NATUS MEDICAL INC
Form 10-Q
November 09, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2009

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to ______

Commission file number: 000-33001

NATUS MEDICAL INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware	**77-0154833**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1501 Industrial Road, San Carlos, CA 94070

(Address of principal executive offices) (Zip Code)

(650) 802-0400

(Registrant s telephone number, including area code)

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

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

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

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

The number of issued and outstanding shares of the registrant s Common Stock, $0.001 par value, as of November 3, 2009 was 28,391,750.

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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 amounts)

	September 30, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 28,679	$ 56,915
Short-term investments	944	
Accounts receivable, net of allowance for doubtful accounts of $1,942 in 2009 and $1,126 in 2008	41,660	36,242
Inventories	29,544	25,009
Prepaid expenses and other current assets	4,214	3,554
Deferred income tax	4,243	3,928
Total current assets	109,284	125,648
Property and equipment, net	13,980	14,002
Intangible assets	70,762	57,729
Goodwill	89,951	60,858
Deferred income tax	2,761	
Other assets		385
Total assets	$ 286,738	$ 258,622
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 12,431	$ 7,375
Current portion of long-term debt	178	206
Accrued liabilities	18,840	11,895
Deferred revenue	4,139	3,836
Total current liabilities	35,588	23,312
Long-term liabilities:		
Long-term debt	976	1,082
Other liabilities	5,520	4,586
Deferred income tax	6,348	3,148
Total liabilities	48,432	32,128
Stockholders equity:		
Common Stock, $0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 28,327,866 in 2009 and 27,959,919 in 2008	249,097	245,476
Retained earnings / (Accumulated deficit)	1,449	(5,342)
Accumulated other comprehensive loss	(12,240)	(13,640)

Total stockholders equity	238,306	226,494
Total liabilities and stockholders equity	$ 286,738	$ 258,622

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 OPERATIONS (unaudited)

(in thousands, except per share amounts)

	Three months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Revenue	$ 44,251	$ 41,714	$ 114,871	$ 118,435
Cost of revenue	17,450	15,835	44,869	45,215
Gross profit	26,801	25,879	70,002	73,220
Operating expenses:				
Marketing and selling	11,767	9,965	32,005	29,020
Research and development	4,175	4,066	11,839	11,961
General and administrative	5,688	4,913	16,462	15,209
Total operating expenses	21,630	18,944	60,306	56,190
Income from operations	5,171	6,935	9,696	17,030
Other income, net	71	567	584	954
Income before provision for income tax	5,242	7,502	10,280	17,984
Provision for income tax	1,573	2,710	3,488	6,798
Net income	$ 3,669	$ 4,792	$ 6,792	$ 11,186
Earnings per share:				
Basic	$ 0.13	$ 0.17	$ 0.25	$ 0.46
Diluted	$ 0.13	$ 0.17	$ 0.24	$ 0.43
Weighted average shares used in the calculation of earnings per share:				
Basic	27,669	27,445	27,640	24,497
Diluted	28,668	28,756	28,343	25,775

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)

	Nine Months Ended September 30, 2009	2008
Operating activities:		
Net income	$ 6,792	$ 11,186
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,840	4,601
Accounts receivable reserves	1,403	209
Warranty reserves	815	399
Loss on disposal of property and equipment		61
Share-based compensation	3,047	2,336
Excess tax benefits on the exercise of options	(31)	(2,066)
Changes in operating assets and liabilities:		
Accounts receivable	1,959	(6,080)
Inventories	(612)	(2,333)
Prepaid expenses and other assets	597	374
Accounts payable	1,418	(2,152)
Deferred income tax	(155)	
Accrued liabilities and deferred revenue	(157)	(2,337)
Net cash provided by operating activities	20,916	4,198
Investing activities:		
Cash paid for business acquisitions and earnout obligations, net of cash acquired	(47,142)	(13,805)
Purchases of property and equipment	(1,884)	(2,174)
Capitalized software development costs	(637)	(1,161)
Purchases of marketable securities	(944)	(12,120)
Sales of marketable securities		11,150
Net cash used in investing activities	(50,607)	(18,110)
Financing activities:		
Proceeds from issuance of common stock, net of issuance costs		99,318
Proceeds from stock option exercises and ESPP purchases	542	2,581
Excess tax benefits upon the exercise of options	31	2,066
Borrowings on credit facility		6,000
Payments on borrowings	(385)	(41,225)
Net cash provided by financing activities	188	68,740
Exchange rate effect on cash and cash equivalents	1,267	1,262
Net increase (decrease) in cash and cash equivalents	(28,236)	56,090
Cash and cash equivalents, beginning of period	56,915	11,916
Cash and cash equivalents, end of period	$ 28,679	$ 68,006

