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

✓ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934  
For the quarterly period ended June 30, 2015

.. 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 (I.R.S. Employer  
incorporation or organization) Identification No.)  
6701 Koll Center Parkway, Suite 120, Pleasanton, CA 94566  
(Address of principal executive offices) (Zip Code)  
(925) 223-6700  
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large Accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

The number of issued and outstanding shares of the registrant's Common Stock, \$0.001 par value, as of July 30, 2015 was 33,085,469.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

NATUS MEDICAL INCORPORATED AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)  
(in thousands, except share and per share amounts)

|   | June 30,<br>2015 | December 31,<br>2014 |
|---|------------------|----------------------|
| <b>ASSETS</b>   |                  |                      |
| Current assets:   |                  |                      |
| Cash and cash equivalents   | \$73,238         | \$66,558             |
| Accounts receivable, net of allowance for doubtful accounts of \$4,458 in 2015 and \$4,324 in 2014                                      | 83,341           | 82,277               |
| Inventories   | 44,873           | 40,051               |
| Prepaid expenses and other current assets   | 15,438           | 17,408               |
| Deferred income tax   | 11,471           | 11,511               |
| Total current assets  | 228,361          | 217,805              |
| Property and equipment, net   | 18,351           | 17,923               |
| Intangible assets, net  | 90,269           | 92,761               |
| Goodwill  | 108,516          | 96,316               |
| Other assets  | 8,361            | 10,016               |
| Total assets  | \$453,858        | \$434,821            |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                  |                      |
| Current liabilities:  |                  |                      |
| Accounts payable  | \$19,270         | \$21,371             |
| Accrued liabilities   | 35,988           | 36,024               |
| Deferred revenue  | 11,112           | 11,745               |
| Total current liabilities   | 66,370           | 69,140               |
| Long-term liabilities:  |                  |                      |
| Other liabilities   | 5,055            | 4,859                |
| Deferred income tax   | 8,667            | 8,107                |
| Total liabilities   | 80,092           | 82,106               |
| Stockholders' equity:   |                  |                      |
| Common Stock, \$0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 33,084,167 in 2015 and 32,265,997 in 2014 | 321,710          | 315,296              |
| Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued and outstanding in 2015 and 2014                     | —                | —                    |
| Retained earnings   | 87,337           | 68,890               |
| Accumulated other comprehensive loss  | (35,281          | ) (31,471            |
| Total stockholders' equity  | \$373,766        | \$352,715            |
| Total liabilities and stockholders' equity  | \$453,858        | \$434,821            |

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

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

|  | Three Months Ended |          | Six Months Ended |           |
|--|--------------------|----------|------------------|-----------|
|  | June 30,           |          | June 30,         |           |
|  | 2015               | 2014     | 2015             | 2014      |
| Revenue  | \$91,937           | \$86,325 | \$181,332        | \$171,948 |
| Cost of revenue  | 33,844             | 35,500   | 68,948           | 69,480    |
| Intangibles amortization   | 683                | 156      | 1,366            | 1,202     |
| Gross profit   | 57,410             | 50,669   | 111,018          | 101,266   |
| Operating expenses:  |                    |          |                  |           |
| Marketing and selling  | 22,108             | 22,061   | 42,850           | 42,690    |
| Research and development   | 7,309              | 7,634    | 14,167           | 14,811    |
| General and administrative   | 11,656             | 10,165   | 23,208           | 21,798    |
| Intangibles amortization   | 2,174              | 646      | 3,129            | 1,782     |
| Restructuring  | 161                | 218      | 316              | 853       |
| Total operating expenses   | 43,408             | 40,724   | 83,670           | 81,934    |
| Income from operations   | 14,002             | 9,945    | 27,348           | 19,332    |
| Other income (expense), net  | (380)              | ) 795    | (1,210)          | ) 1,107   |
| Income before provision for income tax                                 | 13,622             | 10,740   | 26,138           | 20,439    |
| Provision for income tax expense                                       | 3,771              | 3,279    | 7,691            | 6,223     |
| Net income   | \$9,851            | \$7,461  | \$18,447         | \$14,216  |
| Foreign currency translation adjustment                                | 1,269              | (1,078)  | ) (3,810)        | ) (3,969) |
| Comprehensive income   | \$11,120           | \$6,383  | \$14,637         | \$10,247  |
| Earnings per share:  |                    |          |                  |           |
| Basic  | \$0.31             | \$0.24   | \$0.57           | \$0.45    |
| Diluted  | \$0.30             | \$0.23   | \$0.56           | \$0.44    |
| Weighted average shares used in the calculation of earnings per share: |                    |          |                  |           |
| Basic  | 32,273             | 31,424   | 32,201           | 31,244    |
| Diluted  | 33,204             | 32,444   | 33,158           | 32,315    |

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

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

|  | Six Months Ended<br>June 30, |          |
|--|------------------------------|----------|
|  | 2015                         | 2014     |
| Operating activities:  |                              |          |
| Net income   | \$18,447                     | \$14,216 |
| Adjustments to reconcile net income to net cash provided by operating activities:  |                              |          |
| Provision for losses on accounts receivable  | 583                          | 98       |
| Excess tax benefit on the exercise of stock options                                | (4,371)                      | (2,746)  |
| Depreciation and amortization  | 7,178                        | 5,626    |
| Warranty reserve   | 3,153                        | 595      |
| Share-based compensation   | 3,491                        | 3,177    |
| Changes in operating assets and liabilities:                                       |                              |          |
| Accounts receivable  | (967)                        | 3,880    |
| Inventories  | (4,880)                      | 2,353    |
| Prepaid expenses and other assets  | 2,283                        | (144)    |
| Accounts payable   | (1,866)                      | (4,010)  |
| Accrued liabilities  | (7,002)                      | (4,913)  |
| Deferred revenue   | (1,219)                      | (1,312)  |
| Deferred income tax  | 4,693                        | 2,323    |
| Net cash provided by operating activities  | 19,523                       | 19,143   |
| Investing activities:  |                              |          |
| Acquisition of businesses, net of cash acquired                                    | (11,559)                     | (4,925)  |
| Purchases of property and equipment  | (2,375)                      | (2,199)  |
| Purchase of intangible assets  | (890)                        | (576)    |
| Net cash used in investing activities  | (14,824)                     | (7,700)  |
| Financing activities:  |                              |          |
| Proceeds from stock option exercises and Employee Stock Purchase Program purchases | 5,715                        | 9,454    |
| Excess tax benefit on the exercise of stock options                                | 4,371                        | 2,746    |
| Repurchase of common stock   | (5,515)                      | (1,208)  |
| Taxes paid related to net share settlement of equity awards                        | (1,649)                      | —        |
| Contingent consideration earn-out  | (664)                        | —        |
| Payments on borrowings   | —                            | (21,608) |
| Net cash provided by (used in) financing activities                                | 2,258                        | (10,616) |
| Exchange rate changes effect on cash and cash equivalents                          | (277)                        | (915)    |
| Net increase (decrease) in cash and cash equivalents                               | 6,680                        | (88)     |
| Cash and cash equivalents, beginning of period                                     | 66,558                       | 56,106   |
| Cash and cash equivalents, end of period   | \$73,238                     | \$56,018 |
| Supplemental disclosure of cash flow information:                                  |                              |          |
| Cash paid for interest   | \$—                          | \$309    |
| Cash paid for income taxes   | \$2,491                      | \$3,955  |
| Non-cash investing activities:   |                              |          |
| Property and equipment included in accounts payable                                | \$209                        | \$187    |
| Inventory transferred to property and equipment                                    | \$593                        | \$510    |

