Regulus Therapeutics Inc.
Form 10-Q
May 08, 2015
**Table of Contents**

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

# FORM 10-Q

**(Mark One)**

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

**FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2015**

**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: 001-35670**

**Regulus Therapeutics Inc.**

**(Exact name of registrant as specified in its charter)**

| **Delaware** | **26-4738379** |
|---|---|
| **(State or Other Jurisdiction of Incorporation or Organization)** | **(I.R.S. Employer Identification No.)** |
| **3545 John Hopkins Ct., Suite 210** | |
| **San Diego, CA** | **92121** |
| **(Address of Principal Executive Offices)** | **(Zip Code)** |

**858-202-6300**

**(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 such 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 x 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 x No ¨

Indicate by check mark whether 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 x |
| Non-accelerated filer ¨ (Do not check if a smaller reporting company) | Smaller reporting company ¨ |

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

As of April 24, 2015, the registrant had 51,017,405 shares of Common Stock ($0.001 par value) outstanding.

Table of Contents

**REGULUS THERAPEUTICS INC.**

**TABLE OF CONTENTS**

Table of Contents

## PART I. FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

**Regulus Therapeutics Inc.**

**CONDENSED BALANCE SHEETS**

**(in thousands, except share and per share data)**

| | March 31, 2015 (Unaudited) | December 31, 2014 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 19,600 | $ 37,327 |
| Short-term investments | 129,191 | 122,416 |
| Contract and other receivables | 4,859 | 274 |
| Prepaid and other current assets | 4,867 | 4,934 |
| Total current assets | 158,517 | 164,951 |
| Property and equipment, net | 3,444 | 3,568 |
| Intangibles, net | 1,087 | 1,150 |
| Other assets | 1,800 | 1,811 |
| Total assets | $ 164,848 | $ 171,480 |
| **Liabilities and stockholders equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 2,677 | $ 2,188 |
| Accrued liabilities | 5,318 | 4,402 |
| Accrued compensation | 1,049 | 2,108 |
| Current portion of deferred revenue | 5,307 | 3,097 |
| Convertible note payable, at fair value | | 23,397 |
| Total current liabilities | 14,351 | 35,192 |
| Deferred revenue, less current portion | 2,769 | 3,252 |
| Other long-term liabilities | 903 | 1,022 |
| Total liabilities | 18,023 | 39,466 |
| Stockholders equity: | | |
| Common stock, $0.001 par value; 200,000,000 shares authorized, 50,762,489 and 48,944,530 shares issued and outstanding at March 31, 2015 (unaudited) and December 31, 2014, respectively | 51 | 49 |
| Additional paid-in capital | 297,191 | 267,929 |
| Accumulated other comprehensive loss | (163) | (197) |

| | | |
|---|---|---|
| Accumulated deficit | (150,254) | (135,767) |
| Total stockholders equity | 146,825 | 132,014 |
| Total liabilities and stockholders equity | $ 164,848 | $ 171,480 |

See accompanying notes to these condensed financial statements.

Table of Contents

**Regulus Therapeutics Inc.**

**CONDENSED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS**

**(In thousands, except share and per share data)**

| | Three months ended March 31, | |
|---|---|---|
| | 2015 | 2014 |
| | (Unaudited) | |
| Revenues: | | |
| Revenue under strategic alliances and collaborations | $ 4,200 | $ 1,631 |
| Total revenues | 4,200 | 1,631 |
| Operating expenses: | | |
| Research and development | 13,427 | 9,604 |
| General and administrative | 3,644 | 2,732 |
| Total operating expenses | 17,071 | 12,336 |
| Loss from operations | (12,871) | (10,705) |
| Other income (expense): | | |
| Interest and other income | 199 | 100 |
| Interest expense | (8) | (11) |
| Loss from valuation of convertible note payable | (1,811) | (2,124) |
| Loss before income taxes | (14,491) | (12,740) |
| Income tax (benefit) expense | (4) | 1 |
| Net loss | $ (14,487) | $ (12,741) |
| Other comprehensive loss: | | |
| Unrealized gain (loss) on short-term investments, net | 58 | (43) |
| Comprehensive loss | $ (14,434) | $ (12,784) |
| Net loss per share, basic and diluted | $ (0.29) | $ (0.30) |
| Shares used to compute basic and diluted net loss per share | 50,071,165 | 42,690,200 |

See accompanying notes to these condensed financial statements.

Table of Contents

**Regulus Therapeutics Inc.**

**Condensed Statements of Cash Flows**

**(In thousands)**

| | Three months ended March 31, | |
|---|---|---|
| | 2015 | 2014 |
| | (Unaudited) | |
| **Operating activities** | | |
| Net loss | $ (14,487) | $ (12,741) |
| Adjustments to reconcile net loss to net cash used in operating activities | | |
| Depreciation and amortization expense | 394 | 354 |
| Loss from valuation of convertible note payable | 1,811 | 2,124 |
| Stock-based compensation | 3,103 | 1,400 |
| Amortization of premium on investments, net | 425 | 442 |
| Loss on disposal of long-term assets | 50 | 18 |
| Change in operating assets and liabilities: | | |
| Contracts and other receivables | (2,469) | (61) |
| Prepaid and other current assets | 78 | (385) |
| Accounts payable | 471 | 1,519 |
| Accrued liabilities | 899 | (39) |
| Accrued compensation | (1,059) | (438) |
| Deferred revenue | (389) | (1,161) |
| Deferred rent and other liabilities | (79) | (61) |
| Net cash used in operating activities | (11,252) | (9,029) |
| **Investing activities** | | |
| Purchases of short-term investments | (37,157) | (39,780) |
| Maturities and sales of short-term investments | 30,010 | 29,372 |
| Purchases of property and equipment | (236) | (75) |
| Acquisition of intangibles | (7) | |
| Net cash used in investing activities | (7,390) | (10,483) |
| **Financing activities** | | |
| Proceeds from issuance of common stock, net | 257 | 9,728 |
| Principal payments on other long-term obligations | (37) | (34) |
| Proceeds from exercise of stock options | 695 | 487 |
| Net cash provided by financing activities | 915 | 10,181 |
| Net decrease in cash and cash equivalents | (17,727) | (9,331) |

| | | |
|---|---|---|
| Cash and cash equivalents at beginning of period | 37,327 | 17,807 |
| Cash and cash equivalents at end of period | $ 19,600 | $ 8,476 |
| **Supplemental disclosure of cash flow information** | | |
| Interest paid | $ 8 | $ 11 |
| Income taxes paid | $ 1 | $ 1 |
| **Supplemental disclosure of non-cash investing and financing activities** | | |
| Amounts accrued for property and equipment | $ 14 | $ 301 |

See accompanying notes to these condensed financial statements.

