

SURMODICS INC  
Form 10-Q  
February 04, 2015  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D. C. 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended December 31, 2014**

**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: 0-23837**

**SurModics, Inc.**

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

**MINNESOTA**  
**(State of incorporation)**

**41-1356149**  
**(I.R.S. Employer**

**Identification No.)**

**9924 West 74th Street**

**Eden Prairie, Minnesota 55344**

**(Address of principal executive offices) (Zip Code)**

**Registrant's telephone number, including area code: (952) 500-7000**

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  No

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

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

Large accelerated filer  Accelerated filer

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

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

The number of shares of the registrant's Common Stock, \$.05 par value per share, outstanding as of January 30, 2015 was 12,939,333.

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**Table of Contents****PART I. FINANCIAL INFORMATION**

## Item 1. Financial Statements

**SurModics, Inc. and Subsidiaries**

## Condensed Consolidated Balance Sheets

|   | December 31,<br>2014 | September 30,<br>2014 |
|---|----------------------|-----------------------|
|   | <i>(Unaudited)</i>   |                       |
| <i>(in thousands, except share and per share data)</i>  |                      |                       |
| <b>ASSETS</b>   |                      |                       |
| Current Assets:   |                      |                       |
| Cash and cash equivalents   | \$ 26,560            | \$ 43,511             |
| Available-for-sale securities   | 4,125                | 3,040                 |
| Accounts receivable, net of allowance for doubtful accounts of \$30 and \$42 as of December 31, 2014 and September 30, 2014, respectively | 4,442                | 4,751                 |
| Inventories   | 2,829                | 2,817                 |
| Deferred tax assets   | 360                  | 394                   |
| Prepays and other   | 712                  | 751                   |
| Current assets of discontinued operations   |                      | 16                    |
| Total Current Assets  | 39,028               | 55,280                |
| Property and equipment, net   | 12,674               | 13,133                |
| Available-for-sale securities   | 16,933               | 16,823                |
| Deferred tax assets   | 5,741                | 6,718                 |
| Intangible assets, net  | 2,760                | 2,946                 |
| Goodwill  | 8,010                | 8,010                 |
| Other assets, net   | 1,979                | 1,979                 |
| Total Assets  | \$ 87,125            | \$ 104,889            |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                      |                       |
| Current Liabilities:  |                      |                       |
| Accounts payable  | \$ 1,529             | \$ 1,028              |
| Accrued liabilities:  |                      |                       |
| Compensation  | 902                  | 2,061                 |
| Accrued other   | 1,056                | 881                   |
| Deferred revenue  | 52                   | 52                    |
| Current liabilities of discontinued operations  |                      | 45                    |
| Total Current Liabilities   | 3,539                | 4,067                 |
| Deferred revenue, less current portion  | 213                  | 226                   |
| Other long-term liabilities   | 1,722                | 1,845                 |

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|  |           |            |
|--|-----------|------------|
| Total Liabilities  | 5,474     | 6,138      |
| Commitments and Contingencies (Note 16)  |           |            |
| Stockholders' Equity:  |           |            |
| Series A Preferred stock- \$.05 par value, 450,000 shares authorized; no shares issued and outstanding                             |           |            |
| Common stock- \$.05 par value, 45,000,000 shares authorized; 12,938,433 and 13,606,545 shares issued and outstanding, respectively | 647       | 680        |
| Additional paid-in capital   | 729       | 2,662      |
| Accumulated other comprehensive income   | 446       | 1,528      |
| Retained earnings  | 79,829    | 93,881     |
| Total Stockholders' Equity   | 81,651    | 98,751     |
| Total Liabilities and Stockholders' Equity   | \$ 87,125 | \$ 104,889 |

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

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## Condensed Consolidated Statements of Income

|  | <b>Three Months<br/>Ended<br/>December 31,</b> |                 |
|--|--|-----------------|
|  | <b>2014</b>                                    | <b>2013</b>     |
| <i>(Unaudited)</i>                             |  |                 |
| <i>(In thousands, except per share data)</i>   |  |                 |
| Revenue:                                       |  |                 |
| Royalties and license fees                     | \$ 7,275                                       | \$ 7,465        |
| Product sales                                  | 5,847  | 5,400           |
| Research and development                       | 1,083  | 1,018           |
| <b>Total revenue</b>                           | <b>14,205</b>                                  | <b>13,883</b>   |
| Operating costs and expenses:                  |  |                 |
| Product costs                                  | 1,902  | 2,004           |
| Research and development                       | 3,576  | 3,699           |
| Selling, general and administrative            | 3,693  | 3,851           |
| <b>Total operating costs and expenses</b>      | <b>9,171</b>                                   | <b>9,554</b>    |
| <b>Operating income</b>                        | <b>5,034</b>                                   | <b>4,329</b>    |
| Other income:                                  |  |                 |
| Investment income, net                         | 57   | 86              |
| Gain on sale of strategic investment           |  | 681             |
| Other losses, net                              | (7)  |                 |
| <b>Other income</b>                            | <b>50</b>                                      | <b>767</b>      |
| <b>Income before income taxes</b>              | <b>5,084</b>                                   | <b>5,096</b>    |
| Income tax provision                           | (1,470)  | (1,466)         |
| <b>Net income</b>                              | <b>\$ 3,614</b>                                | <b>\$ 3,630</b> |
| <b>Basic net income per share</b>              | <b>\$ 0.27</b>                                 | <b>\$ 0.26</b>  |
| <b>Diluted net income per share</b>            | <b>\$ 0.27</b>                                 | <b>\$ 0.26</b>  |
| Weighted average number of shares outstanding: |  |                 |
| Basic  | 13,225   | 13,756          |
| Diluted  | 13,423   | 14,009          |

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



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## Condensed Consolidated Statements of Comprehensive Income

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>December 31,</b>       |             |
|  | <b>2014</b>               | <b>2013</b> |
|  | <i>(Unaudited)</i>        |             |
| <i>(In thousands)</i>  |                           |             |
| Net income   | \$ 3,614                  | \$ 3,630    |
| Other comprehensive loss, net of tax:  |                           |             |
| Unrealized holding losses on available-for-sale securities arising during the period | (1,089)                   | (33)        |
| Reclassification adjustment for realized losses included in net income               | 7                         |             |
| Other comprehensive loss   | (1,082)                   | (33)        |
| Comprehensive income   | \$ 2,532                  | \$ 3,597    |

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

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## Condensed Consolidated Statements of Cash Flows

|  | <b>Three Months<br/>Ended<br/>December 31,</b> |             |
|--|--|-------------|
|  | <b>2014</b>                                    | <b>2013</b> |
| <i>(Unaudited)</i>   |  |             |
| <i>(in thousands)</i>  |  |             |
| <b>Operating Activities:</b>   |  |             |
| Net income   | \$ 3,614                                       | \$ 3,630    |
| Adjustments to reconcile net income to net cash provided by operating activities from continuing operations: |  |             |
| Depreciation and amortization  | 683  | 697         |
| Stock-based compensation   | 525  | 813         |
| Deferred tax   | 1,025  | 395         |
| Loss (gain) on sales of available-for-sale securities, net and strategic investment                          | 7  | (681)       |
| Excess tax benefit from stock-based compensation plans   | (453)  | (690)       |
| Other  | (39)   |             |
| Change in operating assets and liabilities:  |  |             |
| Accounts receivable  | 309  | 222         |
| Inventories  | (12)   | 496         |
| Prepays and other  | (34)   | 62          |
| Accounts payable and accrued liabilities   | (508)  | (1,641)     |
| Income taxes   | 413  | 947         |
| Net cash provided by operating activities from continuing operations   | 5,530  | 4,250       |
| <b>Investing Activities:</b>   |  |             |
| Purchases of property and equipment  | (41)   | (56)        |
| Cash proceeds from sales of property and equipment   | 41   |             |
| Purchases of available-for-sale securities   | (3,252)  | (2,938)     |
| Sales and maturities of available-for-sale securities  | 973  | 2,867       |
| Cash transferred to discontinued operations  | (45)   | (13)        |
| Cash received from sale of a strategic investment  |  | 681         |
| Net cash (used in) provided by investing activities from continuing operations                               | (2,324)  | 541         |
| <b>Financing Activities:</b>   |  |             |
| Excess tax benefit from stock-based compensation plans   | 453  | 690         |
| Issuance of common stock   | 115  | 61          |
| Repurchase of common stock   | (20,000)                                       | (9,424)     |
| Purchase of common stock to pay employee taxes   | (725)  | (1,097)     |
| Net cash used in financing activities from continuing operations   | (20,157)                                       | (9,770)     |

|  |           |           |
|--|-----------|-----------|
| Net cash used in continuing operations   | (16,951)  | (4,979)   |
| Discontinued Operations:   |           |           |
| Net cash used in operating activities  | (45)      | (13)      |
| Net cash provided by financing activities  | 45        | 13        |
| Net cash provided by discontinued operations                                     |           |           |
| Net change in cash and cash equivalents  | (16,951)  | (4,979)   |
| Cash and Cash Equivalents:   |           |           |
| Beginning of period  | 43,511    | 15,495    |
| End of period  | \$ 26,560 | \$ 10,516 |
| Supplemental Information:  |           |           |
| Cash paid for income taxes   | \$ 31     | \$ 124    |
| Noncash transactions acquisition of property and equipment on account            | \$ 12     | \$ 123    |
| Noncash transactions share repurchase accrual                                    | \$        | \$ 513    |
| Noncash transactions issuance of shares associated with long-term incentive plan | \$ 2,063  | \$ 2,756  |

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

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**SurModics, Inc. and Subsidiaries**

**Notes to Condensed Consolidated Financial Statements**

**Period Ended December 31, 2014**

**(Unaudited)**

**1. Basis of Presentation**

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. ) ( GAAP ) and, in the opinion of management, reflect all adjustments, consisting of normal recurring adjustments, needed to fairly present the financial results of SurModics, Inc. and subsidiaries ( SurModics or the Company ) for the periods presented. These financial statements include some amounts that are based on management's best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of earnings in the period in which the change in estimate is identified. The results of operations for the three months ended December 31, 2014 are not necessarily indicative of the results that may be expected for the entire 2015 fiscal year.

In accordance with the rules and regulations of the U.S. Securities and Exchange Commission ( SEC ), the Company has omitted footnote disclosures that would substantially duplicate the disclosures contained in the audited financial statements of the Company. These unaudited condensed consolidated financial statements should be read together with the audited consolidated financial statements for the fiscal year ended September 30, 2014, and footnotes thereto included in the Company's Form 10-K as filed with the SEC on December 5, 2014.

**2. Key Accounting Policies**

**Revenue recognition**

The Company recognizes revenue when all of the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) shipment has occurred or delivery has occurred if the terms specify destination; (3) the sales price is fixed or determinable; and (4) collectability is reasonably assured. When there are additional performance requirements, revenue is recognized when all such requirements have been satisfied. Under revenue arrangements with multiple deliverables, the Company recognizes each separable deliverable as it is earned.

The Company derives its revenue from three primary sources: (1) royalties and license fees from licensing its proprietary drug delivery and surface modification technologies and *in vitro* diagnostic formats to customers; (2) the sale of reagent chemicals to licensees and the sale of stabilization products, antigens, substrates and surface coatings to the diagnostic and biomedical research markets; and (3) research and commercial development fees generated on customer projects.