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



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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1 - Basis of Presentation

The accompanying interim condensed consolidated financial statements of Natus Medical Incorporated (“Natus,” “we,” “us,” “our,” or the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent in all material respects with those presented in Note 1 to the consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

Interim financial reports are prepared in accordance with the rules and regulations of the Securities and Exchange Commission; accordingly, they do not include all of the information and notes required by GAAP for annual financial statements. The interim financial information is unaudited, and except for the prior period correction of errors disclosed below, reflects all normal adjustments that are, in the opinion of management, necessary for the fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. The consolidated balance sheet as of December 31, 2014 was derived from audited financial statements, but does not include all disclosures required by GAAP. The accompanying financial statements should be read in conjunction with the financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014. We have made certain reclassifications to the prior period to conform to current period presentation.

Operating results for the six months ended June 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 requires revenue recognition to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 sets forth a new revenue recognition model that requires identifying the contract, identifying the performance obligations, determining the transaction price, allocating the transaction price to performance obligations and recognizing the revenue upon satisfaction of performance obligations.

The original effective date for ASU 2014-09 would have required the Company to adopt beginning in its first quarter of 2017. In July 2015, the FASB voted to amend ASU 2014-09 by approving a one-year deferral of the effective date as well as providing the option to early adopt the standard on the original effective date. Accordingly, the Company may adopt the standard in either its first quarter of 2017 or 2018. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company is currently evaluating the timing of its adoption and the impact of adopting the new revenue standard on its consolidated financial statements.

2 - Business Combinations

Global Neuro-Diagnostics

The Company acquired Global Neuro-Diagnostics (“GND”) through an equity purchase on January 23, 2015. GND’s service offers patients a more convenient way to complete routine EEG and video EEG testing which can be performed at the home, hospital or physician’s office. The service also provides comprehensive reporting and support to the physician. The cash consideration for GND was \$11.4 million. The purchase agreement also included



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an earn-out condition which the Company estimates to be \$3.3 million. This earn-out is contingent upon GND achieving certain revenue milestones from 2015 to 2017.

The purchase price allocation is considered preliminary, and final determination of the value of intangible assets and contingent consideration is expected during the third quarter of 2015 as we are in the process of verifying data supporting the valuation of the acquired intangible assets. Final determination of the values may result in an adjustment to the preliminary purchase price allocation, with an offsetting adjustment to goodwill. Pro forma financial information for the GND acquisition is not presented as it is not considered material.

NicView

On January 2, 2015, the Company purchased the assets of NicView for cash consideration of \$1.1 million. NicView provides streaming video for families with babies in the neonatal intensive care unit. The asset purchase agreement included an earn-out condition contingent upon revenue earned in 2015. The Company estimates this earn-out to be \$1.4 million. Pro forma financial information for the NicView acquisition is not presented as it is not considered material.

Hearing Screening as a Service

In the first quarter of 2014, the Company entered into two asset purchase agreements for companies in the newborn hearing screening services market for cash consideration of \$2.6 million. The purchase agreements also included an earn-out condition which was contingent upon annual revenue growth through 2016. This earn-out, previously estimated at \$0.8 million, was settled during the second quarter of 2015 for \$0.7 million. Both acquisitions support the Company's objective to enter this market that complements our newborn hearing screening device business. This hearing screening services business operates under the name Peloton. Pro forma financial information for these two acquisitions is not presented as it is not considered material.

3 - Earnings Per Share

The components of basic and diluted EPS are as follows (in thousands, except per share amounts):

|   | Three Months Ended |         | Six Months Ended |          |
|---|--------------------|---------|------------------|----------|
|   | June 30,           |         | June 30,         |          |
|   | 2015               | 2014    | 2015             | 2014     |
| Net income                                      | \$9,851            | \$7,461 | \$18,447         | \$14,216 |
| Weighted average common shares                  | 32,273             | 31,424  | 32,201           | 31,244   |
| Dilutive effect of stock based awards           | 931                | 1,020   | 957              | 1,071    |
| Diluted Shares                                  | 33,204             | 32,444  | 33,158           | 32,315   |
| Basic earnings per share                        | \$0.31             | \$0.24  | \$0.57           | \$0.45   |
| Diluted earnings per share                      | \$0.30             | \$0.23  | \$0.56           | \$0.44   |
| Shares excluded from calculation of diluted EPS | —                  | 233     | —                | 231      |

4 - Inventories

Inventories consist of the following (in thousands):

|                                 | June 30, 2015 | December 31, 2014 |
|---------------------------------|---------------|-------------------|
| Raw materials and subassemblies | \$23,904      | \$19,821          |
| Work in process                 | 1,700         | 1,808             |
| Finished goods                  | 25,616        | 26,037            |
| Total inventories               | 51,220        | 47,666            |
| Less: Non-current inventories   | (6,347)       | (7,615)           |
| Inventories, current            | \$44,873      | \$40,051          |

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At June 30, 2015 and December 31, 2014, the Company has classified \$6.3 million and \$7.6 million, respectively, of inventories as other assets. This inventory consists primarily of service components used to repair products pursuant to warranty obligations and extended service contracts, including service components for products we are not currently selling. Management believes that these inventories will be utilized for their intended purpose.

## 5 – Intangible Assets

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

|  | June 30, 2015         |                        |                            | December 31, 2014     |                        |                            |
|--|-----------------------|------------------------|----------------------------|-----------------------|------------------------|----------------------------|
|  | Gross Carrying Amount | Accumulated Impairment | Accumulated Net Book Value | Gross Carrying Amount | Accumulated Impairment | Accumulated Net Book Value |
| Intangible assets with definite lives: |                       |                        |                            |                       |                        |                            |
| Technology                             | \$63,747              | —                      | \$ (29,829 )               | \$64,376              | —                      | \$ (28,195 )               |
| Customer related                       | 33,136                | —                      | (12,953 )                  | 31,189                | —                      | (11,786 )                  |
| Trade names                            | 32,077                | (3,380 )               | (1,025 )                   | 32,443                | (3,504 )               | —                          |
| Internally developed software          | 15,161                | —                      | (7,218 )                   | 14,109                | —                      | (6,511 )                   |
| Patents                                | 2,696                 | —                      | (2,143 )                   | 2,794                 | —                      | (2,154 )                   |
| Backlog                                | 718                   | —                      | (718 )                     | 719                   | —                      | (719 )                     |
| Definite-lived intangible assets       | \$147,535             | \$ (3,380 )            | \$ (53,886 )               | \$145,630             | \$ (3,504 )            | \$ (49,365 )               |

Finite-lived intangible assets are amortized over their weighted average lives of 17 years for technology, 12 years for customer related intangibles, 7 years for internally developed software, 7 years for trade names, and 13 years for patents.