Table of Contents

**Regulus Therapeutics Inc.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS**

**(Unaudited)**

## 1. Basis of Presentation and Summary of Significant Accounting Policies

### Basis of Presentation

The accompanying unaudited condensed financial statements have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In management s opinion, the accompanying financial statements reflect all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation of the results for the interim periods presented.

Interim financial results are not necessarily indicative of results anticipated for the full year. These unaudited condensed financial statements should be read in conjunction with the Company s audited financial statements and footnotes included in our Annual Report on Form 10-K for the year ended December 31, 2014, from which the balance sheet information herein was derived.

### Use of Estimates

Our condensed financial statements are prepared in accordance with GAAP, which requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities in our financial statements and accompanying notes. Although these estimates are based on our knowledge of current events and actions we may undertake in the future, actual results may ultimately differ from these estimates and assumptions.

### Revenue Recognition

Our revenues generally consist of upfront payments for licenses or options to obtain licenses in the future, milestone payments and payments for other research services under strategic alliance and collaboration agreements. We recognize revenues when all four of the following criteria are met: (1) persuasive evidence that an arrangement exists; (2) delivery of the products and/or services has occurred; (3) the selling price is fixed or determinable; and (4) collectability is reasonably assured.

Multiple element arrangements, such as our strategic alliance agreements with Sanofi and AstraZeneca AB ( AstraZeneca ) and our collaboration agreement with Biogen Inc. ( Biogen ), formerly Biogen Idec MA Inc., are analyzed to determine whether the deliverables within the agreement can be separated or whether they must be accounted for as a single unit of accounting. Deliverables under the agreement will be accounted for as separate units of accounting provided that (i) a delivered item has value to the customer on a stand-alone basis; and (ii) if the agreement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor. The allocation of consideration amongst the deliverables under the agreement is derived using a best estimate of selling price if vendor specific objective evidence and third-party evidence of fair value is not available. If the delivered element does not have stand-alone value, the arrangement is then accounted for as a single unit of accounting, and we recognize the consideration received under

the arrangement as revenue on a straight-line basis over our estimated period of performance, which for us is often the expected term of the research and development plan.

*Milestones*

We apply the milestone method of accounting to recognize revenue from milestone payments when earned, as evidenced by written acknowledgement from the collaborator or other persuasive evidence that the milestone has been achieved and the payment is non-refundable, provided that the milestone event is substantive. A milestone event is defined as an event (i) that can only be achieved based in whole or in part on either our performance or on the occurrence of a specific outcome resulting from our performance; (ii) for which there is substantive uncertainty at the inception of the arrangement that the event will be achieved; and (iii) that would result in additional payments being due to us. Events for which the occurrence is either contingent solely upon the passage of time or the result of a counterparty s performance are not considered to be milestone events. A milestone event is substantive if all of the following conditions are met: (i) the consideration is commensurate with either our performance to achieve the milestone, or the enhancement of the value to the delivered item(s) as a result of a specific outcome resulting from our performance to achieve the milestone; (ii) the consideration relates solely to past performance; and (iii) the consideration is reasonable relative to all the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

We assess whether a milestone is substantive at the inception of each arrangement. If a milestone is deemed non-substantive, we will account for that milestone payment in accordance with the multiple element arrangements guidance and recognize revenue consistent with the related units of accounting for the arrangement over the related performance period.

Table of Contents

*Deferred Revenue*

Amounts received prior to satisfying the above revenue recognition criteria are recorded as deferred revenue in the accompanying balance sheets. Amounts not expected to be recognized within the next 12 months are classified as non-current deferred revenue.

**Stock-Based Compensation**

We account for stock-based compensation expense related to stock options granted to employees and members of our board of directors by estimating the fair value of each stock option on the date of grant using the Black-Scholes model. We recognize stock-based compensation expense using the accelerated multiple-option approach. Under the accelerated multiple-option approach (also known as the graded-vesting method), we recognize compensation expense over the requisite service period for each separately vesting tranche of the award as though the award was in substance multiple awards, resulting in accelerated expense recognition over the vesting period. For performance-based awards granted to employees (i) the fair value of the award is determined on the grant date, (ii) we assess the probability of the individual milestones under the award being achieved and (iii) the fair value of the shares subject to the milestone is expensed over the implicit service period commencing once management believes the performance criteria is probable of being met.

We account for stock options granted to non-employees using the fair value approach. Stock options granted to non-employees are subject to periodic revaluation over their vesting terms.

**Fair Value Option**

Applicable accounting policies permit entities to choose, at specified election dates, to measure specified items at fair value if the decision about the election is: 1) applied instrument by instrument, 2) irrevocable, and 3) applied to an entire instrument.

In July 2012, we amended and restated the $5.0 million convertible promissory note originally issued in February 2010 to Glaxo Group Limited ( GSK ) (the 2010 GSK Note ), which resulted in a debt extinguishment for accounting purposes. Concurrently with the debt extinguishment, we elected the fair value option for the 2010 GSK Note. The difference between the carrying value of the 2010 GSK Note and the fair value of the amended and restated 2010 GSK Note was recorded as a loss on extinguishment of debt to non-operating earnings. Thereafter, any change to the fair value of the amended note was recorded as gain (loss) from valuation of convertible note payable to non-operating earnings.

The amended and restated 2010 GSK Note provided for a rollover into a new promissory note, effective as of the closing date of a qualifying initial public offering (the Post-IPO GSK Note ). In October 2012, upon our initial public offering, the Post-IPO GSK Note was established in the principal amount of $5.4 million, which was equivalent to the original principal amount of $5.0 million plus accrued but unpaid interest of approximately $0.4 million. The 2010 GSK Note was simultaneously cancelled and obligations thereunder were terminated. In January 2015, the principal balance of the Post-IPO GSK Note was converted into common stock.