Supplemental disclosure of cash flow information:				
Cash paid for interest	$	131	$	983
Cash paid for income taxes	$	268	$	4,243
Non-cash investing activities:				
Acquisition-related earn out obligations included in accrued liabilities	$	19	$	1,102

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, or the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). Except as updated below, the accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent in all material respects with those presented in Note 1 to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

Interim financial reports are prepared in accordance with the rules and regulations of the Securities and Exchange Commission; accordingly, they do not include all of the information and notes required by GAAP for annual financial statements. The interim financial information is unaudited, but reflects all normal adjustments that are, in the opinion of management, necessary for the fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. Operating results for the three and nine months ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. 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.

Comprehensive Income

Comprehensive income is comprised of net income and gains or losses resulting from currency translations of foreign investments. The details of comprehensive income are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	**2008**	**2009**	**2008**
Net income	$ 3,669	$ 4,792	$ 6,792	$ 11,186
Foreign currency translation adjustment	597	(2,529)	1,400	(4,134)
Comprehensive income	$ 4,266	$ 2,263	$ 8,192	$ 7,052

Stockholders Equity

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	**2008**	**2009**	**2008**
Balance, beginning of period	$ 232,619	$ 223,644	$ 226,494	$ 115,718
Net income	3,669	4,792	6,792	11,186
Proceeds from stock option exercises and ESPP	129	1,039	542	2,581
Proceeds from issuance of common stock		(153)		99,318
Share-based compensation expense	1,273	913	3,047	2,336
Tax effect of option exercises	19	1,365	31	2,066
Foreign currency translation adjustment	597	(2,529)	1,400	(4,134)
Balance, end of period	$ 238,306	$ 229,071	$ 238,306	$ 229,071

Foreign Currency

Effective January 1, 2009, the Company s Canadian subsidiary, Xltek changed its functional currency to the U.S. dollar. The change in functional currency reflects the fact that Xltek now conducts the majority of its business transactions in U.S. dollars and maintains a significant portion of its balance sheet in U.S. dollar denominated accounts.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued a *Statement on Accounting Standards Codification*. This Statement establishes the codification as the single official source of authoritative United States accounting and reporting

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

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

standards for all non-governmental entities, other than guidance issued by the Securities and Exchange Commission. The codification changes the referencing and organization on financial standards and is effective for interim and annual periods ending on or after September 15, 2009. We began applying the codification to our disclosures in the third quarter of 2009. As the codification is not intended to change existing accounting guidance, its adoption has not had an impact on our financial position, results of operations, or cash flows.

In October 2009, the FASB issued Accounting Standards Update (ASU), 2009-13, *Revenue Recognition (Topic 605): Multiple Deliverable Revenue Arrangements A Consensus of the FASB Emerging Issues Task Force*. This update provides application guidance on whether multiple deliverables exist, how the deliverables should be separated and how the consideration should be allocated to one or more units of accounting. This update establishes a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor specific objective evidence, if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific or third-party evidence is available. This guidance applies prospectively for revenue arrangements entered into or materially modified after June 15, 2010, with earlier adoption permitted. We do not believe the adoption of this guidance will have a material impact on our financial position, results of operations, or cash flows.

In May 2009, the FASB issued Accounting Codification Statement (ASC) Topic 855, *Subsequent Events*, which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. ASC 855-10 is effective for interim or annual financial periods ending after June 15, 2009. We adopted ASC 855-10 during our second quarter 2009 and have evaluated subsequent events through the date of this filing. See Note 13.