*Royalties and license fees.* The Company licenses technology to third parties and collects royalties. Royalty revenue is generated when a customer sells products incorporating the Company's licensed technologies. Royalty revenue is recognized as licensees report it to the Company, and payment is typically submitted concurrently with the report. For stand-alone license agreements, up-front license fees are recognized over the term of the related licensing agreement.

Minimum royalty fees are recognized in the period earned.

Revenue related to a performance milestone is recognized upon the achievement of the milestone, as defined in the respective agreements and provided the following conditions have been met:

The milestone payment is non-refundable;

The milestone involved a significant degree of risk, and was not reasonably assured at the inception of the arrangement;

Accomplishment of the milestone involved substantial effort;

The amount of the milestone payment is commensurate with the related effort and risk; and

A reasonable amount of time passed between the initial license payment and the first and subsequent milestone payments.

If these conditions have not been met, the milestone payment is deferred and recognized over the term of the agreement.

*Product sales.* Product sales to third parties consist of direct and distributor sales and are recognized at the time of shipment. The Company's sales terms provide no right of return outside of the standard warranty policy. Payment terms are generally set at 30-45 days.

*Research and development.* The Company performs third-party research and development activities, which are typically provided on a time and materials basis. Generally, revenue for research and development is recorded as performance progresses under the applicable contract.

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*Arrangements with multiple deliverables.* Revenue arrangements with multiple deliverables require the Company to:

- (i) disclose whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
- (ii) allocate revenue in an arrangement using estimated selling prices ( ESP ) of deliverables if a vendor does not have vendor-specific objective evidence of selling price ( VSOE ) or third-party evidence of selling price ( TPE ); and
- (iii) allocate revenue using the relative selling price method.

The Company accounts for revenue using a multiple attribution model in which consideration allocated to research and development activities is recognized as performed, and milestone payments are recognized when the milestone events are achieved, when such activities and milestones are deemed substantive. Accordingly, in situations where a unit of accounting includes both a license and research and development activities, and when a license does not have stand-alone value, the Company applies a multiple attribution model in which consideration allocated to the license is recognized ratably, consideration allocated to research and development activities is recognized as performed and milestone payments are recognized when the milestone events are achieved, when such activities and milestones are deemed substantive.

The Company enters into license and development arrangements that may consist of multiple deliverables which could include a license(s) to SurModics technology, research and development activities, manufacturing services, and product sales based on the needs of its customers. For example, a customer may enter into an arrangement to obtain a license to SurModics intellectual property which may also include research and development activities, and supply of products manufactured by SurModics. For these services provided, SurModics could receive upfront license fees upon signing of an agreement and granting the license, fees for research and development activities as such activities are performed, milestone payments contingent upon advancement of the product through development and clinical stages to successful commercialization, fees for manufacturing services and supply of product, and royalty payments based on customer sales of product incorporating SurModics technology. The Company's license and development arrangements generally do not have refund provisions if the customer cancels or terminates the agreement. Typically all payments made are non-refundable.

The Company is required to evaluate each deliverable in a multiple element arrangement for separability. The Company is then required to allocate revenue to each separate deliverable using a hierarchy of VSOE, TPE, or ESP. In many instances, the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements. This may be a result of the Company infrequently selling each element separately or having a limited history with multiple element arrangements. When VSOE cannot be established, the Company attempts to establish a selling price of each element based on TPE. TPE is determined based on competitor prices for similar deliverables when sold separately.

When the Company is unable to establish a selling price using VSOE or TPE, the Company uses ESP in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. ESP is generally used for highly customized offerings.

The Company determines ESP for undelivered elements by considering multiple factors including, but not limited to, market conditions, competitive landscape and past pricing arrangements with similar features. The determination of ESP is made through consultation with the Company's management, taking into consideration the marketing strategies for each business unit.

*New Accounting Pronouncements*

*Accounting Standards to be Adopted*

In May 2014, the Financial Accounting Standards Board ( FASB ) issued new revenue recognition guidance for recognizing revenue from contracts with customers that provides a five-step analysis of transactions to determine when and how revenue is recognized. The guidance states that a company should recognize revenue which depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to receive in exchange for those goods or services. The new standard will also result in enhanced disclosures about revenue related to the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The standard also requires quantitative and qualitative disclosures about customer contracts, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. Additionally, the FASB has provided guidance for transactions that were not previously addressed comprehensively, and improved guidance for multiple-element arrangements. This pronouncement is effective for the Company beginning in fiscal 2018 (October 1, 2017), early adoption is not permitted, and can be adopted by the Company either retrospectively (October 1, 2015) or as a cumulative-effect adjustment as of the date of adoption. The Company is currently evaluating the impact of adopting this new accounting guidance will have on the Company s results of operations, cash flows and financial position.

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No other new accounting pronouncement issued or effective has had, or is expected to have, a material impact on the Company's consolidated financial statements.

**3. Discontinued Operations**

Beginning with the first quarter of fiscal 2012, the results of operations, cash flows, assets and liabilities of SurModics Pharmaceuticals, Inc. ( SurModics Pharmaceuticals ), which were previously reported in the Pharmaceuticals segment as a separate operating segment, are classified as discontinued operations. There was no condensed consolidated statement of income impact associated with discontinued operations for the three months ended December 31, 2014 and 2013. Total assets and liabilities of discontinued operations were zero as of December 31, 2014 and insignificant as of September 30, 2014.

**4. Fair Value Measurements**

The accounting guidance on fair value measurements defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. The guidance is applicable for all financial assets and financial liabilities and for all nonfinancial assets and nonfinancial liabilities recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Fair value is defined as the exchange price that would be received from selling an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and also considers assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions and risk of nonperformance.

*Fair Value Hierarchy*

Accounting guidance on fair value measurements requires that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

Level 1 Quoted (unadjusted) prices in active markets for identical assets or liabilities.

The Company's Level 1 assets consisted of its investment in Intersect ENT, Inc. ( Intersect ENT ) and certain U.S. government and government agency obligations. The fair market value of the Intersect ENT investment was based on the quoted price of Intersect ENT shares as traded on the NASDAQ Global Market Stock Exchange. The fair market value of certain U.S. government and government agency obligations were based on observable prices in highly active treasury and agency security markets for identical securities.

Level 2 Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities 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 asset or liability.

The Company's Level 2 assets consist of money market funds, commercial paper instruments, certain U.S. Treasury securities, corporate bonds, municipal bonds, certain U.S. government agency securities, government agency and municipal securities and certain asset-backed and mortgage-backed securities. Fair market values for these assets are based on quoted vendor prices and broker pricing where all significant inputs are observable. The Company performs

limited tests of the quoted vendor prices based on available U.S. government security pricing on government websites as a means of validating the third party pricing. To ensure the accuracy of quoted vendor prices and broker pricing, the Company performs regular reviews of investment returns to industry benchmarks and sample tests of individual securities to validate quoted vendor prices with other available market data.

Level 3 Unobservable inputs to the valuation methodology that are supported by little or no market activity and that are significant to the measurement of the fair value of the assets or liabilities. Level 3 assets and liabilities include those whose fair value measurements are determined using pricing models, discounted cash flow methodologies or similar valuation techniques, as well as significant management judgment or estimation.

There were no Level 3 assets at December 31, 2014, September 30, 2014 or December 31, 2013 and there was no Level 3 activity in each of the first quarters of fiscal 2015 and fiscal 2014.

In valuing assets and liabilities, the Company is required to maximize the use of quoted market prices and minimize the use of unobservable inputs. The Company changed its valuation techniques from prior periods in the first quarter of fiscal 2015 to classify certain U.S. government and government agency obligations as Level 1 based on observable prices in highly active treasury and agency security markets for identical securities.

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In instances where the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset or liability. The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of December 31, 2014:

| <i>(Dollars in thousands)</i>                     | <b>Quoted Prices in<br/>Active<br/>Markets<br/>for<br/>Identical<br/>Instruments<br/>(Level 1)</b> |       |           | <b>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level<br/>3)</b> | <b>Total Fair<br/>Value as<br/>of<br/>December 31,<br/>2014</b> |
|---|--|-------|-----------|--|--|---|
| <b>Assets:</b>                                    |  |       |           |  |  |   |
| Cash equivalents                                  | \$   |       | \$ 22,373 |  | \$   | \$ 22,373   |
| Available-for-sale equity securities              |  | 464   |           |  |  | 464   |
| <b>Available-for-sale debt securities:</b>        |  |       |           |  |  |   |
| U.S. government and government agency obligations |  | 8,048 | 2,183     |  |  | 10,231  |
| Mortgage-backed securities                        |  |       | 5,376     |  |  | 5,376   |
| Municipal bonds                                   |  |       | 895       |  |  | 895   |
| Asset-backed securities                           |  |       | 2,262     |  |  | 2,262   |
| Corporate bonds                                   |  |       | 1,830     |  |  | 1,830   |
| Total assets measured at fair value               | \$   | 8,512 | \$ 34,919 | \$   | \$   | 43,431  |

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2014:

| <i>(Dollars in thousands)</i>              | <b>Quoted Prices in<br/>Active<br/>Markets<br/>for<br/>Identical<br/>Instruments<br/>(Level 1)</b> |       |           | <b>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level<br/>3)</b> | <b>Total Fair<br/>Value as of<br/>September 30,<br/>2014</b> |
|--|--|-------|-----------|--|--|--|
| <b>Assets:</b>                             |  |       |           |  |  |  |
| Cash equivalents                           | \$   |       | \$ 40,100 |  | \$   | \$ 40,100  |
| Available-for-sale equity securities       |  | 1,550 |           |  |  | 1,550  |
| <b>Available-for-sale debt securities:</b> |  |       |           |  |  |  |
|  |  |       | 7,394     |  |  | 7,394  |

|   |    |       |    |        |
|---|----|-------|----|--------|
| U.S. government and government agency obligations |    |       |    |        |
| Mortgage-backed securities                        |    | 5,545 |    | 5,545  |
| Municipal bonds                                   |    | 1,175 |    | 1,175  |
| Asset-backed securities                           |    | 2,369 |    | 2,369  |
| Corporate bonds                                   |    | 1,830 |    | 1,830  |
| Total assets measured at fair value               | \$ | 1,550 | \$ | 58,413 |
|   |    |       | \$ | 59,963 |

### *Valuation Techniques*

The valuation techniques used to measure the fair value of assets are as follows:

**Cash equivalents** These assets are classified as Level 2 and are carried at historical cost which is a reasonable estimate of fair value because of the relatively short time between origination of the instrument and its expected realization.

**Available-for-sale equity securities** This asset is classified as Level 1 and represents the Company's investment in Intersect ENT. This investment is valued based on the quoted market price of Intersect ENT shares.

**Available-for-sale debt securities** These securities are classified as Level 1 or Level 2 and include various types of debt securities. These securities are valued based on quoted vendor prices in active markets underlying the securities.