Internally developed software consists of \$13.0 million relating to costs incurred for development of internal use computer software and \$2.2 million for development of software to be sold.

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

|                               | Three Months Ended |         | Six Months Ended |         |
|-------------------------------|--------------------|---------|------------------|---------|
|                               | June 30, 2015      | 2014    | June 30, 2015    | 2014    |
| Technology                    | \$961              | \$500   | \$1,921          | \$1,165 |
| Customer related              | 715                | 296     | 1,404            | 1,025   |
| Trade names                   | 1,025              | —       | 1,025            | —       |
| Internally developed software | 353                | 422     | 707              | 698     |
| Patents                       | 28                 | 6       | 56               | 104     |
| Total amortization            | \$3,082            | \$1,224 | \$5,113          | \$2,992 |

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

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|                                     |          |
|-------------------------------------|----------|
| Six months ending December 31, 2015 | \$6,132  |
| 2016                                | 11,701   |
| 2017                                | 11,417   |
| 2018                                | 11,192   |
| 2019                                | 10,217   |
| 2020                                | 8,830    |
| Thereafter                          | 30,780   |
| Total expected amortization expense | \$90,269 |

During the second quarter of 2015 we initiated a strategy to increase the brand strength of Natus by replacing acquired product trade names with Natus branded products over time. The implementation of this strategy places definite expected future lives on our acquired trade names which previously had indefinite lives. In the second quarter of 2015 we assigned these trade names lives of seven years based on the timeline of our strategy to rebrand our products. We will continue to assess the lives of these assets based on the timing and execution of this strategy. Amortization expense for trade names is recorded as a component of operating expense. This change increased the Company's amortization expense and decreased pre-tax income by approximately \$1.0 million, decreased net income by approximately \$0.7 million, and decreased diluted earnings per share by \$0.02 per share for the three months ended June 30, 2015.

## 6 – Goodwill

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

|                              |           |   |
|------------------------------|-----------|---|
| December 31, 2014            | \$96,316  |   |
| Acquisitions                 | 13,489    |   |
| Foreign currency translation | (1,289    | ) |
| June 30, 2015                | \$108,516 |   |

## 7 - Property and Equipment, net

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

|                                    | June 30, 2015 | December 31,<br>2014 |
|------------------------------------|---------------|----------------------|
| Land                               | \$3,062       | \$3,092              |
| Buildings                          | 6,574         | 6,828                |
| Leasehold improvements             | 2,396         | 2,118                |
| Office furniture and equipment     | 13,750        | 12,839               |
| Computer software and hardware     | 9,723         | 8,821                |
| Demonstration and loaned equipment | 11,079        | 10,929               |
|                                    | 46,584        | 44,627               |
| Accumulated depreciation           | (28,233       | ) (26,704            |
| Total                              | \$18,351      | \$17,923             |

Depreciation expense of property and equipment was approximately \$1.0 million and \$2.1 million for the three and six months ended June 30, 2015, respectively, and approximately \$1.0 million and \$2.4 million for the three and six months ended June 30, 2014, respectively.

## 8 - Reserve for Product Warranties

We provide a warranty on all medical device products that is generally one year in length. We also sell extended service agreements on our medical device products that are generally over one year in length. Service for

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domestic customers is provided by Company-owned service centers that perform all service, repair, and calibration services. Service for international customers is provided by a combination of Company-owned facilities and vendors on a contract basis.

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

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

|                              | Three Months Ended |         | Six Months Ended |          |
|------------------------------|--------------------|---------|------------------|----------|
|                              | June 30,           |         | June 30,         |          |
|                              | 2015               | 2014    | 2015             | 2014     |
| Balance, beginning of period | \$2,975            | \$3,011 | \$2,753          | \$3,142  |
| Additions charged to expense | 2,278              | 141     | 3,153            | 595      |
| Reductions                   | (845               | ) (464  | ) (1,498         | ) (1,049 |
| Balance, end of period       | \$4,408            | \$2,688 | \$4,408          | \$2,688  |

#### 9 - Share-Based Compensation

At June 30, 2015, we have two active share-based compensation plans, the 2011 Stock Awards Plan and the 2011 Employee Stock Purchase Plan. The terms of awards granted during the six months ended June 30, 2015 and our methods for determining grant-date fair value of the awards are consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2014.

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

|                            | Three Months Ended |         | Six Months Ended |         |
|----------------------------|--------------------|---------|------------------|---------|
|                            | June 30,           |         | June 30,         |         |
|                            | 2015               | 2014    | 2015             | 2014    |
| Cost of revenue            | \$36               | \$50    | \$87             | \$78    |
| Marketing and selling      | 322                | 261     | 685              | 497     |
| Research and development   | 178                | 257     | 395              | 404     |
| General and administrative | 1,224              | 999     | 2,324            | 2,198   |
| Total                      | \$1,760            | \$1,567 | \$3,491          | \$3,177 |

As of June 30, 2015, unrecognized compensation expense related to the unvested portion of our stock options and other stock awards was approximately \$10.6 million, which is expected to be recognized over a weighted average period of 1.9 years.

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## 10 - Other Income (Expense), net

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

|                                   | Three Months Ended |         | Six Months Ended |           |   |
|-----------------------------------|--------------------|---------|------------------|-----------|---|
|                                   | June 30,           |         | June 30,         |           |   |
|                                   | 2015               | 2014    | 2015             | 2014      |   |
| Interest income                   | \$6                | \$7     | \$16             | \$137     |   |
| Interest expense                  | —                  | (184    | ) —              | (448      | ) |
| Foreign currency gain (loss)      | (501               | ) 852   | (1,491           | ) 1,001   |   |
| Other                             | 115                | 120     | 265              | 417       |   |
| Total other income (expense), net | \$(380             | ) \$795 | \$(1,210         | ) \$1,107 |   |

## 11 - Income Taxes

## Provision for Income Tax Expense

We recorded provisions for income tax of \$3.8 million and \$7.7 million for the three and six months ended June 30, 2015, respectively. Our effective tax rate was 27.7% and 29.4% for the three and six months ended June 30, 2015, respectively.

We recorded provisions for income tax of \$3.3 million and \$6.2 million for the three and six months ended June 30, 2014, respectively. Our effective tax rate was 30.5% and 30.4% for the three and six months ended June 30, 2014.

Our effective tax rate for the three and six months ended June 30, 2015 differed from federal statutory tax rate primarily because profits taxed in foreign jurisdictions with lower tax rates than the federal statutory rate. The decrease in the effective tax rate for the three and six months ended June 30, 2015 compared with the three and six months ended June 30, 2014 is primarily attributable to forecasted shifts in the geographical mix of income.