In April 2009, ASC 825-10-65-1, *Interim Disclosures about Fair Value of Financial Instruments*, was revised to require disclosures about fair value of financial instruments in interim as well as annual financial statements. This standard is effective for periods ending after June 15, 2009. We adopted the provisions of ASC 825-10-65-1 in our second quarter 2009. The adoption of this guidance did not have a material impact on our financial position, results of operations, or cash flows; however we have added additional disclosures with respect to the fair value of our financial instruments in Note 12 pursuant to the provisions of ASC 825-10-65-1.

In February 2009, ASC 805-20-35-3, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*, was revised. The revisions relate to the initial recognition and measurement, subsequent measurement, and disclosure of assets and liabilities arising from contingencies in a business combination under ASC Topic 805. We adopted the provisions of ASC 805-20-35-3 on September 1, 2009 and applied these provisions to two business combinations completed during the third quarter 2009. See Note 2.

In December 2007, the FASB issued ASC Topic 805, *Business Combinations*, which expands the definition of a business combination and requires the fair value of the purchase price of an acquisition, including the issuance of equity securities, to be determined on the acquisition date. ASC Topic 805 also requires that all assets, liabilities, contingent consideration and contingencies of an acquired business to be recorded at fair value at the acquisition date. In addition acquisition costs are generally expensed as incurred, restructuring costs generally are expensed in periods subsequent to the acquisition date. Additionally, changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties resulting from new information obtained during the measurement period about facts and circumstances that existed as of the acquisition date will result in an adjustment to goodwill, while all other changes in these items are recognized as adjustments to income tax expense. We adopted ASC Topic 805 on January 1, 2009.

2 - Business Combinations, Goodwill, and Intangible Assets

Alpine Biomed Holdings Corp.

We acquired Alpine Biomed Holdings Corp. (Alpine Biomed) on September 14, 2009 pursuant to an Agreement and Plan of Merger. Alpine Biomed, with corporate headquarters in Fountain Valley, California and manufacturing facilities in Montreal, Canada, and Copenhagen, Denmark, is a leader in the development, manufacturing, and sales of devices for the diagnosis of neurological disorders. Alpine Biomed s broad range of products includes advanced electromyography systems for the diagnoses of peripheral nervous system dysfunctions as well as devices for routine EEG and long term epilepsy monitoring.

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

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

We acquired all outstanding shares of Alpine Biomed capital stock for $43.2 million in cash and assumed a contingent obligation valued at $600,000. The contingent obligation is associated with an earn out provision of the purchase agreement that may result in the payment of additional cash consideration to the former shareholders of Alpine Biomed based on the achievement of a certain revenue target as of December 31, 2009. The contingent obligation was recorded as a current liability. We also incurred $345,000 of direct costs associated with the acquisition that were expensed as a component of general and administrative expense in the third quarter 2009.

In accordance with ASC 805-10, the acquisition has been accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed from Alpine Biomed at the date of acquisition are recorded in the consolidated financial statements at their respective fair values as of the acquisition date. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill in the amount of $26.4 million. This goodwill is expected to be non-deductible for tax purposes. Alpine Biomed s results of operations are included in the consolidated financial statements from the date of the acquisition.

The determination of estimated fair value of acquired assets and liabilities requires management to make significant estimates and assumptions. We determined the fair value by applying established valuation techniques, based on information that management believed to be relevant to this determination. The following table summarizes the preliminary purchase price allocation of the fair value of the assets acquired and liabilities assumed at the date of acquisition, as adjusted (in thousands):

Cash	$ 1
Accounts receivable	8,577
Inventories	3,619
Prepaid and other assets	991
Identifiable intangible assets:	
Technology	5,800
Customer-related	4,900
Tradenames	4,700
Property and equipment	236
Goodwill	26,408
Deferred income tax	2,761
Accounts payable	(4,435)
Accrued expenses and other current liabilities	(4,731)
Deferred revenue	(1,125)
Deferred income tax	(3,040)
Other long-term liabilities	(1,497)
Total purchase price	$ 43,165

Valuing certain components of the acquisition, including primarily accounts receivable, inventory, prepaid expenses, identifiable intangible assets, goodwill, deferred taxes, accrued warranty costs, accounts payable, other accrued expenses, and deferred revenue, required us to make estimates that may be adjusted in the future. In addition, we have not completed a reconciliation of intercompany account balances among Alpine Biomed and its subsidiaries. Consequently, the purchase price allocation is considered preliminary.