**Clinical Trial and Pre-Clinical Study Accruals**

We make estimates of our accrued expenses as of each balance sheet date in our financial statements based on the facts and circumstances known to us at that time. Our accrued expenses for pre-clinical studies and clinical trials are based on estimates of costs incurred and fees that may be associated with services provided by clinical trial

investigational sites, clinical research organizations ( CROs ) and other clinical trial-related vendors. Payments under certain contracts with such parties depend on factors such as successful enrollment of patients, site initiation and the completion of clinical trial milestones. In accruing service fees, we estimate the time period over which services will be performed and the level of effort to be expended in each period. If possible, we obtain information regarding unbilled services directly from these service providers. However, we may be required to estimate these services based on other information available to us. If we underestimate or overestimate the activity or fees associated with a study or service at a given point in time, adjustments to research and development expenses may be necessary in future periods. Historically, our estimated accrued liabilities have approximated actual expense incurred. Subsequent changes in estimates may result in a material change in our accruals.

**Recent Accounting Pronouncements**

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* ( ASU 2014-19 ). Adoption of ASU No. 2014-09 requires that an entity recognize revenue 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. This update is effective for annual reporting periods beginning after December 15, 2016 and interim periods therein and requires expanded disclosures. We are currently evaluating the impact of adoption on our financial position, results of operations and cash flows.

Table of Contents

In August 2014, the FASB issued ASU No. 2014-15, *Presentation of Financial Statements Going Concern*, which requires management to assess an entity s ability to continue as a going concern, and to provide related footnote disclosure in certain circumstances. This standard is effective for annual reporting periods ending after December 15, 2016 and interim periods thereafter. Early application is permitted. The adoption of this guidance will have no impact on our financial position, results of operations or cash flows.

**2. Net Loss Per Share**

Basic net loss per share is calculated by dividing the net loss by the weighted average number of common shares outstanding for the period, without consideration for common stock equivalents. Diluted net loss per share is calculated by dividing the net loss by the weighted-average number of common share equivalents outstanding for the period determined using the treasury-stock method. Dilutive common stock equivalents are comprised of options outstanding under our stock option plan and convertible note payable. For all periods presented, there is no difference in the number of shares used to calculate basic and diluted shares outstanding due to our net loss position.

Potentially dilutive securities not included in the calculation of diluted net loss per share because to do so would be anti-dilutive are as follows (in common equivalent shares):

| | Three months ended March 31, | |
|---|---|---|
| | **2015** | **2014** |
| Common stock options | 2,813,279 | 2,350,252 |
| Convertible note payable | | 1,425,127 |
| Total | 2,813,279 | 3,775,379 |

**3. Investments**

We invest our excess cash in commercial paper and debt instruments of financial institutions and corporations. As of March 31, 2015, our short-term investments had a weighted average maturity of less than two years.

The following tables summarize our short-term investments (in thousands):

| **As of March 31, 2015** | **Maturity (in years)** | **Amortized cost** | **Unrealized Gains** | **Unrealized Losses** | **Estimated fair value** |
|---|---|---|---|---|---|
| Corporate debt securities | 2 or less | $ 106,842 | $ 6 | $ (114) | $ 106,734 |
| Certificates of deposit | 2 or less | 17,960 | | | 17,960 |
| Commercial paper | 1 or less | 4,495 | 2 | | 4,497 |
| Total | | $ 129,297 | $ 8 | $ (114) | $ 129,191 |

| **As of December 31, 2014** | **Maturity (in years)** | **Amortized cost** | **Unrealized Gains** | **Unrealized Losses** | **Estimated fair value** |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| Corporate debt securities | 2 or less | $ 105,085 | $ 2 | $ (167) | $ 104,920 |
| Certificates of deposit | 2 or less | 14,600 | | | 14,600 |
| Commercial paper | 1 or less | 2,895 | 1 | | 2,896 |
| Total | | $ 122,580 | $ 3 | $ (167) | $ 122,416 |

**4. Fair Value Measurements**

We have certain financial assets and liabilities recorded at fair value which have been classified as Level 1, 2 or 3 within the fair value hierarchy as described in the accounting standards for fair value measurements.

Accounting standards define fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants as of the measurement date. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact, and (iv) willing to transact. The accounting standards provide an established hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in

Table of Contents

valuing the asset or liability and are developed based on market data obtained from independent sources. Unobservable inputs are inputs that reflect our assumptions about the factors that market participants would use in valuing the asset or liability. The accounting standard prioritize the inputs used in measuring the fair value into the following hierarchy:

Level 1 includes financial instruments for which quoted market prices for identical instruments are available in active markets.

Level 2 includes financial instruments for which there are inputs other than quoted prices included within Level 1 that are observable for the instrument such as quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets with insufficient volume or infrequent transactions (less active markets) or model-driven valuations in which significant inputs are observable or can be derived principally from, or corroborated by, observable market data.

Level 3 includes financial instruments for which fair value is derived from valuation techniques in which one or more significant inputs are unobservable, including management s own assumptions.

The following table presents our fair value hierarchy for assets and liabilities measured at fair value on a recurring basis at March 31, 2015 and December 31, 2014 (in thousands):

| | Fair value as of March 31, 2015 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| Assets: | | | | |
| Cash equivalents | $ 18,991 | $ 18,991 | $ | $ |
| Corporate debt securities | 106,734 | | $ 35,503 | $ 37,685 |

At June 30, 2014 and December 31, 2013, the Company has classified $6.6 million and $7.1 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, 2014 | | | | December 31, 2013 | | | |
|---|---|---|---|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Impairment | Accumulated Amortization | Net Book Value | Gross Carrying Amount | Accumulated Impairment | Accumulated Amortization | Net Book Value |
| Intangible assets with definite lives: | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Technology | $ 65,850 | | $ (26,684) | $ 39,166 | $ 65,904 | | $ (25,519) | $ 40,385 |
| Customer related | 32,010 | | (10,788) | 21,222 | 31,231 | | (9,763) | 21,468 |
| Internally developed software | 13,276 | | (5,805) | 7,471 | 11,069 | | (5,107) | 5,962 |
| Patents | 2,954 | | (2,198) | 756 | 2,724 | | (2,094) | 630 |
| Backlog | 722 | | (722) | | 722 | | (722) | |
| Definite-lived intangible assets | 114,812 | | (46,197) | 68,615 | 111,650 | | (43,205) | 68,445 |
| Intangible assets with indefinite lives: | | | | | | | | |
| Tradenames | 32,990 | (3,076) | | 29,914 | 33,435 | (3,060) | | 30,375 |
| Total Intangibles | $ 147,802 | $ (3,076) | $ (46,197) | $ 98,529 | $ 145,085 | $ (3,060) | $ (43,205) | $ 98,820 |

Definite-lived intangible assets are amortized over their weighted average lives of 15 years for technology, 11 years for customer related intangibles, 5 years for internally developed software, and 14 years for patents. Intangible assets with indefinite lives are not subject to amortization.

Internally developed software consists of $11.8 million relating to costs incurred for development of internal use computer software and $1.5 million for development of software to be sold.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Technology | $ 500 | $ 1,096 | $ 1,165 | $ 2,165 |
| Customer Related | 296 | 678 | 1,025 | 1,322 |
| Internally developed software | 422 | 244 | 698 | 509 |
| Patents | 6 | 30 | 104 | 61 |
| Total amortization | $ 1,223 | $ 2,048 | $ 2,992 | $ 4,057 |

Table of Contents

During the second quarter 2014 we identified an inaccuracy related to intangibles amortization. Amortization expense was being recorded on a straight line basis in USD for foreign entities when the expense should have been recorded on a straight line basis in the entities functional currency. As a result there was a $1.1 million adjustment to reduce amortization expense in the second quarter 2014 related to prior periods.

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

| | |
|---|---|
| Six months ending December 31, 2014 | $ 5,101 |
| 2015 | 7,675 |
| 2016 | 6,894 |
| 2017 | 6,605 |
| 2018 | 6,371 |
| 2019 | 5,406 |
| Thereafter | 30,563 |
| Total expected amortization expense | $ 68,615 |

**6 - Goodwill**

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

| | |
|---|---|
| As of December 31, 2013 | $ 97,238 |
| Acquisitions/Purchase Accounting Adjustments | 4,001 |
| Foreign currency translation | (309) |
| As of June 30, 2014 | $ 100,931 |

**7 - Property and Equipment, net**

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

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Land | $ 4,018 | $ 4,152 |
| Buildings | 9,454 | 10,269 |
| Leasehold improvements | 2,910 | 2,796 |
| Office furniture and equipment | 11,829 | 10,820 |
| Computer software and hardware | 9,157 | 10,250 |
| Demonstration and loaned equipment | 10,138 | 9,470 |
| | 47,506 | 47,757 |
| Accumulated depreciation and amortization | (26,398) | (24,462) |

| | | |
|---|---|---|
| Total | $ 21,108 | $ 23,295 |

Depreciation and amortization expense of property and equipment was approximately $965,000 and $2.4 million for the three and six months ended June 30, 2014, respectively, and was approximately $1.2 and $2.3 million for the three and six months ended June 30, 2013, 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 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.

Table of Contents

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Balance, beginning of period | $ 3,011 | $ 2,643 | $ 3,142 | $ 2,260 |
| Acquisition warranty assumed | | | | 191 |
| Warranty accrued for the period | 141 | 115 | 595 | 771 |
| Repairs for the period | (464) | (688) | (1,049) | (1,152) |
| Balance, end of period | $ 2,688 | $ 2,070 | $ 2,688 | $ 2,070 |

**9 - Share-Based Compensation**

At June 30, 2014, 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, 2014 and our methods for determining grant-date fair value of the awards were consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Cost of revenue | $ 50 | $ 37 | $ 78 | $ 96 |
| Marketing and sales | 261 | 202 | 497 | 472 |
| Research and development | 257 | 124 | 404 | 241 |
| General and administrative | 999 | 1,456 | 2,198 | 2,370 |
| Total | $ 1,567 | $ 1,819 | $ 3,177 | $ 3,179 |

As of June 30, 2014, unrecognized compensation expense related to the unvested portion of our stock options and other stock awards was approximately $15.0 million, which is expected to be recognized over a weighted average period of 2.6 years.

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Investment income | $ 7 | $ 34 | $ 137 | $ 65 |
| Interest expense | (184) | (469) | (448) | (946) |
| Foreign currency exchange gain (loss) | 852 | 147 | 1,001 | (50) |
| Other | 120 | (235) | 417 | 75 |
| Total other income (expense), net | $ 795 | $ (523) | $ 1,107 | $ (856) |

During the second quarter 2014 we identified an error related to the classification of revaluation of two intercompany loans acquired in the purchase of Nicolet. The revaluation of these loans was recorded to Other Comprehensive Income rather than Foreign Exchange Gain or Loss. This resulted in a $1.2 million reclassification from Other Comprehensive Income to Foreign Exchange Gains in the second quarter of 2014.

Table of Contents

**11 - Income Taxes**

**Provision for Income Tax Expense**

We recorded provisions for income tax of $3.4 million and $6.1 million for the three and six months ended June 30, 2014, respectively. Our effective tax rate was 30.3% and 30.4% for the three and six months ended June 30, 2014, respectively.

We recorded provisions for income tax of $1.6 million and $2.7 million for the three and six months ended June 30, 2013, respectively. Our effective tax rate was 28.7% and 26.6% for the three and six months ended June 30, 2013, respectively.

Our effective tax rate for the six months ended June 30, 2014 differed from statutory tax rates primarily because of profits taxed in foreign jurisdictions with lower tax rates than the statutory rate. The increase in the effective tax rate for the three months ended June 30, 2014 compared to the three months ended March 31,2014 is primarily attributable to the adjustment related to intangible assets recorded in this quarter; however the effect was offset by an adjustment related to year foreign statutory and income tax filings.

Our effective tax rate for the six months ended June 30, 2013 differed from statutory tax rates primarily because of profits taxed in foreign jurisdictions with lower tax rates than the statutory rate and tax benefits related to the 2012 federal research and development tax credit by enactment of the American Taxpayer Relief Act of 2012 in January 2013 and domestic manufacturer deduction. The federal research and development credit and domestic manufacturer deduction benefited the effective tax rate for the six months ended June 30, 2013 by approximately 4%.

We recorded a tax benefit of $281,000 of unrecognized tax benefit due to the audit closures and expiration of the statute of limitations for the six months ended June 30, 2014. Within the next twelve months, it is possible our uncertain tax benefit may change within a range of approximately zero to $696,000.

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

**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 balance sheets. Employee termination benefits expensed are included as a part of general and administrative expenses.

Activity in the restructuring reserves for the six months ended June 30, 2014 is as follows (in thousands):

| | |
|---|---|
| Balance at December 31, 2013 | $ 335 |
| Expensed | 126 |
| Reversals | (42) |
| Cash payments | (419) |

| | |
|---|---|
| Balance at June 30, 2014 | $ |

**13 - Debt and Credit Arrangements**

The Company has a $75 million credit facility consisting of a $25 million revolving credit line and a $50 million 5-year term loan with Wells Fargo Bank, National Association ( Wells Fargo ). The $25 million credit line is fully available under the credit agreement. The credit facility contains covenants, including covenants relating to liquidity and other financial measurements, and provides for events of default, including failure to pay any interest when due, failure to perform or observe covenants, bankruptcy or insolvency events, and the occurrence of a material adverse effect, and restricts our ability to pay dividends. We are in compliance with all covenants as of June 30, 2014. We have granted Wells Fargo a security interest in substantially all of our assets. We have no other significant credit facilities.

Table of Contents

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

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Term loan $50 million, interest at LIBOR plus 1.75%, due June 30, 2018 with term loan principle repayable in quarterly installments of $2.5 million | $ 16,000 | $ 37,500 |
| Term loan $2.9 million Canadian ( CAD ), interest at cost of funds plus 2.5%, due June 15, 2014 with principle repayable in monthly installments of $16,000 until August 15, 2014 and one final payment of $404,000 collateralized by a first lien on company owned land and building | 409 | 517 |
| Total | 16,409 | 38,017 |
| Less: current portion of long-term debt | (10,409) | (10,517) |
| Total long-term debt | $ 6,000 | $ 27,500 |

Maturities of long-term debt as of June 30, 2014 are as follows (in thousands):

| | |
|---|---|
| Three months ended December 31, 2014 | $ 5,409 |
| 2015 | 10,000 |
| 2016 | 1,000 |
| Total Total long-term debt | $ 16,409 |

At June 30, 2014 and December 31, 2013, the carrying value of total debt approximates fair market value. The fair value of the Company s debt is considered a Level 2 measurement.

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

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

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |

| | | | | |
|---|---|---|---|---|
| Consolidated Revenue: | | | | |
| United States | $ 52,468 | $ 47,926 | $ 100,813 | $ 96,290 |
| Foreign countries | 33,857 | 34,324 | 71,135 | 71,794 |
| Totals | $ 86,325 | $ 82,250 | $ 171,948 | $ 168,084 |

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Revenue by End Market: | | | | |
| Neurology Products | | | | |
| Devices and Systems | $ 35,181 | $ 31,202 | $ 70,349 | $ 65,908 |
| Supplies | 15,085 | 15,192 | 30,259 | 30,639 |
| Services | 5,509 | 6,393 | 11,653 | 11,946 |
| Total Neurology Revenue | 55,775 | 52,787 | 112,261 | 108,537 |
| Newborn Care Products | | | | |
| Devices and Systems | 16,625 | 16,052 | 31,549 | 33,302 |
| Supplies | 11,571 | 11,524 | 23,847 | 22,988 |
| Services | 2,354 | 1,887 | 4,292 | 3,301 |
| Total Newborn Care Revenue | 30,550 | 29,463 | 59,687 | 59,591 |
| Total Revenue | $ 86,325 | $ 82,250 | $ 171,948 | $ 168,084 |

Table of Contents

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Property and equipment, net: | | |
| United States | $ 9,090 | $ 9,619 |
| Canada | 5,744 | 6,060 |
| Argentina | 3,884 | 4,932 |
| Other foreign countries | 2,390 | 2,684 |
| Totals | $ 21,108 | $ 23,295 |

During the three and six months ended June 30, 2014 and 2013, no single customer or foreign country contributed to more than 10% of revenue.

**15 - Fair Value Measurements**

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

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

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

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

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

The following financial instruments are not measured at fair value on the Company s condensed consolidated balance sheet as of June 30, 2014 and December 31, 2013, but require disclosure of their fair values: cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities and debt. Except for debt, the carrying value of these financial instruments approximates fair values because of their relatively short maturity.

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

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

*Natus®, AABR®, ABaer®, ALGO®, AOAE®, AuDX® Aura®, Balance Manager®, Balance Master®, Balance Shape®, Biliband®, Bio-logic®, Bo-JECT®, Brain Atlas®, Ceegraph®, CHAMP®, Clarity System®, Cochlea Scan®, Cool Cap®, CoolCare®, Comet®, Dantec®, Ear Couplers®, Ear Muffin®, EC2®, Echo Screen®, Embla US®, Embletta®,*

*Enterprise®, EquiTest®, Fass®, Fischer-Zoth®, Flexicoupler®, Grass®, Grass Technologies®, Gumdrop®, Halo Ear Muffin®, Hawaii Medical®, Keypoint®, Keypoint AU®, Keypoint EU®, Keypoint JP®, MASTER®, Medelec®, Medix®, MedixI.C.S.A®, Navigator®, Neatnick®, neoBLUE®, Neurocom®, Neuromax®,Neurotrac®, NeuroWorks®, Nicolet®, NicoletElite®, Oxydome®, Panorama®, Pocket®, Polyview®,*

Table of Contents

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**Overview**

The following Management s Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) supplements the MD&A in the Annual Report on Form 10-K for the year ended December 31, 2013 of Natus Medical Incorporated. Management s discussion and analysis should be read in conjunction with our condensed consolidated financial statements and accompanying footnotes, the discussion of certain risks and uncertainties contained in Part II, Item 1A of this report, our Annual Report filed on Form 10-K for the year ended December 31, 2013 and the cautionary information regarding forward-looking statements at the end of this section. MD&A includes the following sections:

Our Business. A general description of our business;

2014 Second Quarter Overview. A summary of key information concerning the financial results for the three months ended June 30, 2014;

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

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

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

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

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

**Our Business**

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

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

***End Markets***

Our products address two primary end markets:

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

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

***Segment and Geographic Information***

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

Table of Contents

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 14 Segment, Customer and Geographic Information* of our Consolidated Financial Statements included in this report and is incorporated in this section by this reference.

***Revenue by Product Category***

We generate our revenue either from sales of Devices and Systems, which are generally non-recurring, and from related Supplies and Services, which are generally recurring. The products that are attributable to these categories are described in our Annual Report on Form 10-K for the year ended December 31, 2013. Revenue from Devices and Systems, Supplies and Services, as a percent of total revenue for the three and six months ended June 30, 2014 and 2013 is as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Devices and Systems | 60% | 58% | 59% | 59% |
| Supplies | 31% | 32% | 32% | 32% |
| Services | 9% | 10% | 9% | 9% |
| Total | 100% | 100% | 100% | 100% |

During the three and six months ended June 30, 2014 and 2013, no single customer or foreign country contributed to more than 10% of revenue.

**2014 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 $4.1 million in the second quarter ended June 30, 2014 to $86.3 million compared to $82.2 million in the second quarter of the previous year. Our revenue increases were primarily in the United States market driven by strength in sales of our Neurology equipment.

Net income was $7.7 million or $0.24 per diluted share in the three months ended June 30, 2014, compared with net income of $4.0 million or $0.13 per share in the same period in 2013. An increase from 58.3% to 59.1% in gross profit percentage for the second quarter of 2014 compared to the same period in 2013 was primarily the result of ongoing cost reduction initiatives.

**Application of Critical Accounting Policies**

We prepare our financial statements in accordance with accounting principles generally accepted in the United States of America ( GAAP ). In so doing, we must often make estimates and use assumptions that can be subjective, and,

consequently, our actual results could differ from those estimates. For any given individual estimate or assumption we make, there may also be other estimates or assumptions that are reasonable.

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

Revenue recognition

Inventory carried at the lower of cost or market value

Carrying value of intangible assets and goodwill

Liability for product warranties

Share-based compensation

Table of Contents

These critical accounting policies are described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2013, under Item 7, *Management s Discussion and Analysis of Financial Condition and Results of Operations*. There have been no changes to these policies during the six months ended June 30, 2014.

**Results of Operations**

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Revenue | 100% | 100% | 100% | 100% |
| Cost of revenue | 40.1 | 41.2 | 41.3 | 41.9 |
| Gross profit | 59.9 | 58.8 | 58.7 | 58.1 |
| Operating expenses: | | | | |
| Marketing and selling | 25.5 | 26.5 | 25.3 | 26.2 |
| Research and development | 9.1 | 10.5 | 8.9 | 10.0 |
| General and administrative | 12.5 | 14.3 | 13.4 | 15.4 |
| Total operating expenses | 47.2 | 51.3 | 47.7 | 51.6 |
| Income from operations | 11.9 | 7.5 | 11.0 | 6.5 |
| Other income (expense), net | 0.9 | (0.6) | 0.6 | (0.5) |
| Income (loss) before provision for income tax (benefit) | 12.9 | 6.9 | 11.7 | (6.0) |
| Provision for income tax expense | 3.9 | 2.0 | 3.5 | 1.6 |
| Net income | 9.0% | 4.9% | 8.1% | 4.4% |

As the operations of Grass since its acquisition date of February 2013 have been reflected in our consolidated results, where significant, we have noted the impact of this acquisition on our results of operations for the six months ended June 30, 2014, as compared to the same period in 2013.

**Revenues**

The following table shows revenue by products during the three and six months ended June 30, 2014 and June 30, 2013 in millions.

| | Three Months Ended June 30, | Six Months Ended June 30, |
|---|---|---|

| | 2014 | 2013 | Change | 2014 | 2013 | Change |
|---|---|---|---|---|---|---|
| Neurology | | | | | | |
| Devices and Systems | $ 35,181 | $ 31,202 | 13% | $ 70,349 | $ 65,908 | 7% |
| Supplies | 15,085 | 15,192 | (1)% | 30,259 | 30,639 | (1)% |
| Services | 5,509 | 6,393 | (14)% | 11,653 | 11,946 | (2)% |
| Total Neurology | 55,775 | 52,787 | 6% | 112,261 | 108,537 | 3% |
| Newborn Care | | | | | | |
| Devices and Systems | 16,625 | 16,052 | 4% | 31,549 | 33,302 | (5)% |
| Supplies | 11,571 | 11,524 | 0% | 23,847 | 22,988 | 4% |
| Services | 2,354 | 1,887 | 25% | 4,292 | 3,301 | 30% |
| Total Newborn Care | 30,550 | 29,463 | 4% | 59,687 | 59,591 | 0% |
| Total Revenue | $ 86,325 | $ 82,250 | 5% | $ 171,948 | $ 168,084 | 2% |

For the three months ended June 30, 2014, Neurology revenue increased by 6% compared to the same quarter last year, with the growth primarily the result of increased revenue in our domestic market. Revenue from sales of Neurology Devices and Systems grew 13%, driven primarily by larger orders in the current quarter as compared to last year. The growth in Devices and Systems revenue was partially offset by a decline in Supplies and Service revenue due to lower service contract revenue from domestic customers and a decrease in the volume of service parts sold to international customers.

Table of Contents

For the six months ended June 30, 2014, Neurology revenue increased by 3% compared to the same period last year with the growth coming mainly from the domestic market. Neurology Devices and Systems revenue for increased 7% for the six month ended June 30, 2014 compared to the same period last year with growth in both the domestic and international markets. Supplies and Service revenues for the six-month period declined slightly compared to the same period last year.

For the three months ended June 30, 2014, Newborn Care revenue increased by 4% compared to the same quarter last year. Geographically, the increase is in our domestic market. Other factors contributing to the increase were the introduction of two new products and the introduction of Peloton, our new hearing screening service initiative. For the six months ended June 30, 2014, Newborn Care has marginal growth compared to prior year. Geographically, demand in our domestic market has increased while we experienced slower international demand in the first three months of the year.

No single customer accounted for more than 10% of our revenue in the second quarter of either 2014 or 2013. Revenue from domestic sales increased 9.5% to $52.5 million for the three months ended June 30, 2014 from $48.4 million in the second quarter of 2013. This increase was primarily driven by the introduction of our new hearing screening services initiative. Revenue from international sales decreased 9.2% to $33.8 million for the three months ended June 30, 2014 compared to $37.3 million in the second quarter of 2013. The decrease in international revenue was driven by lower demand of supplies.

**Cost of Revenue and Gross Profit**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Revenue | $ 86,325 | $ 82,250 | $ 171,948 | $ 168,084 |
| Cost of revenue | 35,295 | 33,859 | 71,028 | 70,460 |
| Gross profit | 51,029 | 48,391 | 100,920 | 97,624 |
| Gross profit percentage | 59.1% | 58.9% | 58.7% | 58.1% |

For the three months ended June 30, 2014, our gross profit increased by 6% compared to the same quarter last year as a result of higher revenues. Gross profit as a percent of sales increased to 59.1% from 58.9% during the same period. For the six months ended June 30, 2014, our gross profit increased as a result of higher revenue. Gross profit as a percent of sales has also increased to 58.7% from 58.1% as a result of our ongoing cost reduction initiatives. The increase in gross profit was driven by ongoing cost reduction initiatives as well as a $0.5 million reduction for the prior period amortization expense adjustment.

**Operating Costs**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Marketing and selling | $ 22,028 | $ 21,848 | $ 43,451 | 43,969 |
| Percentage of revenue | 25.5% | 26.6% | 25.3% | 26.2% |
| Research and development | $ 7,873 | $ 8,626 | $ 15,381 | 16,801 |

| | | | | |
|---|---|---|---|---|
| Percentage of revenue | 9.1% | 10.4% | 9.1% | 10.0% |
| General and administrative | $ 10,823 | $ 11,759 | $ 23,103 | 25,837 |
| Percentage of revenue | 12.5% | 14.3% | 13.4% | 15.4% |

*Marketing and Selling*

Marketing and selling expenses for the three and six months ended June 30, 2014 included a $0.5 million reduction for the prior period amortization expense adjustment.

Table of Contents

*Research and Development*

The reduction in research and development expenses during the three months six months ended June 30, 2014 compared to the same periods in 2013 is primarily due to a reduction in payroll expenses driven by our ongoing cost reduction activities.

*General and Administrative*

There are two main drivers for the decrease in general and administrative expenses for the periods above. The first is a reduction in spending on outside services associated with cost reduction initiatives. The second is related to the medical device tax enacted in 2013. In late 2013 we completed a study and determined an overpayment of $1.0 million was made in 2013 for the medical device tax. An adjustment to reduce our expense was made at the end of 2013. Our payments and associated expenses have been adjusted in 2014 and we are expecting a refund in the third quarter of 2014 for the 2013 overpayment.

**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, 2014 we reported other income of $795,000, compared to other expense of $523,000 for the same period in 2013. This increase was driven by an increase in currency exchange gains and losses. In the second quarter of 2014 we recognized $1.2 million of prior period currency exchange gains related to the revaluation of loans that were acquired as part of the Nicolet acquisition.

For the six months ended June 30, 2014 we reported other income of $1.1 million, compared to other expense of $856,000 for the same period in 2013. This increase was driven by an increase in currency exchange gains, as described above as well as a reduction in interest expense. The decrease in interest expense is driven by the accelerated repayment of long term debt.

**Provision for Income Tax**

We recorded provisions for income tax of $3.4 million and $6.1 million for the three and six months ended June 30, 2014, respectively. Our effective tax rate was 30.3% and 30.4% for the three and six months ended June 30, 2014, respectively.

We recorded provisions for income tax of $1.6 million and $2.7 million for the three and six months ended June 30, 2013, respectively. Our effective tax rate was 28.7% and 26.6% for the three and six months ended June 30, 2014, respectively.

Our effective tax rate for the six months ended June 30, 2014 differed from statutory tax rates primarily because of profits taxed in foreign jurisdictions with lower tax rates than the statutory rate. The adjustment related to intangible and goodwill assets for this quarter has increased effective tax rate approximately 4.9% for the six months ended June 30, 2014.

The increase in tax expense for the six months ended June 30, 2014 compared to the same period of 2013 is primarily attributable to the increase in income before provision for income taxes. The increase in the effective tax rate for the three months ended June 30, 2014 compared to three months ended March 31, 2014 is primarily attributable to the adjustment related to intangible assets recorded in this quarter; however the effect was offset by an adjustment related to prior year foreign statutory and income tax filings.

The increase in tax expense for the six months ended June 30, 2014 compared to the same period of 2013 is primarily attributable to the increase in income before provision for income taxes. The increase in the effective tax rate for the six months ended June 30, 2014 compared to the same period of 2013 is primarily attributable to the adjustment related to intangible and goodwill assets recorded in this quarter and the tax benefit taken in 2013 related to the 2012 federal research and development tax credit by enactment of the American Relief Act of 2012 in January 2013.

**Liquidity and Capital Resources**

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Cash and cash equivalents | $ 56,018 | $ 56,106 |
| Property, plant and equipment, net | 21,108 | 23,295 |
| Long-term debt | 16,409 | 38,017 |
| Working capital | 119,634 | 116,690 |

Table of Contents

| | Six Months Ended | |
|---|---|---|
| | June 30, 2014 | June 30, 2013 |
| Net cash provided by operating activities | $ 19,142 | $ 4,674 |
| Net cash used in investing activities | (7,700) | (20,882) |
| Net cash provided by (used in) financing activities | (10,616) | 21,964 |

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, 2014, we had cash and cash equivalents outside the U.S. in certain of our foreign operations of $33.0 million. We currently intend to permanently reinvest the cash held by our foreign subsidiaries. If, however, a portion of these funds were needed for and distributed to our operations in the United States, we would be subject to additional U.S. income taxes and foreign withholding taxes. The amount of taxes due would depend on the amount and manner of repatriation, as well as the location from where the funds were repatriated.

At June 30, 2014 we had a $75 million credit facility consisting of a $25 million revolving credit line and a $50 million 5-year term loan with Wells Fargo. The credit facility contains covenants, including covenants relating to liquidity and other financial measurements, and provides for events of default, including failure to pay any interest when due, failure to perform or observe covenants, bankruptcy or insolvency events, and the occurrence of a material adverse effect, and restricts our ability to pay dividends. We have granted Wells Fargo a security interest in substantially all of our assets. We have no other significant credit facilities.

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

During the six months ended June 30, 2014 cash generated from operating activities of $19.1 million was the result of $14.0 million of net income, non-cash adjustments to net income of $6.7 million, and net cash outflows of $1.6 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 related to the acquisition of businesses of $4.9 million and cash used to acquire property and equipment and intangible assets of $2.8 million. Cash used in financing activities during the six months ended June 30, 2014 was $10.6 million and consisted of $21.6 million repayment of long term debt offset by proceeds from stock option exercises and ESPP purchases and their related tax benefits of $11.0 million.

During the six months ended June 30, 2013 cash generated from operating activities of $4.7 million was the result of $7.5 million of net income, non-cash adjustments to net income of $10.1 million, and net cash outflows of $12.9 million from changes in operating assets and liabilities. Cash used in investing activities during the period was $20.9 million and consisted of cash used to acquire Grass of $18.6 million and cash used to acquire property and equipment and intangible assets of $2.3 million. Cash generated by financing activities during the six months ended June 30, 2013 was $21.9 million and consisted of a $17.7 million net change in long term debt related to the restructuring of the Wells Fargo credit facility offset by proceeds from stock option exercises and ESPP purchases and their related tax benefits of $4.2 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.

Table of Contents

**Commitments and Contingencies**

In the normal course of business, we enter into obligations and commitments that require future contractual payments. The commitments result primarily from firm, noncancellable purchase orders placed with contract vendors that manufacture some of the components used in our medical devices and related disposable supply products, as well as commitments for leased office, manufacturing, and warehouse facilities. There were no material changes to the table of contractual obligations presented in Item 7, *Management s Discussion and Analysis of Financial Condition and Results of Operations*, of our Annual Report on Form 10-K for the year ended December 31, 2013.

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

**Recent Accounting Pronouncements**

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

**Cautionary Information Regarding Forward Looking Statements**

*This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 about Natus Medical Incorporated. These statements include, among other things, statements concerning our expectations, beliefs, plans, intentions, future operations, financial condition and prospects, and business strategies. The words may, will, continue, estimate, project, intend, believe, expect, anticipate, and other similar expressions generally identify forward-looking statements. Forward-looking statements in this Item 2 include, but are not limited to, statements regarding the following: our belief that the recovery from the worldwide economic downturn has continued, our expectation regarding expansion of our international operations, our expectations regarding our new products, the sufficiency of our current cash, cash equivalents, and short-term investment balances, and any cash generated from operations to meet our ongoing operating and capital requirements for the foreseeable future, the use of debt to fund acquisitions, our expectations of earnout arrangements related to acquisitions, and our intent to acquire additional technologies, products, or businesses.*

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

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

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

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

If the U.S. Dollar uniformly increased or decreased in strength by 10% relative to the currencies in which our sales were denominated, our net income would have correspondingly increased or decreased by an immaterial amount for the six months ended June 30, 2014. Our interest income is sensitive to changes in the general level of interest rates in the U.S. However, because current market conditions have resulted in historically low rates of return on our investments, a hypothetical decrease of 10% in market interest rates would not result in a material decrease in interest income earned on our investments held as of June 30, 2014.

Table of Contents

When feasible, we invest excess cash in bank money-market funds or discrete short-term investments. The fair value of short-term investments and cash equivalents ( investments ) is sensitive to changes in the general level of interest rates in the U.S., and the fair value of these investments will fall if market interest rates increase. However, since we generally have the ability to hold the investments to maturity, these declines in fair value may never be realized. If market interest rates were to increase by 10% from levels at June 30, 2014, the fair value of our investments would decline by an immaterial amount.

All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of June 30, 2014. Actual results may differ as our analysis of the effects of changes in interest rates does not account for, among other things, sales of securities prior to maturity and repurchase of replacement securities, the change in mix or quality of the investments in the portfolio, and changes in the relationship between short-term and long-term interest rates.

We are also exposed to risks associated with changes in interest rates, as the interest rate on our Credit Agreement and Term Loan may vary with the LIBOR rate.

## ITEM 4. Controls and Procedures

### Evaluation of Disclosure Controls and Procedures

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

Based on that evaluation, our management, including our chief executive officer and chief financial officer, has concluded that our disclosure controls and procedures were effective at a reasonable assurance level as of June 30, 2014.

### Inherent Limitations Over Internal Controls

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

### Changes in Internal Control over Financial Reporting

There were no changes in the Company s internal control over financial reporting during the second quarter of 2014, which were identified in connection with management s evaluation required by paragraph (d) of Rules 13a-15 and

15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. Legal Proceedings

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

### ITEM 1A. Risk Factors

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

Table of Contents

**ITEM 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 six months ended June 30, 2014.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Amount Remaining that May Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| June 9, 2014 June 30, 2014 | 47,825 | $ 25.26 | 47,825 | $ 8,791,937 |
| Total | 47,825 | $ 25.26 | 47,825 | $ 8,791,937 |

The Company s Board of Directors authorized the repurchase of up to $10 million of the Company s common stock pursuant to a stock repurchase program. This program was publicly announced on June 9, 2014 and has no set expiration date.

Table of Contents

**ITEM 6. Exhibits**

(a) Exhibits

| Exhibit No. | Exhibit | Incorporated By Reference | | | |
|---|---|---|---|---|---|
| | | Filing | Exhibit No. | File No. | File Date |
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | | |
| 31.2 | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | | |
| 32.1 | Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | | |
| 101 | The following materials from the Company s Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations and Comprehensive Income, (iii) Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements. | | | | |

Table of Contents

**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 8, 2014

By: /s/ James B. Hawkins
**James B. Hawkins**

**President and Chief Executive Officer**

**(Principal Executive Officer)**

Dated: August 8, 2014

By: /s/ Jonathan A. Kennedy
**Jonathan A. Kennedy**

**Senior Vice President Finance and**

**Chief Financial Officer**

**(Principal Financial and**

**Accounting Officer)**