We recorded \$101,000 net tax benefit of unrecognized tax benefits for the six months ended June 30, 2015. Within the next twelve months, it is possible our uncertain tax benefit may change with a range of approximately zero to \$490,000. Our tax returns remain open to examinations as follows: U.S. Federal, 2011 through 2014, U.S. States 2010 through 2013 and significant foreign jurisdictions 2010 through 2014.

## 12 - Restructuring Reserves

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

The balance of the restructuring reserve is included in accrued liabilities on the accompanying condensed consolidated balance sheets. Employee termination benefits are included as a part of restructuring expenses.

Activity in the restructuring reserves for the six months ended June 30, 2015 is as follows (in thousands):

|                              | Personnel<br>Related | Facility Related | Total  |   |
|------------------------------|----------------------|------------------|--------|---|
| Balance at December 31, 2014 | \$368                | \$—              | \$368  |   |
| Additions                    | 309                  | 77               | 386    |   |
| Reversals                    | (70                  | )—               | (70    | ) |
| Payments                     | (415                 | ) (77            | ) (492 | ) |
| Balance at June, 2015        | \$192                | \$—              | \$192  |   |

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## 13 - Segment, Customer and Geographic Information

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

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

Revenue and long-lived asset information are as follows (in thousands):

|                              | Three Months Ended |          | Six Months Ended |                   |
|------------------------------|--------------------|----------|------------------|-------------------|
|                              | June 30,           |          | June 30,         |                   |
|                              | 2015               | 2014     | 2015             | 2014              |
| Consolidated Revenue:        |                    |          |                  |                   |
| United States                | \$60,505           | \$52,468 | \$115,069        | \$100,813         |
| Foreign countries            | 31,432             | 33,857   | 66,263           | 71,135            |
| Totals                       | \$91,937           | \$86,325 | \$181,332        | \$171,948         |
|                              | Three Months Ended |          | Six Months Ended |                   |
|                              | June 30,           |          | June 30,         |                   |
|                              | 2015               | 2014     | 2015             | 2014              |
| Revenue by End Market:       |                    |          |                  |                   |
| Neurology Products           |                    |          |                  |                   |
| Devices and Systems          | \$41,011           | \$40,691 | \$81,120         | \$81,994          |
| Supplies                     | 15,415             | 15,139   | 30,291           | 30,313            |
| Services                     | 2,201              | —        | 3,489            | —                 |
| Total Neurology Revenue      | 58,627             | 55,830   | 114,900          | 112,307           |
| Newborn Care Products        |                    |          |                  |                   |
| Devices and Systems          | 17,926             | 17,180   | 36,109           | 32,549            |
| Supplies                     | 12,080             | 11,604   | 24,649           | 23,879            |
| Services                     | 3,304              | 1,711    | 5,674            | 3,213             |
| Total Newborn Care Revenue   | 33,310             | 30,495   | 66,432           | 59,641            |
| Total Revenue                | \$91,937           | \$86,325 | \$181,332        | \$171,948         |
|                              |                    |          | June 30, 2015    | December 31, 2014 |
| Property and equipment, net: |                    |          |                  |                   |
| United States                |                    |          | \$6,377          | \$5,782           |
| Canada                       |                    |          | 5,286            | 5,538             |
| Argentina                    |                    |          | 3,452            | 3,692             |
| Other foreign countries      |                    |          | 3,236            | 2,911             |
| Totals                       |                    |          | \$18,351         | \$17,923          |

During the three and six months ended June 30, 2015 and 2014, no single customer or foreign country contributed to more than 10% of revenue.

## 14 - Fair Value Measurements

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

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

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

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

The Company does not have any financial assets or liabilities measured at fair value on a recurring basis.

The following financial instruments are not measured at fair value on the Company's consolidated balance sheet as of June 30, 2015 and December 31, 2014, but require disclosure of their fair values: cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities. The carrying value of these financial instruments approximates fair values because of their relatively short maturity.

In the third quarter of 2014 the Company listed its facility in Mundelein, Illinois for sale. This asset was measured at fair value less cost to sell as of September 30, 2014 based on market price and is classified as a Level 2 asset. The book value of this asset on June 30, 2014 was \$3.6 million. We expensed \$2.2 million during the third quarter 2014 for this impairment. As of June 30, 2015 we are carrying the asset as held for sale in other current assets on the balance sheet at a value of \$1.4 million.

The Company also has contingent consideration associated with earn-outs from acquisitions. Contingent consideration liabilities are classified as Level 3 liabilities, as the Company uses unobservable inputs to value them, which is a probability-based income approach. Subsequent changes in the fair value of contingent consideration liabilities are recorded within the Company's income statement as an operating expense.

|                          | December 31,<br>2014 | Additions | Payments | Adjustments | June 30, 2015 |
|--------------------------|----------------------|-----------|----------|-------------|---------------|
| Liabilities:             |                      |           |          |             |               |
| Contingent consideration | \$812                | \$4,705   | \$(664)  | \$(148)     | \$4,705       |
| Total                    | \$812                | \$4,705   | \$(664)  | \$(148)     | \$4,705       |

The significant unobservable inputs used in the fair value measurement of contingent consideration related to the acquisitions are annualized revenue forecasts developed by the Company's management and the probability of achievement of those revenue forecasts. Significant increases (decreases) in these unobservable inputs in isolation would result in a significantly lower (higher) fair value measurement.

#### 15 - Immaterial Corrections to Prior Period Financial Statements

Certain amounts previously reported in the consolidated statements of income and statements of cash flows for the three months ended June 30, 2014 have been restated to reflect the correction of an immaterial error as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2014. The error related to the amount of manufacturing labor and overhead applied to inventory. We believe the effects of the error are not material to our consolidated financial statements.

A summary of the effects of the correction of this error on our statement of income and comprehensive income for the three and six months ended June 30, 2014 and our statement of cash flow for the six months ended June 30, 2014 is presented in the table below (in thousands, except per share data):

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|  | Three Months Ended<br>June 30, 2014 |          | Six Months Ended June<br>30, 2014 |          |
|--|-------------------------------------|----------|-----------------------------------|----------|
|  | Previously<br>Reported              | Revised  | Previously<br>Reported            | Revised  |
| Statements of Income and Comprehensive Income  |                                     |          |                                   |          |
| Cost of revenue  | \$35,295                            | \$35,500 | \$71,028                          | \$69,480 |
| Intangibles amortization   | —                                   | 156      | —                                 | 1,202    |
| Gross profit   | 51,029                              | 50,669   | 100,920                           | 101,266  |
| Income from operations   | 10,305                              | 9,945    | 18,986                            | 19,332   |
| Income before provision for income tax   | 11,100                              | 10,740   | 20,093                            | 20,439   |
| Provision for income tax expense   | 3,359                               | 3,279    | 6,101                             | 6,223    |
| Net income   | 7,741                               | 7,461    | 13,991                            | 14,216   |
| Comprehensive income   | 6,662                               | 6,383    | 10,022                            | 10,247   |
| Net income per share, basic  | \$0.25                              | \$0.24   | \$0.45                            | \$0.45   |
| Net income per share, diluted  | \$0.24                              | \$0.23   | \$0.43                            | \$0.44   |
| Statements of Cash Flows   |                                     |          |                                   |          |
| Net income   |                                     |          | \$13,991                          | \$14,216 |
| Changes in operating assets and liabilities, net of assets and liabilities acquired in acquisitions: |                                     |          |                                   |          |
| Inventories  |                                     |          | 2,699                             | 2,353    |
| Accrued liabilities  |                                     |          | (5,034)                           | (4,913)  |
| Net cash provided by operating activities  |                                     |          | \$19,142                          | \$19,143 |