Identifiable intangible assets. Intangible assets included in the purchase price allocation consist of: (a) technology of $5.8 million assigned an average economic life of 20 years being amortized on the straight line method, (b) customer-related intangible assets of $4.9 million assigned an economic life of 15 years being amortized on the straight line method, and (c) tradenames of $4.7 million that have an indefinite life and are not being amortized.

Goodwill. Approximately $26.4 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the underlying net tangible and intangible assets. In accordance with ASC 350-20, goodwill will not be amortized but instead will be tested for impairment at least annually (more frequently if certain indicators are present). In the event that management determines that the value of goodwill has become impaired, we will incur an accounting charge for the amount of impairment during the fiscal quarter in which the determination is made.

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

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

Deferred tax assets (liabilities) / valuation allowance. A preliminary estimate of $4.7 million has been allocated to non-current deferred tax assets, and $3.0 million has been allocated to non-current deferred tax liabilities, which result primarily from amortizable intangible assets. A preliminary valuation allowance of $1.9 million has been recorded on certain non-current deferred tax assets.

The following unaudited pro forma combined results of operations of Natus for the nine months ended September 30, 2009 and 2008 are presented as if the acquisition of Alpine Biomed had occurred on the first day of the periods presented:

Unaudited Pro Forma Financial Information

(in thousands)

	September 30, 2009	September 30, 2008
Revenue	$ 140,511	$ 148,086
Income from operations	$ 427	$ 5,769

The unaudited pro forma financial information are provided for comparative purposes only and are not necessarily indicative of what actual results would have been had we acquired Alpine Biomed on such dates, nor do they give effect to synergies, cost savings, and other changes expected to result from the acquisition. Accordingly, the pro forma financial results do not purport to be indicative of results of operations as of the date hereof, for any period ended on the date hereof, or for any other future date or period.

Hawaii Medical

We acquired Hawaii Medical, LLC on July 2, 2009 pursuant to an Agreement and Plan of Merger. Massachusetts based Hawaii Medical manufactures and markets single-use disposable products sold into the NICU and nursery in hospitals.

We acquired all outstanding units of Hawaii Medical for $2.9 million in cash. In addition to the purchase price paid at closing, an earn out provision of the purchase agreement may result in additional cash consideration depending upon the achievement of certain revenue targets over a 36 month period. Although there is no limit to the additional consideration that will be paid if the revenue targets are exceeded, no contingent obligation has been recorded as there is significant uncertainty that the revenue targets will be achieved. We also incurred $115,000 of direct costs associated with the acquisition that were expensed as a component of general and administrative expense in the third quarter 2009.

In accordance with ASC 805-10, the acquisition has been accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed from Hawaii Medical at the date of acquisition are recorded in the consolidated financial statements at their respective fair values as of the acquisition date. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill in the amount of $2.4 million. This goodwill is expected to be non-deductible for tax purposes. Hawaii Medical s results of operations are included in the consolidated financial statements from the date of the acquisition.

The determination of estimated fair value requires management to make significant estimates and assumptions. We determined the fair value by applying established valuation techniques, based on information that management believed to be relevant to this determination. The following table summarizes the preliminary purchase price allocation of the fair value of the assets acquired and liabilities assumed at the date of acquisition, as adjusted (in thousands):

Cash	$ 5
Accounts receivable	203
Inventories	304

Prepaid and other assets	29
Identifiable intangible assets:	
Tradenames	300
Property and equipment	259
Goodwill	2,449
Accounts payable	(200)
Accrued expenses and other current liabilities	(402)
Total purchase price	$ 2,947

NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

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

Valuing certain components of the acquisition, including primarily inventory, required us to make estimates that may be adjusted in the future; consequently, the purchase price allocation is considered preliminary.

Identifiable intangible assets. Intangible assets included in the purchase price allocation consisting of tradenames valued at $300,000 have an indefinite life and are not being amortized.

Goodwill. Approximately $2.4 million has been allocated to goodwill.

Neurocom

We acquired Neurocom International Inc. (Neurocom) on October 2, 2008. Neurocom, based in Clackamas, Oregon, develops and markets computerized systems for the assessment and rehabilitation of balance and mobility disorders. The acquisition added to our growth opportunities by broadening the product offerings in our neurology business.