**Table of Contents****5. Investments**

Investments consist principally of U.S. government and government agency obligations, mortgage-backed securities and corporate and municipal securities and are classified as available-for-sale at December 31, 2014 and September 30, 2014. Available-for-sale securities are reported at fair value with unrealized gains and losses, net of tax, excluded from the condensed consolidated statements of income and reported in the condensed consolidated statements of comprehensive income as well as a separate component of stockholders' equity in the condensed consolidated balance sheets, except for other-than-temporary impairments, which are reported as a charge to current earnings. A loss would be recognized when there is an other-than-temporary impairment in the fair value of any individual security classified as available-for-sale, with the associated net unrealized loss reclassified out of accumulated other comprehensive income with a corresponding adjustment to other income. This adjustment results in a new cost basis for the investment. Investments for which management has the intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost. When an other-than-temporary impairment in the fair value of any individual security classified as held-to-maturity occurs, the Company writes down the security to fair value with a corresponding adjustment to other income. Interest earned on debt securities, including amortization of premiums and accretion of discounts, is included in other income. Realized gains and losses from the sales of debt securities, which are included in other income, are determined using the specific identification method.

The amortized cost, unrealized holding gains and losses, and fair value of available-for-sale securities as of December 31, 2014 and September 30, 2014 were as follows:

| <i>(Dollars in thousands)</i>                     | <b>December 31, 2014</b> |                         |                          | <b>Fair Value</b> |
|---|--------------------------|-------------------------|--------------------------|-------------------|
|   | <b>Amortized Cost</b>    | <b>Unrealized Gains</b> | <b>Unrealized Losses</b> |                   |
| U.S. government and government agency obligations | \$ 10,228                | \$ 13                   | \$ (10)                  | \$ 10,231         |
| Mortgage-backed securities                        | 5,402                    | 51                      | (77)                     | 5,376             |
| Municipal bonds                                   | 895                      | 3                       | (3)                      | 895               |
| Asset-backed securities                           | 2,265                    | 2                       | (5)                      | 2,262             |
| Corporate bonds                                   | 1,827                    | 5                       | (2)                      | 1,830             |
| Equity securities                                 | 2                        | 462                     |                          | 464               |
| <b>Total</b>                                      | <b>\$ 20,619</b>         | <b>\$ 536</b>           | <b>\$ (97)</b>           | <b>\$ 21,058</b>  |

| <i>(Dollars in thousands)</i>                     | <b>September 30, 2014</b> |                         |                          | <b>Fair Value</b> |
|---|---------------------------|-------------------------|--------------------------|-------------------|
|   | <b>Amortized Cost</b>     | <b>Unrealized Gains</b> | <b>Unrealized Losses</b> |                   |
| U.S. government and government agency obligations | \$ 7,397                  | \$ 12                   | \$ (15)                  | \$ 7,394          |
| Mortgage-backed securities                        | 5,576                     | 43                      | (74)                     | 5,545             |
| Municipal bonds                                   | 1,173                     | 5                       | (3)                      | 1,175             |
| Asset-backed securities                           | 2,370                     | 3                       | (4)                      | 2,369             |
| Corporate bonds                                   | 1,829                     | 6                       | (5)                      | 1,830             |
| Equity securities                                 | 2                         | 1,548                   |                          | 1,550             |

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|       |           |          |          |           |
|-------|-----------|----------|----------|-----------|
| Total | \$ 18,347 | \$ 1,617 | \$ (101) | \$ 19,863 |
|-------|-----------|----------|----------|-----------|

As of December 31, 2014 and September 30, 2014, the Company concluded that the unrealized losses related to the available-for-sale securities shown above were not other-than-temporary as the Company does not have the intent to sell, nor is it more likely than not that the Company will be required to sell, before recovery of their amortized cost.

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The amortized cost and fair value of available-for-sale debt securities, by contractual maturity, at December 31, 2014 were as follows:

| <i>(Dollars in thousands)</i> | <b>Amortized Cost</b> | <b>Fair Value</b> |
|-------------------------------|-----------------------|-------------------|
| Debt securities due within:   |                       |                   |
| One year                      | \$ 3,655              | \$ 3,662          |
| One to five years             | 11,151                | 11,148            |
| Five years or more            | 5,811                 | 5,784             |
| <b>Total</b>                  | <b>\$ 20,617</b>      | <b>\$ 20,594</b>  |

The following table summarizes sales of available-for-sale debt securities:

| <i>(Dollars in thousands)</i> | <b>Three months ended</b> |             |
|-------------------------------|---------------------------|-------------|
|                               | <b>December 31</b>        |             |
|                               | <b>2014</b>               | <b>2013</b> |
| Proceeds from sales           | \$ 973                    | \$ 2,867    |
| Gross realized gains          | \$                        | \$          |
| Gross realized losses         | \$ (7)                    | \$          |

**6. Inventories**

Inventories are principally stated at the lower of cost or market using the specific identification method and include direct labor, materials and overhead, with cost of product sales determined on a first-in, first-out basis. Inventories consisted of the following components:

| <i>(Dollars in thousands)</i> | <b>December 31,</b> | <b>September 30,</b> |
|-------------------------------|---------------------|----------------------|
|                               | <b>2014</b>         | <b>2014</b>          |
| Raw materials                 | \$ 1,097            | \$ 1,056             |
| Finished products             | 1,732               | 1,761                |
| <b>Total</b>                  | <b>\$ 2,829</b>     | <b>\$ 2,817</b>      |

**7. Other Assets**

Other assets consist principally of strategic investments as follows:

| <i>(Dollars in thousands)</i> | <b>December 31,</b> | <b>September 30,</b> |
|-------------------------------|---------------------|----------------------|
|                               | <b>2014</b>         | <b>2014</b>          |

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|                            |    |       |    |       |
|----------------------------|----|-------|----|-------|
| CeloNova BioSciences, Inc. | \$ | 1,500 | \$ | 1,500 |
| ViaCyte, Inc.              |    | 479   |    | 479   |
| Other assets, net          | \$ | 1,979 | \$ | 1,979 |

The Company accounts for all of its strategic investments under the cost method as of December 31, 2014 and September 30, 2014.

In February 2011, the stent technology of Nexeon MedSystems, Inc. ( Nexeon ) was acquired by CeloNova BioSciences, Inc. ( CeloNova ). Prior to the acquisition by CeloNova, Nexeon created a wholly-owned subsidiary, Nexeon Stent, to hold the company's stent-related assets. Nexeon distributed to its stockholders the Nexeon Stent stock which was exchanged for Series B-1 preferred shares of CeloNova. CeloNova is a privately-held Texas-based medical technology company that is marketing a variety of medical products. The Company's investment in CeloNova, which is accounted for under the cost method, represents less than a 2% ownership interest. The Company does not exert significant influence over CeloNova's operating or financial activities.

The Company has invested a total of \$5.3 million in ViaCyte, Inc. ( ViaCyte ), a privately-held California-based biotechnology firm that is developing a unique treatment for diabetes using coated islet cells, the cells that produce insulin in the human body. In fiscal 2006, the Company determined that its investment in ViaCyte was impaired and that the impairment was other than temporary. Accordingly, the Company recorded an impairment loss of \$4.7 million. In the second quarter of fiscal 2013, the Company recorded

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an additional other-than-temporary impairment loss on this investment totaling \$0.1 million based on a current financing round and market valuations. The balance of the investment of \$0.5 million, which is accounted for under the cost method, represents less than a 1% ownership interest. The Company does not exert significant influence over ViaCyt's operating or financial activities.

The total carrying value of cost method investments is reviewed quarterly for changes in circumstances or the occurrence of events that suggest the Company's investment may not be recoverable. The fair value of cost method investments is not adjusted if there are no identified events or changes in circumstances that may have a material adverse effect on the fair value of the investment.

**8. Intangible Assets**

Intangible assets consist principally of acquired patents and technology, customer relationships, licenses and trademarks. For the three months ended December 31, 2014 and 2013, the Company recorded amortization expense of \$0.2 million for each period.

Intangible assets consisted of the following:

| <b>December 31, 2014</b>                 |   |                                  |                                     |                 |
|--|---|----------------------------------|-------------------------------------|-----------------|
| <i>(Dollars in thousands)</i>            | <b>Weighted<br/>Average<br/>Original Life (Years)</b> | <b>Gross Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> | <b>Net</b>      |
| <b>Definite-lived intangible assets:</b> |   |                                  |                                     |                 |
| Customer lists                           | 9.0   | \$ 4,857                         | \$ (3,948)                          | \$ 909          |
| Core technology                          | 8.0   | 530                              | (491)                               | 39              |
| Patents and other                        | 16.8  | 2,256                            | (1,024)                             | 1,232           |
| <b>Subtotal</b>                          |   | <b>7,643</b>                     | <b>(5,463)</b>                      | <b>2,180</b>    |
| <b>Unamortized intangible assets:</b>    |   |                                  |                                     |                 |
| Trademarks                               |   | 580                              |                                     | 580             |
| <b>Total</b>                             |   | <b>\$ 8,223</b>                  | <b>\$ (5,463)</b>                   | <b>\$ 2,760</b> |

| <b>September 30, 2014</b>                |   |                                  |                                     |              |
|--|---|----------------------------------|-------------------------------------|--------------|
| <i>(Dollars in thousands)</i>            | <b>Weighted<br/>Average<br/>Original Life (Years)</b> | <b>Gross Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> | <b>Net</b>   |
| <b>Definite-lived intangible assets:</b> |   |                                  |                                     |              |
| Customer lists                           | 9.0   | \$ 4,857                         | \$ (3,813)                          | \$ 1,044     |
| Core technology                          | 8.0   | 530                              | (475)                               | 55           |
| Patents and other                        | 16.8  | 2,256                            | (989)                               | 1,267        |
| <b>Subtotal</b>                          |   | <b>7,643</b>                     | <b>(5,277)</b>                      | <b>2,366</b> |

**Unamortized intangible assets:**

|            |          |                     |
|------------|----------|---------------------|
| Trademarks | 580      | 580                 |
| Total      | \$ 8,223 | \$ (5,277) \$ 2,946 |

Based on the intangible assets in service as of December 31, 2014, estimated amortization expense for the remainder of fiscal 2015 and each of the next five fiscal years is as follows (*Dollars in thousands*):

|                   |        |
|-------------------|--------|
| Remainder of 2015 | \$ 546 |
| 2016              | 594    |
| 2017              | 183    |
| 2018              | 137    |
| 2019              | 137    |
| 2020              | 137    |

Future amortization amounts presented above are estimates. Actual future amortization expense may be different, as a result of future acquisitions, impairments, changes in amortization periods, or other factors.

**9. Goodwill**

Goodwill represents the excess of the cost of an acquired entity over the fair value assigned to the assets purchased and liabilities assumed in connection with a business acquisition. Goodwill is not amortized but is subject, at a minimum, to annual tests for impairment in accordance with accounting guidance for goodwill. The carrying amount of goodwill is evaluated annually, and between annual evaluations if events occur or circumstances change indicating that the carrying amount of goodwill may be impaired.

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The \$8.0 million of goodwill at December 31, 2014 and September 30, 2014 is related to the In Vitro Diagnostics reporting unit and represents the gross value from the acquisition of BioFX Laboratories, Inc. ( BioFX ) in 2007. The goodwill was not impaired based on the outcome of the fiscal 2014 annual impairment test, and there have been no events or circumstances that have occurred in the first quarter of fiscal 2015 associated with the In Vitro Diagnostics reporting unit to indicate that the goodwill should be impaired.

**10. Stock-based Compensation Plans**

The Company has stock-based compensation plans under which it grants stock options, restricted stock awards, performance share awards, restricted stock units and deferred stock units. Accounting guidance requires all share-based payments to be recognized as an operating expense, based on their fair values, over the requisite service period.

The Company's stock-based compensation expenses were allocated to the following expense categories:

| <i>(Dollars in thousands)</i>       | <b>Three months ended<br/>December 31</b> |             |
|-------------------------------------|---|-------------|
|                                     | <b>2014</b>                               | <b>2013</b> |
| Product costs                       | \$ 7                                      | \$ 4        |
| Research and development            | 61  | 52          |
| Selling, general and administrative | 457                                       | 757         |
| Total                               | \$ 525                                    | \$ 813      |

As of December 31, 2014, approximately \$2.9 million of total unrecognized compensation costs related to non-vested awards is expected to be recognized over a weighted average period of approximately 2.3 years. The unrecognized compensation costs above include \$0.2 million based on payout levels associated with performance share awards that are currently anticipated to be expensed because the performance conditions are expected to be met at or above minimum threshold levels.

*Stock Option Awards*

The Company uses the Black-Scholes option pricing model to determine the weighted average grant date fair value of stock options granted. The weighted average per share fair values of stock options granted during the three months ended December 31, 2014 and 2013 were \$7.22 and \$8.80, respectively. The assumptions used as inputs in the model were as follows:

|                          | <b>Three months ended<br/>December 31</b> |             |
|--------------------------|---|-------------|
|                          | <b>2014</b>                               | <b>2013</b> |
| Risk-free interest rates | 1.4%                                      | 1.2%        |
| Expected life (years)    | 4.5                                       | 4.6         |
| Expected volatility      | 43.3%                                     | 45.1%       |

Dividend yield

0.0%

0.0%

The risk-free interest rate assumption was based on the U.S. Treasury's rates for U.S. Treasury zero-coupon bonds with maturities similar to those of the expected term of the award. The expected life of options granted is determined based on the Company's experience. Expected volatility is based on the Company's stock price movement over a period approximating the expected term. Based on management's judgment, dividend rates are expected to be zero for the expected life of the options. The Company also estimates forfeitures of options granted, which are based on historical experience.

Non-qualified stock options are granted at fair market value on the date of grant. Non-qualified stock options expire in seven to ten years or upon termination of employment or service as a Board member. With respect to members of our Board, non-qualified stock options generally become exercisable on a pro-rata basis within the one-year period following the date of grant. With respect to our employees, non-qualified stock options generally become exercisable with respect to 25% of the shares on each of the first four anniversaries following the grant date.

The total pre-tax intrinsic value of options exercised during the three months ended December 31, 2014 and 2013 was \$0.1 million and \$0.5 million, respectively. The intrinsic value represents the difference between the average exercise price and the fair market value of the Company's common stock on the last day of the respective fiscal period end.

**Table of Contents***Restricted Stock Awards*

The Company has entered into restricted stock agreements with certain key employees, covering the issuance of common stock ( Restricted Stock ). Under accounting guidance these shares are considered to be non-vested shares. The Restricted Stock is released to key employees if they are employed by the Company at the end of the vesting period. Compensation has been recognized for the estimated fair value of the common shares and is being expensed over the vesting term. The stock-based compensation table above includes Restricted Stock expenses recognized related to these awards, which totaled less than \$0.1 million in each of the three months ended December 31, 2014 and 2013, respectively.

*Performance Share Awards*

The Company has entered into performance share agreements with certain key employees and executives, covering the issuance of common stock ( Performance Shares ). The Performance Shares vest upon the achievement of all or a portion of certain performance objectives (which may include financial or project objectives), which must be achieved during the performance period. The Organization and Compensation Committee of the Board of Directors (the Committee ) approves the performance objective used for our executive compensation programs, which objectives were cumulative earnings per share and cumulative revenue for the three-year performance periods for fiscal 2012 (2012 - 2014), fiscal 2013 (2013 - 2015), fiscal 2014 (2014 - 2016), and cumulative revenue and cumulative EBITDA for fiscal 2015 (2015 - 2017). Assuming that the minimum performance level is attained, the number of shares that may actually vest will vary based on performance from 20% (minimum) to 200% (maximum) of the target number of shares. Shares will be issued to participants as soon as practicable following the end of the performance periods subject to Committee approval and verification of results. The fiscal 2012 awards were finalized in the three months ended December 31, 2014 and resulted in issuance of 98,093 shares (maximum was 124,994 shares) based on the performance objectives and actual results. The compensation cost related to the number of shares to be granted under each performance period is fixed on the grant date, which is the date the performance period begins. Compensation is recognized in each period based on management's best estimate of the achievement level of actual results compared with the specified performance objectives for Performance Shares. For the three months ended December 31, 2014 and 2013, the Company recognized expense of less than \$0.1 million and \$0.3 million, respectively. The stock-based compensation table above includes the Performance Shares expenses.

The fair values of the Performance Shares, at target, were \$0.9 million in each fiscal year for grants awarded in fiscal 2015, 2014 and 2013, respectively.

The aggregate number of shares that could be awarded to our executives if the minimum, target and maximum performance goals are met, based upon the fair value at the date of grant is as follows:

| <b>Performance Period</b> | <b>Minimum Shares</b> | <b>Target Shares</b> | <b>Maximum Shares</b> |
|---------------------------|-----------------------|----------------------|-----------------------|
| Fiscal 2013 - 2015        | 8,551                 | 42,753               | 85,506                |
| Fiscal 2014 - 2016        | 7,861                 | 39,303               | 78,606                |
| Fiscal 2015 - 2017        | 8,440                 | 42,199               | 84,398                |

*1999 Employee Stock Purchase Plan*

Under the 1999 Employee Stock Purchase Plan ( Stock Purchase Plan ), the Company is authorized to issue up to 400,000 shares of common stock. All full-time and part-time employees can choose to have up to 10% of their annual compensation withheld, with a limit of \$25,000, to purchase the Company's common stock at purchase prices defined

within the provisions of the Stock Purchase Plan. As of December 31, 2014 and September 30, 2014, there was \$0.1 million and less than \$0.1 million of employee contributions, respectively, included in accrued liabilities in the condensed consolidated balance sheets. Stock compensation expense recognized related to the Stock Purchase Plan for the three months ended December 31, 2014 and 2013 totaled less than \$0.1 million in each period. The stock-based compensation table above includes the Stock Purchase Plan expenses.

*Restricted Stock and Deferred Stock Units*

In the quarter ended December 31, 2014, the Company awarded 10,678 restricted stock units ( RSU ), and has cumulatively awarded 35,512 RSUs to non-employee directors since fiscal 2013 under the 2009 Equity Incentive Plan. There were no forfeitures or issuances in the three months ended December 31, 2014, with forfeitures of 3,417 RSUs and issuance of 2,183 shares of common stock to departed non-employee directors in fiscal 2014. The RSU awards vest on a pro-rata basis over a one-year period. RSU awards are not considered as issued or outstanding common stock of the Company until shares are issued to a non-employee director upon retirement from the Board of Directors. The estimated fair value of the RSU awards was determined based on the closing market price of SurModics common stock on the date of grant. Compensation expense has been recognized for the estimated fair value of the common shares and is being expensed over the vesting term. The stock-based compensation table above includes RSU expenses recognized related to these awards, which totaled less than \$0.1 million for each of the three months ended December 31, 2014 and 2013.

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Directors can also elect to receive their cash retainers for services to the Board of Directors and its committees in deferred stock units ( DSU ). Certain directors elected this option beginning on January 1, 2013, with deferral elections made annually, which has resulted in 1,554 units issued with a total value of \$34,000 in the three months ended December 31, 2014. These DSUs are fully vested. The stock-based compensation table above includes DSU expenses recognized related to these awards, which totaled less than \$0.1 million and \$0.1 million for the three months ended December 31, 2014 and 2013, respectively.

**11. Revolving Credit Facility**

On November 4, 2013, the Company entered into a three-year \$20.0 million secured revolving credit facility. The Company's obligations under the credit facility are secured by substantially all of its and its subsidiaries' assets, other than intellectual property and real estate. Borrowings under the credit facility, if any, will bear interest at a benchmark rate plus a margin ranging from 1.375% to 2.00% based on the Company's leverage ratio. A facility fee is payable on unused commitments at a rate of 0.20% per annum.

On November 5, 2014, the credit facility was amended and modified to increase the size of stock repurchases that may be effected by the Company up to \$30.0 million without the consent of the lender.

In connection with the credit facility, the Company is required to maintain financial covenants related to a maximum leverage ratio and a minimum EBITDA amount and nonfinancial covenants. As of December 31, 2014, the Company has no debt outstanding and was in compliance with all financial covenants.

**12. Income Per Share Data**

Basic income per common share is calculated based on the weighted average number of common shares outstanding during the period. Diluted income per common share is computed by dividing income by the weighted average number of common and common equivalent shares outstanding during the period. The Company's only potentially dilutive common shares are those that result from dilutive common stock options, non-vested stock relating to restricted stock awards, restricted stock units, deferred stock units and performance shares.

The following table sets forth the denominator for the computation of basic and diluted income per share (in thousands):

|  | <b>Three months<br/>ended<br/>December 31</b> |             |
|--|---|-------------|
|  | <b>2014</b>                                   | <b>2013</b> |
| Basic weighted average shares outstanding  | 13,225  | 13,756      |
| Dilutive effect of outstanding stock options, non-vested restricted stock and performance shares | 198   | 253         |
| Diluted weighted average shares outstanding  | 13,423  | 14,009      |

The calculation of weighted average diluted shares outstanding excludes outstanding stock options associated with the right to purchase 0.6 million and 0.4 million shares of common stock for the three months ended December 31, 2014 and 2013, respectively, as their inclusion would have had an antidilutive effect on diluted income per share.

On November 5, 2014, the Company's Board of Directors authorized it to repurchase up to \$30.0 million of the Company's outstanding common stock in open-market purchases, privately negotiated transactions, block trades, accelerated share repurchase transactions, tender offers or by any combination of such methods. The authorization has no fixed expiration date. During the three months ended December 31, 2014, the Company repurchased 758,143 shares of common stock for a total of \$16.0 million under the \$30.0 million November 2014 Board authorization and as of December 31, 2014, \$14.0 million remained available for future repurchases under the current authorization. The \$14.0 million includes \$4.0 million of the initial payment to Wells Fargo in the first quarter of fiscal 2015 under the accelerated share repurchase program discussed below.

On November 11, 2014, the Company entered into an accelerated share repurchase program with Wells Fargo Bank, National Association. In connection with this agreement, the Company made an initial \$20.0 million payment to the bank and immediately received an initial delivery of 758,143 shares of its common stock with a fair value of \$16.0 million as of the purchase date. Effective as of the date of the initial share purchase, the transaction was accounted for as a share retirement, resulting in a reduction of common stock of less than \$0.1 million, additional paid-in capital of \$2.5 million and retained earnings of \$13.5 million. The remaining \$4.0 million of the Company's initial payment was also reported as a reduction in retained earnings. Upon final settlement of the program, the Company may be entitled to receive additional shares of common stock, or, under certain circumstances specified in the program, the Company may be required to deliver shares or remit a settlement amount in cash, at the Company's option. Based on the facts associated with the agreement, the forward contract is indexed to the Company's common stock and meets the U.S. GAAP requirements to be classified as permanent equity. As long as the forward contract continues to meet the requirements to be classified as permanent equity, the Company will not record future changes in its fair value. The Company expects it will continue to meet those requirements through the settlement date.

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The accelerated share repurchase program with Wells Fargo expires in the fourth quarter of fiscal 2015; however, the bank has the right to accelerate the end of the purchase period. Upon settlement of the contract, the Company will adjust common stock and either additional paid-in capital or retained earnings, as appropriate, to reflect the final settlement amount. The specific number of shares that the Company will ultimately purchase under the accelerated share purchase agreement will be based on the volume weighted average price ( VWAP ) of the Company's common stock during the purchase period, less an agreed upon discount. The maximum amount of shares of common stock the Company can be required to issue to settle the agreement cannot exceed 1,870,907. The Company has sufficient authorized and unissued shares available to deliver the maximum share amount. For every \$1.00 increase or decrease in the Company's VWAP, based on a closing stock price of \$21.38 on November 11, 2014, the settlement amount will change by approximately 45,000 shares.

During the three months ended December 31, 2013, the Company repurchased 380,011 shares of common stock for a total of \$8.9 million pursuant to previously authorized share repurchases.

**13. Income Taxes**

The Company recorded income tax provisions associated with income from continuing operations of \$1.5 million in each of the three months ended December 31, 2014 and 2013, respectively, representing effective tax rates of 28.9% and 28.8%, respectively. The difference between the U.S. federal statutory tax rate of 35% and the Company's effective tax rate for the three months ended December 31, 2014 and 2013 reflects the impact of state income taxes, permanent tax items and discrete tax benefits. The three months ended December 31, 2014 reflects a \$0.2 million discrete tax benefit associated with the December 2014 signing of the Tax Increase Prevention Act of 2014 which retroactively reinstated the federal research and development income tax credit which had expired in December 2013. The three months ended December 31, 2013 reflects the impact of a gain related to a Vessix contingent consideration payment which resulted in recognition of tax expense with an offsetting reversal of a capital loss valuation allowance.

The total amount of unrecognized tax benefits including interest and penalties that, if recognized, would affect the effective tax rate as of December 31, 2014 and September 30, 2014, respectively, are \$1.0 million and \$0.9 million for each period. Currently, the Company does not expect the liability for unrecognized tax benefits to change significantly in the next 12 months with the above balances classified on the condensed consolidated balance sheets in other long-term liabilities. Interest and penalties related to unrecognized tax benefits are recorded in income tax expense.

The Company files income tax returns, including returns for its subsidiaries, in the U.S. federal jurisdiction and in various state jurisdictions. Uncertain tax positions are related to tax years that remain subject to examination. U.S. income tax returns for years prior to fiscal 2011 are no longer subject to examination by federal tax authorities. For tax returns for state and local jurisdictions, the Company is no longer subject to examination for tax years generally before fiscal 2004.

**14. Amounts Reclassified Out of Accumulated Other Comprehensive Income**

Amounts reclassified out of accumulated other comprehensive income ( AOCI ) were less than \$0.1 million on a pre-tax basis for each of the three months ended December 31, 2014 and 2013. The amounts reclassified out of AOCI are associated with unrealized losses or gains on available-for-sale securities that were realized on the sale of the securities and are presented in other losses, net in the condensed consolidated statements of income.

## **15. Operating Segment Information**

The accounting standards for reporting information about operating segments define operating segments as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, who is the Company's Chief Executive Officer, in deciding how to allocate resources and in assessing performance. For financial accounting and reporting purposes, the Company reports its results for the two reportable segments as follows: (1) the Medical Device unit, which is comprised of surface modification coating technologies to improve access, deliverability, and predictable deployment of medical devices, as well as drug delivery coating technologies to provide site-specific drug delivery from the surface of a medical device, with end markets that include coronary, peripheral, and neuro-vascular, and urology, among others, and (2) the In Vitro Diagnostics unit, which consists of component products and technologies for diagnostic test kits and biomedical research applications, with products that include protein stabilization reagents, substrates, antigens and surface coatings.

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The tables below present segment revenue, operating income from continuing operations and depreciation and amortization, as follows:

| <i>(Dollars in thousands)</i>         | <b>Three months ended</b> |             |
|---------------------------------------|---------------------------|-------------|
|                                       | <b>December 31</b>        |             |
|                                       | <b>2014</b>               | <b>2013</b> |
| <b>Revenue:</b>                       |                           |             |
| Medical Device                        | \$ 10,635                 | \$ 10,549   |
| In Vitro Diagnostics                  | 3,570                     | 3,334       |
| Total revenue                         | \$ 14,205                 | \$ 13,883   |
| <b>Operating income:</b>              |                           |             |
| Medical Device                        | \$ 5,515                  | \$ 5,328    |
| In Vitro Diagnostics                  | 1,098                     | 671         |
| Total segment operating income        | 6,613                     | 5,999       |
| Corporate                             | (1,579)                   | (1,670)     |
| Total operating income                | \$ 5,034                  | \$ 4,329    |
| <b>Depreciation and amortization:</b> |                           |             |
| Medical Device                        | \$ 270                    | \$ 294      |
| In Vitro Diagnostics                  | 213                       | 214         |
| Corporate                             | 200                       | 189         |
| Total depreciation and amortization   | \$ 683                    | \$ 697      |

The Corporate category includes expenses for administrative corporate functions, such as executive, corporate accounting, legal, human resources and Board of Directors related, that have not been fully allocated to the Medical Device and In Vitro Diagnostics segments. Corporate may also include expenses, such as litigation, which are not specific to a segment and thus not allocated to the operating segments.

Asset information by segment is not presented because the Company does not provide its chief operating decision maker assets by segment, as the data is not readily available.

**16. Commitments and Contingencies**

*Litigation.* From time to time, the Company has been, and may become, involved in various legal actions involving its operations, products and technologies, including intellectual property and employment disputes. The outcomes of these legal actions are not within the Company's complete control and may not be known for prolonged periods of time. In some actions, the claimants seek damages, as well as other relief, including injunctions barring the sale of products that are the subject of the lawsuit, which, if granted, could require significant expenditures or result in lost revenue. The Company records a liability in the consolidated financial statements for these actions when a loss is known or considered probable and the amount can be reasonably estimated. If the reasonable estimate of a known or

probable loss is a range, and no amount within the range is a better estimate, the minimum amount of the range is accrued. If a loss is possible but not known or probable, and can be reasonably estimated, the estimated loss or range of loss is disclosed. In most cases, significant judgment is required to estimate the amount and timing of a loss to be recorded.

*InnoRx, Inc.* In January 2005, the Company entered into a merger agreement whereby SurModics acquired all of the assets of InnoRx, Inc. ( InnoRx ), an early stage company developing drug delivery devices and therapies for the ophthalmology market. SurModics will be required to issue up to approximately 480,059 additional shares of its common stock to the stockholders of InnoRx upon the successful completion of the remaining development and commercial milestones involving InnoRx technology acquired in the transaction. The Company has not recorded any accrual for this contingency as of December 31, 2014 as the milestones have not been achieved and the probability of achievement is low.

*InnoCore Technologies BV.* In March 2006, the Company entered into a license agreement whereby SurModics obtained an exclusive license to a drug delivery coating for licensed products within the vascular field which include peripheral, coronary and neurovascular biodurable stent products. The license requires an annual minimum payment of 200,000 euros (equivalent to \$243,000 using a euro to U.S. \$ exchange rate of 1.2155 as of December 31, 2014) until the last patent expires which is currently estimated to be September 2027. The total minimum future payments associated with this license are approximately \$3.1 million. The license is currently utilized with one of SurModics drug delivery customers.

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**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis provides information that we believe is useful in understanding our operating results, cash flows and financial condition. The discussion should be read in conjunction with both the unaudited condensed consolidated financial statements and related notes included in this Form 10-Q, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2014. This discussion contains various Forward-Looking Statements within the meaning of the Private Securities Litigation Reform Act of 1995. We refer readers to the statement entitled Forward-Looking Statements located at the end of this Item 2.

**Overview**

SurModics is a leading provider of surface modification and *in vitro* diagnostic technologies to the healthcare industry. In fiscal 2014, our business performance continued to be driven by growth from our Medical Device hydrophilic coatings royalty revenue, product sales and contract coating services included in research and development revenue. Our In Vitro Diagnostics segment has experienced solid demand in the first quarter of fiscal 2015 as well the last six months of fiscal 2014.

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. For financial accounting and reporting purposes, we report our results for the two reportable segments as follows: (1) the Medical Device unit, which is comprised of surface modification coating technologies to improve access, deliverability, and predictable deployment of medical devices, as well as drug delivery coating technologies to provide site-specific drug delivery from the surface of a medical device, with end markets that include coronary, peripheral, and neurovascular, and urology, among others, and (2) the In Vitro Diagnostics unit, which consists of component products and technologies for diagnostic immunoassay and molecular tests and biomedical research applications, with products that include protein stabilization reagents, substrates, antigens and surface coatings. We made this determination based on how we manage our operations and the information provided to our chief operating decision maker who is our Chief Executive Officer.

We derive our revenue from three primary sources: (1) royalties and license fees from licensing our proprietary surface modification and device drug delivery technologies and *in vitro* diagnostic formats to customers; the vast majority (typically in excess of 90%) of revenue in the royalties and license fees category is in the form of royalties; (2) the sale of reagent chemicals to licensees and the sale of stabilization products, antigens, substrates and surface coatings to the diagnostic and biomedical research markets; and (3) research and commercial development fees generated on customer projects. Revenue fluctuates from quarter to quarter depending on, among other factors: our customers' success in selling products incorporating our technologies; the timing of introductions of licensed products by customers; the timing of introductions of products that compete with our customers' products; the number and activity level associated with customer development projects; the number and terms of new license agreements that are finalized; and the value of reagent chemicals and other products sold to customers.

We have several U.S. and international issued patents and pending international patent applications protecting various aspects of these technologies, including compositions, methods of manufacture and methods of coating devices. The expiration dates for these patents and the anticipated expiration dates of the patent applications range from 2015 to 2033. Among these, the third generation of our PhotoLink® hydrophilic technology is protected by a family of patents that are expected to expire in November 2015 (in the U.S.) and October 2016 (in certain other countries). The royalty revenue associated with our third generation technology that has not yet converted, or that is not in the process of converting, to one of our advanced generation technologies was approximately 19% of our fiscal 2014 revenue. A majority of the customer products utilizing this early generation technology (representing approximately 14% of our

fiscal 2014 revenue) will continue to generate royalty revenue at a reduced royalty rate beyond the expiration of these patents. The royalty obligation for these customer products extends beyond the expiration of these patents because the license also includes rights to our know-how or other proprietary rights. While we are actively seeking to convert our customers to one of our advanced generations of our hydrophilic coating technology, there can be no assurance that we will be successful in doing so, or that those customers that have converted, or will convert, will sell products utilizing our technology which will generate earned royalty revenue for us.

### **Overview of Research and Development Activities**

We manage our customer-sponsored research and development ( R&D ) programs based largely on the requirements of our customers. In this regard, our customers typically establish the various measures and metrics that are used to monitor a program s progress, including key deliverables, milestones, timelines, and an overall program budget. The customer is ultimately responsible for deciding whether to continue or terminate a program, and does so based on research results (relative to the above measures and metrics) and other factors, including their own strategic and/or business priorities. Customer R&D programs are mainly in our Medical Device segment.

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Our internal R&D activities are engaged in the exploration, discovery and application of technologies that solve meaningful problems in the diagnosis and treatment of disease. Our key R&D activities include efforts that support and expand our core offerings. These efforts included freezing of the design of our SurModics SurVeil Drug Coated Balloon for use in the superficial femoral and popliteal arteries. We initiated a Good Laboratory Practice (GLP) animal study in the first quarter of fiscal 2015 and plan to initiate a first-in-human study of the SurModics *SurVeil* Drug Coated Balloon in fiscal 2015.

In addition, in fiscal 2014 we launched new in vitro diagnostic products including a stop solution for TMB microwell substrates that is non-corrosive to skin and eyes and a protein-free AP stabilizer.

For our internal R&D programs in our segments, we prioritize these programs based on a number of factors, including a program's strategic fit, commercial impact, potential competitive advantage, technical feasibility, and the amount of investment required. The measures and metrics used to monitor a program's progress vary based on the program, and typically include many of the same factors discussed above with respect to our customer R&D programs. We typically make decisions to continue or terminate a program based on research results (relative to the above measures and metrics) and other factors, including our own strategic and/or business priorities, and the amount of additional investment required.

With respect to cost components, R&D expenses consist of labor, materials and overhead costs (for example, utilities, depreciation, and indirect labor) for both customer R&D and internal R&D programs. We manage our R&D organization in a flexible manner, balancing workloads/resources between customer R&D and internal R&D programs primarily based on the level of customer program activity. Therefore, costs incurred for customer R&D and internal R&D can shift as customer activity increases or decreases.

**Critical Accounting Policies**

Critical accounting policies are those policies that require the application of management's most challenging subjective or complex judgment, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Critical accounting policies involve judgments and uncertainties that are sufficiently likely to result in materially different results under different assumptions and conditions. For a detailed description of our critical accounting policies, see the notes to the consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2014.

**Results of Operations – Three Months Ended December 31**

**Revenue.** Revenue during the first quarter of fiscal 2015 was \$14.2 million, an increase of \$0.3 million or 2% from the first quarter of fiscal 2014. The change in revenue, as detailed in the table below, is further explained in the narrative below.

| <i>(Dollars in thousands)</i> | <b>Three Months Ended December 31</b> |             |                                |               |
|-------------------------------|---------------------------------------|-------------|--------------------------------|---------------|
|                               | <b>2014</b>                           | <b>2013</b> | <b>Increase<br/>(Decrease)</b> | <b>Change</b> |
| Revenue:                      |                                       |             |                                |               |
| Medical Device                | \$ 10,635                             | \$ 10,549   | \$ 86                          | 0.8%          |
| In Vitro Diagnostics          | 3,570                                 | 3,334       | 236                            | 7.1%          |

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|               |    |        |    |        |    |     |      |
|---------------|----|--------|----|--------|----|-----|------|
| Total revenue | \$ | 14,205 | \$ | 13,883 | \$ | 322 | 2.3% |
|---------------|----|--------|----|--------|----|-----|------|

*Medical Device.* Revenue in Medical Device was \$10.6 million in the first quarter of fiscal 2015, essentially unchanged compared with the first quarter of fiscal 2014. The change in total revenue was attributable to \$0.2 million of higher product sales offset substantially by \$0.2 million of lower license fees.

*In Vitro Diagnostics.* Revenue in In Vitro Diagnostics was \$3.6 million in the first quarter of fiscal 2015, an increase of \$0.2 million, or 7%, compared with the first quarter of fiscal 2014. In Vitro Diagnostics fiscal 2015 results included increases in sales of microarray slides of \$0.3 million and reagents of \$0.1 million which were partially offset by \$0.1 million decreases in both antigen sales and BioFX branded products.

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The following is a summary of our major costs and expenses as a percent of total revenue:

| <i>(Dollars in thousands)</i>       | Three months ended<br>December 31, 2014 |                       | Three months ended<br>December 31, 2013 |                       |
|-------------------------------------|---|-----------------------|---|-----------------------|
|                                     | Amount                                  | % of Total<br>Revenue | Amount                                  | % of Total<br>Revenue |
| Product costs                       | \$ 1,902                                | 13%                   | \$ 2,004                                | 14%                   |
| Research and development            | 3,576                                   | 25                    | 3,699                                   | 27                    |
| Selling, general and administrative | 3,693                                   | 26                    | 3,851                                   | 28                    |

**Product costs.** Product costs were \$1.9 million and \$2.0 million in each of the three months ended December 31, 2014 and 2013, or 13% and 14% of total revenue in each respective period. Product gross margins were 67% in fiscal 2015 and 63% in fiscal 2014, respectively. The improved product gross margins in the first quarter of fiscal 2015 were driven by manufacturing leverage from increased production volume as well as reduced scrap expense and favorable product mix compared with the prior-year period.

**Research and development (R&D) expenses.** R&D expenses were \$3.6 million and \$3.7 million for the first quarter of fiscal 2015 and 2014, or 25% and 27% of total revenue in each respective period. The fiscal 2015 decrease from fiscal 2014 of \$0.1 million, or 3%, was primarily a result of \$0.1 million lower outbound royalty expenses. Overall project related external expenses, including those related to development of our SurModics *SurVeil* Drug Coated Balloon, were unchanged in the first quarter of fiscal 2015 when compared with expenses in the first quarter of fiscal 2014. We continue to expect R&D expenses to increase approximately 5% to 7% for the twelve months of fiscal 2015 as compared with fiscal 2014 primarily related to our drug coated balloon development activities.

**Selling, general and administrative expenses.** Selling, general and administrative expenses were \$3.7 million and \$3.9 million for the three months ended December 31, 2014 and 2013, respectively, or 26% and 28% of total revenue for each respective period. The decrease in the first quarter of fiscal 2015 from the first quarter of fiscal 2014 of \$0.2 million, or 4%, was primarily attributable to \$0.3 million of lower stock-based compensation expense offset partially by \$0.1 million of higher salary expenses. We are currently not accruing stock-based compensation related to our fiscal 2014 and 2015 performance share awards as current projections do not meet or exceed the minimum threshold for the performance objectives associated with each applicable performance period.

**Other income.** Major classifications of other income are as follows:

| <i>(Dollars in thousands)</i>        | Three months ended<br>December 31 |        |
|--------------------------------------|-----------------------------------|--------|
|                                      | 2014                              | 2013   |
| Investment income                    | \$ 57                             | \$ 86  |
| Gain on sale of strategic investment |                                   | 681    |
| Other losses, net                    | (7)                               |        |
| Total other income                   | \$ 50                             | \$ 767 |

Other income was \$0.1 million in the first quarter of fiscal 2015, compared with \$0.8 million for the first quarter of fiscal 2014. The first quarter of fiscal 2014 includes a gain of \$0.7 million from a milestone contingent consideration

payment from the sale of our ownership interest in Vessix. Income from investments in fiscal 2015 decreased compared with the prior-year period primarily from lower investment balances as the Company used \$20.0 million to repurchase common stock in the first quarter of fiscal 2015.

**Income tax provision.** Reconciliation of the statutory U.S. federal tax rate of 35.0% and our effective tax rate for the three months ended December 31, 2014 and 2013 is as follows:

|  | <b>Three months ended</b> |             |
|--|---------------------------|-------------|
|  | <b>December 31</b>        |             |
|  | <b>2014</b>               | <b>2013</b> |
| Statutory U.S. federal income tax rate                       | 35.0%                     | 35.0%       |
| State income taxes, net of federal benefit                   | 0.7                       | 0.8         |
| Gain on strategic investment                                 |                           | (1.3)       |
| Discrete item state tax reserve release                      | (2.0)                     | (4.4)       |
| Discrete item 2014 retroactive federal R&D income tax credit | (4.0)                     |             |
| Other  | (0.8)                     | (1.3)       |
| Effective tax rate   | 28.9%                     | 28.8%       |

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The income tax provision was \$1.5 million for each of the three months ended December 31, 2014 and 2013, representing effective tax rates of 28.9% and 28.8%, respectively. The difference between the U.S. federal statutory tax rate of 35.0% and our effective tax rate for the three months ended December 31, 2014 and 2013 reflects the impact of state income taxes, permanent tax items and discrete tax benefits. Discrete items largely consist of state income tax reserve reversals related to the expiration of statutory filing requirements in each period. In addition, the three months ended December 31, 2014 reflects a \$0.2 million discrete tax benefit associated with the December 2014 signing of the Tax Increase Prevention Act of 2014 which retroactively reinstated the federal research and development income tax credit which had expired in December 2013.

The three months ended December 31, 2013 also reflects the impact of a gain related to a Vessix milestone contingent consideration payment, for which there is tax expense recognized which has been offset by the reversal of a capital loss valuation allowance. We may receive an additional \$3.1 million of future contingent payments through fiscal 2017 based on sales of Vessix products. These proceeds, if any, will generate capital gains which will result in reduction of the existing capital loss carryforward valuation allowance.

**Segment Operating Results**

Operating income for each of our reportable segments was as follows:

| <i>(Dollars in thousands)</i>  | <b>Three Months Ended December 31</b> |             |                            |
|--------------------------------|---------------------------------------|-------------|----------------------------|
|                                | <b>2014</b>                           | <b>2013</b> | <b>Increase/(Decrease)</b> |
| Operating income:              |                                       |             |                            |
| Medical Device                 | \$ 5,515                              | \$ 5,328    | 4%                         |
| In Vitro Diagnostics           | 1,098                                 | 671         | 64%                        |
| Total segment operating income | 6,613                                 | 5,999       | 10%                        |
| Corporate                      | (1,579)                               | (1,670)     | (5)%                       |
| Total operating income         | \$ 5,034                              | \$ 4,329    | 16%                        |

*Medical Device.* Operating income was \$5.5 million in the first quarter of fiscal 2015, compared with \$5.3 million in the first quarter of fiscal 2014. The increase in operating income resulted from higher gross margins generated on \$0.2 million of higher reagent product sales and a reduction in allocated corporate costs of \$0.2 million based on a 4% decrease in the portion of corporate costs allocated to the Medical Device reporting segment. Direct expenses increased \$0.2 million as salaries and facility costs both increased by \$0.1 million each in the first quarter of fiscal 2015 compared with the first quarter of fiscal 2014. Operating income as a percentage of revenue was 52% and 51% in the first quarter of fiscal 2015 and 2014, respectively.

*In Vitro Diagnostics.* Operating income was \$1.1 million in the first quarter of fiscal 2015, compared with \$0.7 million in the first quarter of fiscal 2014. Product sales increased \$0.2 million and the related product gross margins of 66% in the first quarter of fiscal 2015 were substantially higher compared with product gross margins of 60% in the first quarter of fiscal 2014. Product gross margins increased as a result of improved manufacturing leverage from increased production volume compared with the prior-year period. In Vitro Diagnostics direct expenses decreased by less than \$0.1 million in the fiscal 2015 compared with fiscal 2014 driven by lower compensation expenses. Allocated corporate expenses were relatively unchanged, decreasing by less than \$0.1 million in the first quarter of fiscal 2015 compared with the first quarter of fiscal 2014. The operating income as a percentage of revenue

was 31% and 20% in the first quarter of fiscal 2015 and 2014, respectively.

*Corporate.* The Corporate category includes expenses for administrative corporate functions, such as executive, corporate accounting, legal, human resources and Board of Directors related, that have not been fully allocated to the Medical Device and In Vitro Diagnostics segments. Corporate also includes expenses, such as litigation, which are not specific to a segment. Operating loss was \$1.6 million in the first quarter of fiscal 2015 compared with \$1.7 million in the first quarter of fiscal 2014. Lower compensation expenses of \$0.1 million, primarily from \$0.3 million of lower stock-based compensation, was the key contributor to the decrease. We are currently not accruing stock-based compensation related to our fiscal 2014 and 2015 performance share awards as current projections do not meet or exceed the minimum threshold for the performance objectives associated with each applicable performance period.

### **Liquidity and Capital Resources**

As of December 31, 2014, we had working capital of \$35.5 million, a decrease of \$15.7 million from September 30, 2014. Working capital is defined by us as current assets minus current liabilities. Our cash, cash equivalents and available-for-sale securities totaled \$47.6 million at December 31, 2014, a decrease of \$15.8 million from \$63.4 million at September 30, 2014, principally related to the initial payment made related to our accelerated share repurchase program of \$20.0 million in the first quarter of fiscal 2015.

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Our investments consist principally of U.S. government and government agency obligations, asset-backed securities, mortgage-backed securities and investment grade, interest-bearing corporate and municipal debt securities with varying maturity dates, the majority of which are five years or less. Our investment policy excludes ownership of collateralized mortgage obligations, mortgage-backed derivatives and other derivative securities without prior written approval of the Board of Directors. Our investment policy requires that no more than 5% of investments be held in any one credit or issue, excluding U.S. government and government agency obligations. The primary investment objective of the portfolio is to provide for the safety of principal and appropriate liquidity while generating an above benchmark ( Merrill Lynch 1-3 Year Government-Corporate Index ) total rate of return on a pre-tax basis. Management plans to continue to direct its investment advisors to manage our securities investments primarily for the safety of principal for the foreseeable future as it continues to assess other investment opportunities and uses of its cash and securities investments, including those described below.

On November 4, 2013, we entered into a three-year \$20.0 million secured revolving credit facility. The credit facility was amended on November 5, 2014 to increase the size of stock repurchased that may be effected by the Company to \$30.0 million without the consent of the lender. Borrowings under the credit facility, if any, will bear interest at a benchmark rate plus an applicable margin based on the Company's leverage ratio. No borrowings have been made on the credit facility and the Company is in compliance with the financial covenants related to a maximum leverage ratio and a minimum EBITDA amount and nonfinancial covenants.

On July 31, 2014, we filed a registration statement with the Securities and Exchange Commission, using a shelf registration process. Under this shelf process we may sell, either separately or together, debt securities, preferred stock, depository shares, common stock and security warrants in one or more offerings up to an aggregate initial offering price of \$175 million. As of December 31, 2014, we have not completed any securities offerings associated with the registration statement.

We generated cash flows from operating activities from continuing operations of approximately \$5.5 million and \$4.3 million in the first quarter ended December 31, 2014 and 2013, respectively. The following table depicts our cash flows provided by operating activities from continuing operations:

|   | <b>Three Months Ended</b> |                 |
|---|---------------------------|-----------------|
|   | <b>December 31</b>        |                 |
|   | <b>2014</b>               | <b>2013</b>     |
| <i>(Dollars in thousands)</i>   |                           |                 |
| Net income  | \$ 3,614                  | \$ 3,630        |
| Depreciation and amortization   | 683                       | 697             |
| Stock-based compensation  | 525                       | 813             |
| Deferred tax  | 1,025                     | 395             |
| Net other operating activities  | (485)                     | (1,371)         |
| Net change in other operating assets and liabilities                        | 168                       | 86              |
| <b>Net cash provided by operating activities from continuing operations</b> | <b>\$ 5,530</b>           | <b>\$ 4,250</b> |

*Operating Activities.* We generated cash flows from operating activities from continuing operations of \$5.5 million and \$4.3 million for the first quarter ended December 31, 2014 and 2013, respectively. The first quarter of fiscal 2015 increase compared with the first quarter of fiscal 2014 reflected key changes from higher operating income and a

\$0.6 million reduction in net deferred taxes.

*Investing Activities.* We used cash in investing activities of \$2.3 million in the first quarter of fiscal 2015 compared with cash generated from investing activities of \$0.5 million in the first quarter of fiscal 2014. We invested less than \$0.1 million in property and equipment in the first quarter of fiscal 2015, compared with \$0.1 million in the prior-year period. The property and equipment investment in the first quarter of fiscal 2015 is lower than our historical range of investment. We anticipate spending \$2.1 million to \$2.4 million for the remainder of fiscal 2015 which will result in a full year increase when compared with fiscal 2014 investment. We invested \$3.2 million in available-for-sale debt securities in the first quarter of fiscal 2015 resulting from the cash generated from operations. We received cash of \$0.7 million (contingent milestone payment) in the first quarter of fiscal 2014 associated with the sale of our ownership interest in Vessix Vascular. In the first quarter of both fiscal 2015 and fiscal 2014, we invested less than \$0.1 million of cash associated with our discontinued operations.

*Financing Activities.* We used cash flows from financing activities from continuing operations of \$17.0 million in the first quarter of fiscal 2015, compared with \$9.8 million in the first quarter of fiscal 2014, principally related to share repurchase activity, including the fiscal 2015 accelerated share repurchase program described in the paragraph below. We also used cash of \$0.7 million in the first quarter of fiscal 2015 to purchase common stock to pay employee taxes resulting primarily from issuance of common shares associated with our fiscal year 2012-2014 performance share program.

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On November 11, 2014, the Company entered into an accelerated share repurchase program with Wells Fargo Bank, National Association. In connection with the agreement, the Company made an initial \$20.0 million payment to the bank and immediately received an initial delivery of 758,143 shares of its common stock with a fair value of \$16.0 million as of the purchase date. Effective as of the date of the initial share purchase, the transaction was accounted for as a share retirement, resulting in a reduction of common stock of less than \$0.1 million, additional paid-in capital of \$2.5 million and retained earnings of \$13.5 million. The remaining \$4.0 million of the Company's initial payment was also reported as a reduction in retained earnings. Upon final settlement of the program, the Company may be entitled to receive additional shares of common stock, or, under certain circumstances specified in the program, the Company may be required to deliver shares or remit a settlement amount in cash, at the Company's option. Based on the facts associated with the agreement, the forward contract is indexed to the Company's common stock and meets the U.S. GAAP requirements to be classified as permanent equity. As long as the forward contract continues to meet the requirements to be classified as permanent equity, the Company will not record future changes in its fair value. The Company expects it will continue to meet those requirements through the settlement date.

During the three months ended December 31, 2014, the Company repurchased 758,143 shares of common stock for a total of \$16.0 million under the \$30.0 million November 2014 Board authorization and as of December 31, 2014, \$14.0 million remained available for future repurchases under this authorization. The \$14.0 million includes \$4.0 million of the initial payment to Wells Fargo in the first quarter of fiscal 2015 under the accelerated share repurchase program.

The agreement with Wells Fargo expires in the fourth quarter of fiscal 2015; however the bank has the right to accelerate the end of the purchase period. Upon settlement of the contract, the Company will adjust common stock, as well as either additional paid-in capital or retained earnings, as appropriate, to reflect the final settlement amount. The specific number of shares that the Company will ultimately purchase under the accelerated share purchase agreement will be based on the volume weighted average price ( VWAP ) of the Company's common stock during the purchase period, less an agreed upon discount. The maximum amount of shares of common stock the Company can be required to issue to settle the agreement cannot exceed 1,870,907. The Company has sufficient authorized and unissued shares available to deliver the maximum share amount. For every \$1.00 increase or decrease in the Company's VWAP, based on a closing stock price of \$21.38 on November 11, 2014, the settlement amount will change by approximately 45,000 shares.

Pursuant to previously authorized share repurchases, during the first quarter of fiscal 2014, we repurchased 380,011 shares of common stock worth \$8.9 million at an average price of \$23.48 per share. We also used cash of \$1.1 million in the first quarter of fiscal 2014 to purchase common stock to pay employee taxes resulting principally from issuance of common shares associated with our fiscal year 2011-2013 performance share program.

We believe that our existing cash, cash equivalents and available-for-sale securities, which totaled \$47.6 million as of December 31, 2014, together with cash flow from operations, our \$20 million credit facility and \$175 million shelf registration statement, will provide liquidity sufficient to meet the below stated needs and fund our operations for the remainder of fiscal 2015. There can be no assurance, however, that our business will continue to generate cash flows at current levels, and disruptions in financial markets may negatively impact our ability to access capital in a timely manner and on attractive terms. Our anticipated liquidity needs for the remainder of fiscal 2015 may include, but are not limited to, the following: general capital expenditures in the range of \$2.1 million to \$2.4 million, \$10.0 million associated with the remaining authorized amount available under our share repurchase program discussed previously and any cash requirements associated with other investment opportunities.

*Discontinued Operations.* Our Pharmaceuticals discontinued operation used operating cash of less than \$0.1 million in the first quarter of fiscal 2015 and fiscal 2014. Cash generated in financing activities of less than \$0.1 million in the

first quarter of fiscal 2015 and fiscal 2014 related to transfers of cash from the continuing operations of SurModics and consisted of cash used to make payments on accrual balances.

*Customer Concentrations.* Our licensed technologies provide royalty revenue, which represents the largest revenue stream to the Company. We have licenses with a diverse base of customers and certain customers have multiple products using our technology. Medtronic, Inc. ( Medtronic ) was our largest customer comprising 19% of our consolidated revenue for fiscal 2014 and remains at this level in the first quarter of fiscal 2015. Medtronic has several separately licensed products that generate royalty revenue for SurModics, none of which represented more than 7% of SurModics total revenue. On June 15, 2014, Medtronic and Covidien PLC ( Covidien ) announced that they had entered into an agreement under which Medtronic would acquire Covidien. This transaction was approved by shareholders of both companies in January 2015, which approval was also received from the High Court of Ireland on January 26, 2015. Our revenue from the combined Medtronic/Covidien entity, on a post-merger basis, will now represent approximately 23% of our future consolidated revenue. No other individual customer using licensed technology constitutes more than 10% of SurModics total revenue.

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**Off-Balance Sheet Arrangements**

As of December 31, 2014, we did not have any off-balance sheet arrangements with any unconsolidated entities.

**Forward-Looking Statements**

This Quarterly Report on Form 10-Q, including Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 2, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include expectations concerning our growth strategy, including our ability to sign new license agreements and broaden our hydrophilic coatings royalty revenue, product development programs, various milestone achievements, research and development expenses, increased legal expenses within selling, general and administrative expenses, future cash flow and sources of funding, short-term liquidity requirements, future property and equipment investment levels, the impact of potential lawsuits or claims, and the impact of Medtronic, as well as other significant customers, including new diagnostic kit customers. Without limiting the foregoing, words or phrases such as anticipate, believe, could, estimate, expect, forecast, intend, may, possible, project, will and similar terminology, generally identify forward-looking statements. Forward-looking statements may also represent challenging goals for us. These statements, which represent the Company's expectations or beliefs concerning various future events, are based on current expectations that involve a number of risks and uncertainties that could cause actual results to differ materially from those of such forward-looking statements. We caution that undue reliance should not be placed on such forward-looking statements, which speak only as of the date made. Some of the factors which could cause results to differ from those expressed in any forward-looking statement are set forth under Risk Factors in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2014. We disclaim any intent or obligation to update publicly these forward-looking statements, whether because of new information, future events or otherwise.

Although it is not possible to create a comprehensive list of all factors that may cause actual results to differ from our forward-looking statements, such factors include, among others:

our reliance on a small number of significant customers, which causes our financial results and stock price to be subject to factors affecting those significant customers and their products, the timing of market introduction of their or competing products, product safety or efficacy concerns and intellectual property litigation could adversely affect our growth strategy and the royalty revenue we derive;

general economic conditions which are beyond our control, such as the impact of recession, customer mergers and acquisitions (including the merger of Medtronic, our largest customer, with Covidien), business investment and changes in consumer confidence;

a decrease in our available cash or the value of our investment holdings could impact short-term liquidity requirements and expected capital and other expenditures;

the difficulties and uncertainties associated with the lengthy and costly new product development and foreign and domestic regulatory approval processes, such as delays, difficulties or failures in achieving acceptable clinical results or obtaining foreign or U.S. Food and Drug Administration marketing

clearances or approvals, which may result in lost market opportunities or postpone or preclude product commercialization by licensees;

the development of new products or technologies by competitors, technological obsolescence and other changes in competitive factors;

our ability to perform successfully certain product development activities, the related R&D expense impact and governmental and regulatory compliance activities which we have not previously undertaken in any significant manner; and

other factors described in Risk Factors and other sections of SurModics Annual Report on Form 10-K for the fiscal year ended September 30, 2014, which you are encouraged to read carefully.

Many of these factors are outside the control and knowledge of us, and could result in increased volatility in period-to-period results. Investors are advised not to place undue reliance upon our forward-looking statements and to consult any further disclosures by us on this subject in its filings with the SEC.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Our investment policy requires investments with high credit quality issuers and limits the amount of credit exposure to any one issuer. Our investments consist principally of U.S. government and government agency obligations, mortgage-backed securities, municipal bonds, asset-backed securities and corporate bonds with varying maturity dates, the majority of which are five years or less. Because of the credit criteria of our investment policies, the primary market risk associated with these investments is interest rate risk.

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We do not use derivative financial instruments to manage interest rate risk or to speculate on future changes in interest rates. A one percentage point increase in interest rates would result in an approximate \$0.4 million decrease in the fair value of our available-for-sale securities as of December 31, 2014, but would have no material impact on the results of operations or cash flows.

Management believes that a reasonable change in raw material prices would not have a material impact on future earnings or cash flows because our inventory exposure is not material.

Although we conduct business in foreign countries, our international operations consist primarily of sales of reagent and stabilization chemicals. Additionally, all sales transactions are denominated in U.S. dollars. We generate royalty revenue from the sale of customer products in foreign jurisdictions. Royalties generated in foreign jurisdictions by customers are converted and paid in U.S. dollars per contractual terms. To the extent our customers transact sales in foreign jurisdictions, we will realize reduced royalty revenue resulting from the recent strengthening of the U.S. dollar as our customers convert local currency revenue and related royalty obligations to U.S. dollars. Given the diverse nature of our customers' products and international operations, changes in foreign currencies are not expected to materially impact our operating results. A limited number of our purchasing transactions are denominated in foreign currencies and they are converted to U.S. dollars. These purchasing transactions are not material to our operating results. Accordingly, we do not expect to be subject to material foreign currency risk with respect to future costs or cash flows from our foreign sales. To date, we have not entered into any foreign currency forward exchange contracts or other derivative financial instruments to hedge the effects of adverse fluctuations in foreign currency exchange.

## **Item 4. Controls and Procedures**

### **Evaluation of Disclosure Controls and Procedures**

Our Chief Executive Officer and Chief Financial Officer, referred to collectively herein as the Certifying Officers, are responsible for establishing and maintaining our disclosure controls and procedures. The Certifying Officers have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the Exchange Act)) as of December 31, 2014. Based on that review and evaluation, which included inquiries made to certain other employees of the Company, the Certifying Officers have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures, as designed and implemented, are effective to ensure that information required to be disclosed by the Company in reports that it files under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the Securities Exchange Commission rules and forms, and to ensure that information required to be disclosed by the Company in the reports the Company files or submits under the Exchange Act is accumulated and communicated to the Company's manager, including its Certifying Officers, as appropriate, to allow timely decisions regarding required disclosures.

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

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) during the three months ended December 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

There have been no material developments in the legal proceedings previously disclosed in the Company's Form 10-K for the fiscal year ended September 30, 2014.

**Item 1A. Risk Factors**

In our report on Form 10-K for the fiscal year ended September 30, 2014, filed with the SEC on December 5, 2014, we identify under Part 1, Item 1A. Risk Factors, important factors which could affect our financial performance and could cause our actual results for future periods to differ materially from our anticipated results or other expectations, including those expressed in any forward-looking statements made in this Form 10-Q.

There have been no material changes in our risk factors subsequent to the filing of our Form 10-K for the fiscal year ended September 30, 2014.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****(c) Issuer Purchases of Equity Securities**

The following table presents information with respect to purchases of common stock of the Company made during the three months ended December 31, 2014, by the Company or on behalf of the Company or any affiliated purchaser of the Company, as defined in Rule 10b-18(a)(3) under the Exchange Act.

| <b>Period</b>      | <b>Total Number of Shares Purchased (1)</b> | <b>Average Price Paid per Share (1)</b> | <b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b> | <b>Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs (2)</b> |
|--------------------|---|---|---|---|
| 10/1/14 - 10/31/14 | 0   | N/A                                     | 0   | \$ 8  |
| 11/1/14 - 11/30/14 | 759,632                                     | \$ 21.10                                | 758,143   | \$ 14,000,000   |
| 12/1/14 - 12/31/14 | 32,963                                      | \$ 21.03                                | 0   | \$ 14,000,000   |
| <b>Total</b>       | <b>792,595</b>                              | <b>\$ 21.10</b>                         | <b>758,143</b>  | <b>\$ 14,000,000</b>  |

(1) The purchases in this column included shares repurchased as part of our publicly announced program and in addition include 32,963 shares that were repurchased by the Company to satisfy tax withholding obligations in

connection with so-called stock swap exercises related to the issuance of performance share awards and vesting of restricted stock awards.

- (2) On November 5, 2014, our Board of Directors authorized the repurchase of up to \$30.0 million of our outstanding common stock in open-market purchases, privately negotiated transactions, block trades, accelerated share repurchase transactions, tender offers or by any combination of such methods. The authorization has no fixed expiration date.

On November 11, 2014, the Company entered into an accelerated share repurchase program with Wells Fargo Bank, National Association. In connection with the agreement, the Company made an initial \$20.0 million payment to the bank and immediately received an initial delivery of 758,143 shares of its common stock with a fair value of \$16.0 million as of the purchase date. Effective as of the date of the initial share purchase, the transaction was accounted for as a share retirement, resulting in a reduction of common stock of less than \$0.1 million, additional paid-in capital of \$2.5 million, and retained earnings of \$13.5 million. The remaining \$4.0 million of the Company's initial payment was also reported as a reduction in retained earnings. Upon final settlement of the program, the Company may be entitled to receive additional shares of common stock, or, under certain circumstances specified in the program, the Company may be required to deliver shares or remit a settlement amount in cash, at the Company's option. The table above includes the initial payment of \$4.0 million to Wells Fargo in the approximated dollar value of shares that may yet be purchased column until the final delivery of shares which is expected to be completed at the latest in the fourth quarter of fiscal 2015.

The specific number of shares that the Company will ultimately purchase under the accelerated share purchase agreement will be based on the volume weighted average price ( VWAP ) of the Company's common stock during the purchase period, less an

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agreed upon discount. The agreement expires in the fourth quarter of fiscal 2015; however the bank has the right to accelerate the end of the purchase period. Upon settlement of the contract, the Company will adjust common stock, as well as either additional paid-in capital or retained earnings, as appropriate, to reflect the final settlement amount.

Through December 31, 2014, we have repurchased 758,143 shares at an average price of \$21.10 under the November 2014 authorization and as of December 31, 2014 there remains \$14.0 million available to repurchase shares in the future. The repurchase authorization does not have a fixed expiration date.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not Applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

| <b>Exhibit</b> | <b>Description</b>   |
|----------------|--|
| 3.1            | Restated Articles of Incorporation, as amended - incorporated by reference to Exhibit 4.1 of the Company's Registration Statement on Form S-3 filed on July 31, 2014, SEC File No. 333-197757.   |
| 3.2            | Restated Bylaws of SurModics, Inc., as amended November 30, 2009 - incorporated by reference to Exhibit 3.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 2009, SEC File No. 0-23837.  |
| 10.1           | First Amendment to Credit Agreement dated November 5, 2014, by and between SurModics, Inc., and Wells Fargo Bank, National Association - incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on November 6, 2014, SEC File No. 000-23837.  |
| 10.2           | Fixed Discounted Share Buyback ( DSB ) with Initial Delivery Agreement dated November 11, 2014, by and between SurModics, Inc. and Wells Fargo Bank, National Association - incorporated by reference to Exhibit 10.31 of the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2014, SEC File No. 000-23837. |
| 10.3*          | Form of Restricted Stock Unit Agreement (Non-Employee Director) - SurModics, Inc. 2009 Equity Incentive Plan.  |
| 10.4*          | Form of Deferred Stock Unit Agreement (Non-Employee Director) - SurModics, Inc. 2009 Equity Incentive Plan.  |

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- 10.5\* Form of Restricted Stock Agreement - SurModics, Inc. 2009 Equity Incentive Plan.
- 12\* Computation of Ratio of Earnings to Fixed Charges.
- 31.1\* Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
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- 32.1\* Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\* Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101\* Financial statements from the Quarterly Report on Form 10-Q for SurModics, Inc. for the quarterly period ended December 31, 2014, filed on February 4, 2015, formatted in Extensible Business Reporting Language (XBRL): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Income, (iii) Condensed Consolidated Statements of Comprehensive Income, (iv) Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements.

\* Filed herewith

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**SIGNATURES**

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

February 4, 2015

**SurModics, Inc.**

By: /s/ Andrew D. C. LaFrence  
Andrew D. C. LaFrence  
Vice President of Finance and  
Chief Financial Officer  
(duly authorized signatory and  
  
principal financial officer)

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**EXHIBIT INDEX TO FORM 10-Q**  
**For the Quarter Ended December 31, 2014**  
**SURMODICS, INC.**

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| 101.INS*       | XBRL Instance Document   |
| 101.SCH*       | XBRL Taxonomy Extension Schema Document  |
| 101.CAL*       | XBRL Taxonomy Extension Calculation Linkbase Document  |

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101.DEF\* XBRL Taxonomy Extension Definition Linkbase Document  
101.LAB\* XBRL Taxonomy Extension Label Linkbase Document  
101.PRE\* XBRL Taxonomy Extension Presentation Linkbase Document

\* Filed herewith