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

## Overview

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") supplements the MD&A in the Annual Report on Form 10-K for the year ended December 31, 2014 of Natus Medical Incorporated. MD&A should be read in conjunction with our condensed consolidated financial statements and accompanying footnotes, the risk factors referred to in Part II, Item 1A of this report, our Annual Report filed on Form 10-K for the year ended December 31, 2014 and the cautionary information regarding forward-looking statements at the end of this section.

## Our Business

Natus is a leading provider of healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments in newborn care, hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and balance and mobility disorders.

We have completed a number of acquisitions since 2003, consisting of either the purchase of a company, substantially all of the assets of a company, or individual products or product lines. Our most recent significant acquisition was Grass Technologies Product Group ("Grass") in 2013. In 2015 we completed two acquisitions, NicView and GND. We expect to continue to pursue opportunities to acquire other businesses in the future.

## End Markets

Our products address two primary end markets:

Neurology - Includes products and services for diagnostic electroencephalography and long term monitoring, Intensive Care Unit monitoring, electromyography, sleep analysis or polysomnography, intra-operative monitoring, and diagnostic and monitoring transcranial doppler ultrasound technology.

Newborn Care - Includes products and services for newborn care including hearing screening, brain injury, thermoregulation, jaundice management, and various disposable products, as well as products for diagnostic hearing assessment for children through adult populations, and products to diagnose and assist in treating





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balance and mobility disorders.

**Segment and Geographic Information**

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

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

Information regarding our sales and long-lived assets in the U.S. and in countries outside the U.S. is contained in Note 13 – Segment, Customer and Geographic Information of our condensed consolidated financial statements included in this report and is incorporated in this section by this reference.

**Revenue by Product Category**

We generate our revenue from sales of Devices and Systems, which are generally non-recurring, and from related Supplies, and Services, which are generally recurring. The products that are attributable to these categories are described in our Annual Report on Form 10-K for the year ended December 31, 2014. Revenue from Devices and Systems, Supplies and Services, as a percent of total revenue for the three and six months ended June 30, 2015 and 2014 is as follows:

|                     | Three Months Ended |       | Six Months Ended |       |   |
|---------------------|--------------------|-------|------------------|-------|---|
|                     | June 30,           |       | June 30,         |       |   |
|                     | 2015               | 2014  | 2015             | 2014  |   |
| Devices and Systems | 64                 | % 67  | % 65             | % 67  | % |
| Supplies            | 30                 | % 31  | % 30             | % 31  | % |
| Services            | 6                  | % 2   | % 5              | % 2   | % |
| Total               | 100                | % 100 | % 100            | % 100 | % |

During the three and six months ended June 30, 2015 and 2014, no single customer or foreign country contributed to more than 10% of revenue.

**2015 Second Quarter Overview**

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

Our consolidated revenue increased \$5.6 million in the second quarter ended June 30, 2015 to \$91.9 million compared to \$86.3 million in the second quarter of the previous year. Our revenue increases were primarily in the United States market driven by the strength of sales and recent acquisitions.

Net income was \$9.9 million or \$0.30 per diluted share in the three months ended June 30, 2015, compared with net income of \$7.5 million or \$0.23 per diluted share in the same period in 2014. An increase to 62.5% from 58.7% in gross profit percentage for the second quarter of 2015 compared to the same period in 2014 was primarily the result of recent acquisitions and facility consolidation.

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## Application of Critical Accounting Policies

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

We believe that the following critical accounting policies require the use of significant estimates, assumptions, and judgments:

Revenue recognition

Inventory carried at the lower of cost or market value

Carrying value of intangible assets and goodwill

Liability for product warranties

Share-based compensation

The use of different estimates, assumptions, or judgments could have a material effect on the reported amounts of assets, liabilities, revenue, expenses, and related disclosures as of the date of the financial statements and during the reporting period. These critical accounting policies are described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2014, under Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations.

During the second quarter 2015 we made a change in accounting estimate related to our indefinite lived intangible assets. See Note 5 - Intangible Assets. There have been no other changes to our critical accounting policies during the six months ended June 30, 2015.

## Results of Operations

The following table sets forth selected consolidated statement of operations data as a percentage of total revenue for the periods indicated.

|  | Three Months Ended |         | Six Months Ended |         |   |
|--|--------------------|---------|------------------|---------|---|
|  | June 30,           |         | June 30,         |         |   |
|  | 2015               | 2014    | 2015             | 2014    |   |
| Revenue                                | 100.0              | % 100.0 | % 100.0          | % 100.0 | % |
| Cost of revenue                        | 36.8               | % 41.1  | % 38.0           | % 40.4  | % |
| Intangibles amortization               | 0.7                | % 0.2   | % 0.8            | % 0.7   | % |
| Gross profit                           | 62.5               | % 58.7  | % 62.0           | % 59.6  | % |
| Operating expenses:                    |                    |         |                  |         |   |
| Marketing and selling                  | 24.0               | % 25.6  | % 23.6           | % 24.8  | % |
| Research and development               | 8.0                | % 8.8   | % 7.8            | % 8.6   | % |
| General and administrative             | 12.7               | % 11.8  | % 12.8           | % 12.7  | % |
| Intangibles Amortization               | 2.4                | % 0.7   | % 1.7            | % 1.0   | % |
| Restructuring                          | 0.2                | % 0.3   | % 0.2            | % 0.5   | % |
| Total operating expenses               | 47.3               | % 47.2  | % 46.1           | % 47.6  | % |
| Income from operations                 | 15.2               | % 11.5  | % 15.9           | % 12.0  | % |
| Other expense, net                     | (0.4               | )% 0.9  | % (0.7           | )% 0.6  | % |
| Income before provision for income tax | 14.8               | % 12.4  | % 15.2           | % 12.6  | % |
| Provision for income tax expense       | 4.1                | % 3.8   | % 4.2            | % 3.6   | % |
| Net income                             | 10.7               | % 8.6   | % 11.0           | % 9.0   | % |

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## Revenues

The following table shows revenue by products during the three and six months ended June 30, 2015 and June 30, 2014 in thousands.

|                              | Three Months Ended |          |        | Six Months Ended |           |        |    |
|------------------------------|--------------------|----------|--------|------------------|-----------|--------|----|
|                              | June 30,<br>2015   | 2014     | Change | June 30,<br>2015 | 2014      | Change |    |
| <b>Neurology Products</b>    |                    |          |        |                  |           |        |    |
| Devices and Systems          | \$41,011           | \$40,691 | 1      | % \$81,120       | \$81,994  | (1     | )% |
| Supplies                     | 15,415             | 15,139   | 2      | % 30,291         | 30,313    | —      | %  |
| Services                     | 2,201              | —        | —      | % 3,489          | —         | —      | %  |
| Total Neurology Revenue      | 58,627             | 55,830   | 5      | % 114,900        | 112,307   | 2      | %  |
| <b>Newborn Care Products</b> |                    |          |        |                  |           |        |    |
| Devices and Systems          | 17,926             | 17,180   | 4      | % 36,109         | 32,549    | 11     | %  |
| Supplies                     | 12,080             | 11,604   | 4      | % 24,649         | 23,879    | 3      | %  |
| Services                     | 3,304              | 1,711    | 93     | % 5,674          | 3,213     | 77     | %  |
| Total Newborn Care Revenue   | 33,310             | 30,495   | 9      | % 66,432         | 59,641    | 11     | %  |
| Total Revenue                | \$91,937           | \$86,325 | 7      | % \$181,332      | \$171,948 | 5      | %  |

For the three months ended June 30, 2015, Neurology revenue increased by 5% compared to the same quarter last year. Growth in our domestic market was offset by a decline in revenue from international markets due mainly to weakness of the Euro as compared to the US Dollar. Revenue from sales of Devices and Systems increased by 1% driven mainly by strong EEG revenue in the quarter. Revenue from Supplies increased by 2% mainly from our domestic market. The growth in Services revenue is the result of our January 2015 acquisition of Global Neuro-Diagnostics.

For the three months ended June 30, 2015, Newborn Care revenue increased by 9% compared to the same quarter last year. Geographically, the increase is primarily in our domestic market. Revenue from Devices and Systems increased by 4% compared to the same period in 2014. This increase is attributable to entering the video streaming market with the January 2015 acquisition of NicView. Revenue from supplies increased by 4% primarily from increased sales in international markets. Revenue from Services increased by 93% compared to the same period in 2014 due to the growth of Peloton, our hearing screening service launched in the first quarter 2014.

For the six months ended June 30, 2015, Neurology revenue increased by 2% compared to the same period last year. Growth in our domestic market was offset by a decline in revenue from international markets due mainly to weakness of the Euro as compared to the US Dollar. Revenue from sales of Devices and Systems declined 1% mainly due to the unfavorable exchange rate impact. Revenue from Supplies was flat compared to the same period last year. The decline in Devices and Systems revenue was more than offset by the growth in Services revenue from Global Neuro-Diagnostics.

For the six months ended June 30, 2015, Newborn Care revenue increased by 11% compared to the same quarter last year. Geographically, the increase is primarily in our domestic market. Revenue from Devices and Systems increased 11% compared to the same period in 2014 driven by strength in our domestic market. This increase is attributable to our acquisition of NicView. Revenue from Supplies increased 3% primarily in our international market. This increase was primarily related to the introduction of two new products in the hearing and phototherapy market segments. Revenue from Services increased by 77% compared to the same period in 2014 due to the growth of Peloton.

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No single customer accounted for more than 10% of our revenue in the six months ended June 30, 2015 or June 30, 2014. Revenue from domestic sales increased 12.9% to \$60.5 million for the three months ended June 30, 2015 from \$52.5 million in the second quarter of 2014. Revenue from international sales decreased 6.6% to \$31.4 million for the three months ended June 30, 2015 compared to \$33.9 million in the second quarter of 2014. The decrease in international revenue was driven by the weakness of the Euro relative to the US Dollar.

## Cost of Revenue and Gross Profit

Cost of revenue and gross profit consists of (in thousands):

|                          | Three Months Ended |          | Six Months Ended |           |   |
|--------------------------|--------------------|----------|------------------|-----------|---|
|                          | June 30,<br>2015   | 2014     | June 30,<br>2015 | 2014      |   |
| Revenue                  | \$91,937           | \$86,325 | \$181,332        | \$171,948 |   |
| Cost of revenue          | 33,844             | 35,500   | 68,948           | 69,480    |   |
| Intangibles amortization | 683                | 156      | 1,366            | 1,202     |   |
| Gross profit             | 57,410             | 50,669   | 111,018          | 101,266   |   |
| Gross profit percentage  | 62.5               | % 58.7   | % 61.2           | % 58.9    | % |

For the three and six months ended June 30, 2015, gross profit as a percentage of revenue increased by 3.7% and 2.3%, respectively compared to the same periods in the prior year. These increases in gross profit as a percentage of revenue are attributable to the growth of Peloton and our acquisition of Global Neuro-Diagnostics. In addition to the growth of our services businesses we have realized cost reductions through facility consolidations and reductions in material cost.

## Operating Costs

Operating costs consist of (in thousands):

|                            | Three Months Ended |          | Six Months Ended |          |   |
|----------------------------|--------------------|----------|------------------|----------|---|
|                            | June 30,<br>2015   | 2014     | June 30,<br>2015 | 2014     |   |
| Marketing and selling      | \$22,108           | \$22,061 | \$42,850         | \$42,690 |   |
| Percentage of revenue      | 24.0               | % 25.6   | % 23.6           | % 24.8   | % |
| Research and development   | \$7,309            | \$7,634  | \$14,167         | \$14,811 |   |
| Percentage of revenue      | 8.0                | % 8.8    | % 7.8            | % 8.6    | % |
| General and administrative | \$11,656           | \$10,165 | \$23,208         | \$21,798 |   |
| Percentage of revenue      | 12.7               | % 11.8   | % 12.8           | % 12.7   | % |
| Intangibles amortization   | \$2,174            | \$646    | \$3,129          | \$1,782  |   |
| Percentage of revenue      | 2.4                | % 0.7    | % 1.7            | % 1.0    | % |
| Restructuring              | \$161              | \$218    | \$316            | \$853    |   |
| Percentage of revenue      | 0.2                | % 0.3    | % 0.2            | % 0.5    | % |

## Marketing and Selling

Marketing and selling expenses were relatively flat during three and six months ended June 30, 2015 as compared to the same periods in 2014. We experienced an increase in spending in our Newborn Care business attributable to our acquisition of NicView and growth of Peloton. This was offset by a reduction in expense in our Neurology business related to timing of hiring.

## Research and Development

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Research and development expenses decreased slightly during the three and six months ended June 30, 2015 compared to the same periods in 2014. This decrease is attributable to a reduction in information technology overhead allocation.

General and Administrative

General and administrative expense increased during the three and six months ended June 30, 2015 as compared to the same period in 2014. This increase is attributable to fluctuations in bad debt expense and an increase in consulting fees as we invest in international tax planning activities. During the second quarter of 2014 our bad debt reserve was reduced by approximately \$0.5 million as a result of previously reserved items being collected, and there was no corresponding event in the second quarter of 2015.