We acquired all outstanding shares of Neurocom for $18.2 million in cash including direct costs of the acquisition.

Valuing certain components of the acquisition, including primarily accrued warranty costs and other accrued expenses, required us to make estimates that may be adjusted in the future; consequently, the purchase price allocation is considered preliminary.

Schwarzer Neurology

We acquired Schwarzer Neurology, a division of Schwarzer GmbH, on July 2, 2008. Schwarzer Neurology develops and markets computer-based electrodiagnostic systems and disposable supplies used by medical practitioners to aid in the detection, diagnosis, and monitoring of neurologic disorders. The acquisition broadened our product offerings in the EEG market, allowing us to further leverage its international distribution organization.

We acquired the assets of Schwarzer Neurology for EUR 4.5 million, or approximately $7.0 million, including direct costs of the acquisition. We were obligated to make additional payments pursuant to an earnout provision in the purchase agreement based on the achievement of certain revenue targets through September 30, 2009. The revenue targets were not achieved and no additional purchase consideration was or will be paid.

Olympic

We acquired Olympic Medical on October 16, 2006 for $16.9 million. To date we have recorded $1.6 million of additional purchase consideration pursuant to an earnout provision in the purchase agreement based on the achievement of certain revenue targets for sales of the Olympic Cool-Cap. At September 30, 2009 the maximum potential future amount payable under this provision, based on sales results from January 1, 2009 through December 31, 2009, is $1.5 million.

Goodwill

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

Balance, January 1, 2009	$ 60,858
Goodwill resulting from acquisitions	28,857
Purchase accounting adjustments	185
Adjustments associated with earnout provisions	19

Change in foreign currency exchange rates	32
Balance, September 30, 2009	$ 89,951

Amortization of Intangible Assets Acquired Through Business Combinations

Amortization of intangible assets associated with our business combinations was $1.0 million and $3.1 million for the three and nine months ended September 30, 2009, respectively, and $782,000 and $2.6 million for the three and nine months ended September 30, 2008, respectively.

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

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

Capitalized Software Development Costs

Pursuant to ASC 350-40, we capitalized software development costs of $293,000 and $637,000 during the three and nine months ended September 30, 2009, respectively, and $372,000 and $1.2 million during the three and nine months ended September 30, 2008, respectively.

We report capitalized software development costs as a component of intangible assets. Amortization of capitalized software development costs was $50,000 and $235,000 during the three and nine months ended September 30, 2009, respectively, and $36,000 during the three and nine months ended September 30, 2008.

3 - Basic and Diluted Earnings Per Common Share

Earnings per share is computed in accordance with ASC 260-10. Basic earnings per share is based upon the weighted average number of common shares outstanding during the period. Diluted earnings per share is based upon the weighted average number of common shares outstanding and dilutive common stock equivalents outstanding during the period. Common stock equivalents are options granted and shares of restricted stock issued under our stock awards plans and are calculated under the treasury stock method. Common equivalent shares from unexercised stock options and restricted stock are excluded from the computation when there is a loss as their effect is anti-dilutive, or if the exercise price of such options is greater than the average market price of the stock for the period.

For the three and nine months ended September 30, 2009, common stock equivalents of 998,969 and 702,751 shares, respectively, were included in the weighted average shares outstanding used to calculate diluted earnings per share. For the three and nine months ended September 30, 2009, common stock equivalents of 1,411,152 and 1,594,888 shares, respectively, were excluded from the calculation of diluted earnings per share because the exercise price of such options was greater than the average market price of the stock for the periods. For the three and nine months ended September 30, 2008, common stock equivalents of 1,311,262 and 1,277,836 shares, respectively, were included in the weighted average shares outstanding used to calculate diluted earnings per share. For the three and nine months ended September 30, 2008, common stock equivalents of 366,551 and 220,254 shares, respectively, were excluded from the calculation of diluted earnings per share because the exercise price of such options was greater than the average market price of the stock for the periods.

4 - Inventories

Inventories consist of the following (in thousands):

	September 30, 2009	December 31, 2008
Raw materials and subassemblies	$ 11,554	$ 13,051
Finished goods	17,990	11,958
Total	$ 29,544	$ 25,009

Work in process represents an immaterial amount in all periods presented.