Intangibles Amortization

Intangibles amortization increased during the three and six months ended June 30, 2015 as compared to the same periods in 2014. During the second quarter 2015 we initiated a strategy to increase the brand strength of Natus by replacing acquired product trade names with Natus branded products over time. The implementation of this strategy places definite expected future lives on our trade names which previously had indefinite lives. In the second quarter of 2015 we assigned these trade names lives of seven years. Trade name amortization expense recorded during the second quarter was \$1.0 million. In addition, intangibles amortization for the three and six months ended June 30, 2014 included a \$0.5 million reduction for a prior period amortization adjustment.

Restructuring

Restructuring expenses decreased during the six months ended June 30, 2015 compared to the same period in 2014. During the first two quarters of 2014 we incurred higher expenses related to severance of higher paid employees. In 2014 we also experienced higher expense related to facilities consolidation as we transitioned in to a new manufacturing facility in Middleton, Wisconsin.

Other Income (Expense), net

Other income (expense), net consists of investment income, interest expense, net currency exchange gains and losses, and other miscellaneous income and expense. For the three months ended June 30, 2015 we reported other expense of \$0.4 million compared to other income of \$0.8 million for the same period in 2014. For the six months ended June 30, 2015 we reported other expense of \$1.2 million compared to other income of \$1.1 million for the same period in 2014. This increase in expense for both the three and six month periods ended June 30, 2015 is attributable to an increase in net currency exchange losses driven by the weakness of the Euro. These losses were offset by a reduction in interest expense in 2015 after repaying our outstanding term loan during the fourth quarter of 2014.

Provision for Income Tax

We recorded provisions for income tax of \$3.8 million and \$7.7 million for the three and six months ended June 30, 2015, respectively. Our effective tax rate was 27.7% and 29.4% for the three and six months ended June 30, 2015, respectively.

We recorded provisions for income tax of \$3.3 million and \$6.2 million for the three and six months ended June 30, 2014, respectively. Our effective tax rate was 30.5% and 30.4% for the three and six months ended June 30, 2014.

Our effective tax rate for the three and six months ended June 30, 2015 differed from federal statutory tax rate primarily because profits taxed in foreign jurisdictions with lower tax rates than the federal statutory rate. The decrease in the effective tax rate for the three and six months ended June 30, 2015 compared with the three and six months ended June 30, 2014 is primarily attributable to forecasted shifts in the geographical mix of income.

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We recorded \$101,000 net tax benefit of unrecognized tax benefits for the six months ended June 30, 2015. Within the next twelve months, it is possible our uncertain tax benefit may change with a range of approximately zero to \$490,000. Our tax returns remain open to examinations as follows: U.S. Federal, 2011 through 2014, U.S. States 2010 through 2013 and significant foreign jurisdictions 2010 through 2014.

## Liquidity and Capital Resources

Liquidity and capital resources consist of (in thousands):

|   | June 30, 2015    | December 31,<br>2014 |
|---|------------------|----------------------|
| Cash and cash equivalents                           | \$73,238         | \$66,558             |
| Working capital                                     | 161,991          | 148,665              |
|   | Six Months Ended |                      |
|   | June 30,         | 2014                 |
|   | 2015             | 2014                 |
| Net cash provided by operating activities           | \$19,523         | \$19,143             |
| Net cash used in investing activities               | (14,824)         | (7,700)              |
| Net cash provided by (used in) financing activities | 2,258            | (10,616)             |

We believe that our current cash and cash equivalents and any cash generated from operations will be sufficient to meet our ongoing operating requirements for the foreseeable future.

As of June 30, 2015, we had cash and cash equivalents outside the U.S. in certain of our foreign operations of \$52.8 million. We intend to permanently reinvest the cash held by our foreign subsidiaries. If, however, a portion of these funds were needed for and distributed to our operations in the United States, we would be subject to additional U.S. income taxes and foreign withholding taxes. The amount of taxes due would depend on the amount and manner of repatriation, as well as the country from which the funds were repatriated.

At June 30, 2015, we had a \$25 million revolving credit line with Wells Fargo. The credit line is fully available under the credit agreement. The credit facility contains covenants, including covenants relating to liquidity and other financial measurements, and provides for events of default, including failure to pay any interest when due, failure to perform or observe covenants, bankruptcy or insolvency events, and the occurrence of a material adverse effect, and restricts our ability to pay dividends. We have provided a security interest in substantially all of our assets. We have no other significant credit facilities. As of June 30, 2015 no amounts were outstanding.

During the six months ended June 30, 2015 cash provided by operating activities of \$19.5 million was the result of \$18.4 million of net income, non-cash adjustments to net income of \$9.9 million, and net cash outflows of \$9.0 million from changes in operating assets and liabilities. Cash used in investing activities during the period was \$14.8 million and consisted primarily of cash used in the acquisition of GND for \$11.0 million, net of cash acquired, and NicView for \$1.1 million. Cash used to acquire other property and equipment and intangible assets was \$2.4 million and \$0.8 million, respectively. Cash provided by financing activities during the six months ended June 30, 2015 was \$2.3 million and consisted of proceeds from stock option exercises and Employee Stock Purchase Program ("ESPP") purchases and their related tax benefits of \$10.1 million, offset by \$5.5 million for repurchases of common stock under our share repurchase program, \$1.6 million for taxes paid related to net share settlement of equity awards related to stock, and \$0.7 million for a contingent consideration payment to Tender Touch, which we acquired in 2014.

During the six months ended June 30, 2014 cash provided by operating activities of \$19.1 million was the result of \$14.2 million of net income, non-cash adjustments to net income of \$6.8 million, and net cash outflows of \$1.8 million from changes in operating assets and liabilities. Cash used in investing activities during the period was \$7.7 million and consisted of cash used to acquire Tender Touch and Hearing Health Consultants LLC ("HHC") of

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\$2.5 million, purchase accounting adjustments of \$2.4 million related to the Grass acquisition, and cash used to acquire property and equipment and intangible assets of \$2.2 million and \$0.6 million, respectively. Cash used in financing activities during the six months ended June 30, 2014 was \$10.6 million and consisted primarily of repayment of long term debt of \$21.6 million and \$1.2 million for repurchases of common stock under the our share repurchase program partially offset by ESPP purchases and their related tax benefits of \$12.2 million. Our future liquidity and capital requirements will depend on numerous factors, including the:

• Extent to which we make acquisitions;

• Amount and timing of revenue;

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

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

• Cost and timing of marketing and selling activities;  
• and

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

**Commitments and Contingencies**

In the normal course of business, we enter into obligations and commitments that require future contractual payments. The commitments result primarily from firm, noncancellable purchase orders placed with contract vendors that manufacture some of the components used in our medical devices and related disposable supply products, as well as commitments for leased office, manufacturing, and warehouse facilities.

There are no material changes to the table of contractual obligations presented in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of our Annual Report on Form 10-K for the year ended December 31, 2014.

**Off Balance Sheet Arrangements**

Under our bylaws, we have agreed to indemnify our officers and directors for certain events or occurrences arising as a result of the officer or director's serving in such capacity. We have a directors and officers' liability insurance policy that limits our exposure and enables us to recover a portion of any future amounts paid resulting from the indemnification of our officers and directors. In addition, we enter into indemnification agreements with other parties in the ordinary course of business. In some cases we have obtained liability insurance providing coverage that limits our exposure for these other indemnified matters. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. We believe the estimated fair value of these indemnification agreements is minimal and have not recorded a liability for these agreements. During the six months ended June 30, 2015, we had no other off-balance sheet arrangements that had, or are reasonably likely to have, a material effect on our consolidated financial condition, results of operations, or liquidity.

**Recent Accounting Pronouncements**

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

**Cautionary Information Regarding Forward Looking Statements**

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 about Natus Medical Incorporated. These statements include, among other things, statements concerning our expectations, beliefs, plans, intentions, future operations,



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financial condition and prospects, and business strategies. The words “may,” “will,” “continue,” “estimate,” “project,” “intend,” “believe,” “expect,” “anticipate,” and other similar expressions generally identify forward-looking statements.

Forward-looking statements in this Item 2 include, but are not limited to, statements regarding the following: our belief that the recovery from the worldwide economic downturn has continued, our expectation regarding expansion of our international operations, our expectations regarding our new products, the sufficiency of our current cash, cash equivalents, and short-term investment balances, and any cash generated from operations to meet our ongoing operating and capital requirements for the foreseeable future, the use of debt to fund acquisitions, our expectations of earnout arrangements related to acquisitions, and our intent to acquire additional technologies, products, or businesses. Forward-looking statements are not guarantees of future performance and are subject to substantial risks and uncertainties that could cause the actual results predicted in the forward-looking statements as well as our future financial condition and results of operations to differ materially from our historical results or currently anticipated results. Investors should carefully review the information contained under the caption “Risk Factors” contained in Part II, Item 1A of this report for a description of risks and uncertainties. All forward-looking statements are based on information available to us on the date hereof, and we assume no obligation to update forward-looking statements.

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

During the six months ended June 30, 2015, there were no significant changes to our quantitative and qualitative disclosures about market risk. Please refer to Part II, Item 7A. Quantitative and Qualitative Disclosures About Market Risk included in our Annual Report on Form 10-K for the year ended December 31, 2014 for a more complete discussion on the market risks we encounter.

**ITEM 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

Under the rules of the Securities and Exchange Commission, “disclosure controls and procedures” are controls and other procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in our reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

At December 31, 2014, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were not effective as of December 31, 2014. This conclusion was based on the material weakness in our internal control over financial reporting further described below.

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the company’s annual or interim consolidated financial statements will not be prevented or detected on a timely basis.

Our management concluded that as of December 31, 2014 our internal control over financial reporting was not effective due to a lack of sufficient resources to effectively design, implement, and operate controls over certain accounts with an appropriate degree of precision. Specifically, the design of controls over the accounting for inventory, accounts receivable and revenue recognition for software contracts and multiple element arrangements was inadequate, which in the aggregate constituted a material weakness in our internal control over financial reporting. This material weakness resulted in misstatements of inventory in our financial statements, which were corrected prior to the issuance of our financial statements as of and for the year ended December 31, 2014.

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At June 30, 2015, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were not effective as of June 30, 2015 due to the material weakness that we identified as of December 31, 2014.

Remediation Efforts to Address Material Weakness

To remediate the material weakness in our internal control over financial reporting described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014, we made substantive changes to enhance the sufficiency of our resources in 2014. Specifically, we added additional resources with expertise in inventory cost accounting and have redesigned our controls to ensure the proper capitalization of overhead costs and the proper monitoring of inventory valuation. We have also added additional resources within our credit and collections group during 2014 and 2015. We have added incremental resources in 2015 to enhance the design and operating effectiveness of our controls over accounts receivable, inventory, and revenue recognition.

In addition to the changes described above, we will continue to evaluate and enhance the complement of our resources during 2015, as needed, to address the material weakness identified above. We also expect to finalize our world-wide implementation of a single ERP system during the third quarter of 2015, a project we began in 2011 to consolidate eight different systems into one global platform. The completion of this project will eliminate duplicative processes and increase the capacity of our existing accounting and financial reporting resources to further focus on remediating the material weakness identified above. The material weakness will not be considered remediated until the applicable remedial controls operate for a sufficient period of time and management has concluded, through testing, that the controls are operating effectively.

With the oversight of senior management and our audit committee, we have begun taking the above steps. While our remediation efforts are in process, they have not been completed.

Changes in Internal Control over Financial Reporting

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

Inherent Limitations over Internal Controls

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

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

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

ITEM 1A. Risk Factors

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A description of the risks associated with our business, financial condition and results of operations is set forth in Part 1, Item 1A “Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended December 31, 2014. There have been no material changes in our risks from such description.

## ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information regarding repurchases by the Company of its common stock for the three months ended June 30, 2015.

| Period                         | Total<br>Number of<br>Shares<br>Purchased | Average Price<br>Paid per Share | Total Number<br>of Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or<br>Programs | Approximate<br>Dollar Value of<br>Shares that May<br>Yet Be<br>Purchased<br>Under the Plans<br>or Programs |
|--------------------------------|---|---------------------------------|--|--|
| April 1, 2015 - April 30, 2015 | 19,000                                    | \$40.15                         | 19,000   | \$3,300,656  |
| May 1, 2015 - May 31, 2015     | 42,000                                    | \$37.17                         | 42,000   | \$1,739,687  |
| June 1, 2015 - June 30, 2015   | 45,000                                    | \$41.69                         | 45,000   | \$19,863,729   |
| Total                          | 106,000                                   | \$39.62                         | 106,000  | \$19,863,729   |

On June 9, 2014, the Company announced the Board of Directors authorization of the repurchase of up to \$10 million of the Company’s common stock pursuant to a stock repurchase program. On June 5, 2015, the Company announced the expansion of this stock repurchase program, authorizing the repurchase of up to an additional \$20 million of the Company's common stock. There is no set expiration date for the program.

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## ITEM 6. Exhibits

## (a) Exhibits

| Exhibit No. | Exhibit   | Incorporated By Reference |             |          | Filed Herewith |
|-------------|---|---------------------------|-------------|----------|----------------|
|             |   | Filing                    | Exhibit No. | File No. |                |
| 31.1        | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |                           |             |          | X              |
| 31.2        | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |                           |             |          | X              |
| 32.1        | Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |                           |             |          | X              |
| 101         | The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2015, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations and Comprehensive Income, (iii) Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements. |                           |             |          | X              |

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SIGNATURES

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

NATUS MEDICAL INCORPORATED

Dated: August 5, 2015

By: /s/ James B. Hawkins  
James B. Hawkins  
President and Chief Executive Officer  
(Principal Executive Officer)

Dated: August 5, 2015

By: /s/ Jonathan A. Kennedy  
Jonathan A. Kennedy  
Senior Vice President and  
Chief Financial Officer  
(Principal Financial and  
Accounting Officer)