5 - Property and Equipment

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

	September 30, 2009	December 31, 2008
Land	$ 3,403	$ 3,480
Building	4,693	4,766
Leasehold improvements	1,461	963
Office furniture and equipment	7,153	6,406
Computer software and hardware	5,312	4,609
Demonstration and loaned equipment	6,114	4,620
	28,136	24,844
Accumulated depreciation	(14,156)	(10,842)
Total	$ 13,980	$ 14,002

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

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

Depreciation and amortization expense of property and equipment was $313,000 and $2.4 million for the three and nine months ended September 30, 2009, respectively, and was $819,000 and $2.0 million for the three and nine months ended September 30, 2008, respectively.

6 - Reserve for Product Warranties

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

We have accrued a warranty reserve, included in accrued liabilities on the accompanying condensed consolidated balance sheets, for the expected future costs of servicing products during the initial warranty period. Amounts are added to the reserve on a per-unit basis by reference to historical experience in honoring warranty obligations. On new products, where we do not have historical experience of the cost to honor warranties, additions to the reserve are based on a combination of factors including the standard cost of the product and other judgments, such as the degree to which the product incorporates new technology. As warranty costs are incurred, the reserve is reduced.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Balance, beginning of period	$ 1,028	$ 938	$ 1,076	$ 1,000
Warranty assumed through acquisitions	520		520	
Warranty accrued for the period	176	149	815	399
Repairs for the period	(99)	(74)	(786)	(386)
Balance, end of period	$ 1,625	$ 1,013	$ 1,625	$ 1,013

7 - Share-Based Compensation

At September 30, 2009, we have the following plans that give rise to share-based compensation: (i) two active stock option plans, the Amended and Restated 2000 Stock Awards Plan and the 2000 Director Option Plan, and (ii) the 2000 Employee Stock Purchase Plan. The terms of awards granted during the nine months ended September 30, 2009 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, 2008.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Cost of revenue	$ 117	$ 86	$ 208	$ 253
Marketing and sales	326	229	739	558
Research and development	87	102	159	273

General and administrative	743	496	1,941	1,252
Total	$ 1,273	$ 913	$ 3,047	$ 2,336

As of September 30, 2009, unrecognized compensation expense related to the unvested portion of our stock options and other stock awards was approximately $12.9 million, which is expected to be recognized over a weighted average period of 3.0 years.

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

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

Stock Options

Activity in our stock option plans during the nine months ended September 30, 2009 is as follows:

	Shares	Weighted Average Exercise Price	Weighted-average remaining contractual life (years)	Aggregate intrinsic value ($ 000 s)
Outstanding, beginning of period	2,876,072	$ 9.97		
Granted	676,600	$ 10.71		
Exercised	(14,712)	$ 9.79		
Cancelled	(62,304)	$ 15.01		
Outstanding, end of period	3,475,656	$ 10.03	4.40	$ 20,804
Exercisable, end of period	2,410,005	$ 8.51	4.11	$ 17,533

As of September 30, 2009, the grant date weighted average fair value of stock options granted in 2009 was $3.67 per share using the Black-Scholes option pricing model. The intrinsic value of options exercised during the nine months ended September 30, 2009 was $144,036.

As of September 30, 2009, there were: (a) 3,311,910 options vested and expected to vest with a weighted average exercise price of $9.90, an intrinsic value of $20.2 million, and a weighted average remaining contractual term of 4.3 years.

Restricted Stock Awards

Activity in our stock plans related to restricted stock awards during the nine months ended September 30, 2009 is as follows:

	Shares	Weighted-average grant date fair value	Remaining cost expected to be recognized ($ 000 s)
Unvested, beginning of period	338,518	$ 17.52	
Granted	314,700	$ 10.71	
Vested	(88,384)	$ 16.07	
Forfeited	(15,500)	$ 16.71	
Unvested, end of period	549,334	$ 13.88	$ 7,545

Of the shares awarded, 272,200 were awarded to U.S. employees of the Company that vest 50% upon the second anniversary of the vesting start date and 25% upon each of the third and fourth anniversaries of the vesting start date, and 42,500 shares were granted to non-employee directors of the Company that vest on the first anniversary of the grant date.

Restricted Stock Units

Activity in our stock plans related to the award of restricted stock units during the nine months ended September 30, 2009 is as follows:

