

SURMODICS INC  
Form 10-Q  
August 06, 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 June 30, 2015**

**or**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 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 July 31, 2015 was 12,932,028.

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

## Item 1. Financial Statements

**SurModics, Inc. and Subsidiaries**

## Condensed Consolidated Balance Sheets

	June 30, 2015	September 30, 2014
<i>(Unaudited)</i>		
<i>(in thousands, except share and per share data)</i>		
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 54,108	\$ 43,511
Available-for-sale securities		3,040
Accounts receivable, net of allowance for doubtful accounts of \$10 and \$42 as of June 30, 2015 and September 30, 2014, respectively	5,995	4,751
Inventories	3,464	2,817
Deferred tax assets	470	394
Income tax receivable	649	59
Prepays and other	624	692
Current assets of discontinued operations		16
<b>Total Current Assets</b>	<b>65,310</b>	<b>55,280</b>
Property and equipment, net	12,102	13,133
Available-for-sale securities		16,823
Deferred tax assets	6,197	6,718
Intangible assets, net	2,389	2,946
Goodwill	8,010	8,010
Other assets, net	1,979	1,979
<b>Total Assets</b>	<b>\$ 95,987</b>	<b>\$ 104,889</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 958	\$ 1,028
Accrued liabilities:		
Compensation	2,135	2,061
Accrued other	1,112	881
Deferred revenue	49	52
Current liabilities of discontinued operations		45
<b>Total Current Liabilities</b>	<b>4,254</b>	<b>4,067</b>
Deferred revenue, less current portion	227	226
Other long-term liabilities	1,778	1,845

Total Liabilities	6,259	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; 13,022,396 and 13,606,545 shares issued and outstanding, respectively	651	680
Additional paid-in capital	2,276	2,662
Accumulated other comprehensive (loss) income	(3)	1,528
Retained earnings	86,804	93,881
Total Stockholders' Equity	89,728	98,751
Total Liabilities and Stockholders' Equity	\$ 95,987	\$ 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

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2015	2014	2015	2014
<i>(In thousands, except per share data)</i>				
<b>Revenue:</b>				
Royalties and license fees	\$ 7,908	\$ 7,385	\$ 22,566	\$ 22,179
Product sales	6,583	6,067	18,082	16,632
Research and development	1,423	1,164	3,887	3,292
<b>Total revenue</b>	<b>15,914</b>	<b>14,616</b>	<b>44,535</b>	<b>42,103</b>
<b>Operating costs and expenses:</b>				
Product costs	2,174	2,037	6,031	5,737
Research and development	3,860	3,655	11,839	11,488
Selling, general and administrative	4,023	3,591	11,841	11,736
<b>Total operating costs and expenses</b>	<b>10,057</b>	<b>9,283</b>	<b>29,711</b>	<b>28,961</b>
<b>Operating income</b>	<b>5,857</b>	<b>5,333</b>	<b>14,824</b>	<b>13,142</b>
<b>Other income:</b>				
Investment income, net	36	42	149	194
Gain on sales of strategic investments		28		709
Other (loss) income, net	(40)		496	125
<b>Other (loss) income, net</b>	<b>(4)</b>	<b>70</b>	<b>645</b>	<b>1,028</b>
<b>Income from continuing operations before income taxes</b>	<b>5,853</b>	<b>5,403</b>	<b>15,469</b>	<b>14,170</b>
Income tax provision	(1,929)	(1,729)	(4,879)	(4,407)
<b>Income from continuing operations</b>	<b>3,924</b>	<b>3,674</b>	<b>10,590</b>	<b>9,763</b>
Loss from discontinued operations, net of income taxes		(76)		(76)
<b>Net income</b>	<b>\$ 3,924</b>	<b>\$ 3,598</b>	<b>\$ 10,590</b>	<b>\$ 9,687</b>
<b>Basic net income (loss) per share:</b>				
Continuing operations	\$ 0.30	\$ 0.27	\$ 0.81	\$ 0.72
Discontinued operations	0.00	(0.01)	0.00	(0.01)
<b>Net income</b>	<b>\$ 0.30</b>	<b>\$ 0.26</b>	<b>\$ 0.81</b>	<b>\$ 0.71</b>
<b>Basic net income (loss) per share:</b>				

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Diluted net income per share				
Continuing operations	\$ 0.30	\$ 0.27	\$ 0.79	\$ 0.70
Discontinued operations	0.00	(0.01)	0.00	(0.01)
Net income	\$ 0.30	\$ 0.26	\$ 0.79	\$ 0.70
Weighted average number of shares outstanding:				
Basic	13,002	13,585	13,057	13,639
Diluted	13,279	13,813	13,324	13,891

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>Nine Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
<i>(In thousands)</i>	<i>(Unaudited)</i>		<i>(Unaudited)</i>	
Net income	\$ 3,924	\$ 3,598	\$ 10,590	\$ 9,687
Other comprehensive income (loss), net of tax:				
Unrealized holding gains (losses) on available-for-sale securities arising during the period	(59)	46	(1,216)	62
Reclassification adjustment for realized gains included in net income	26		(315)	(84)
Other comprehensive income (loss)	(33)	46	(1,531)	(22)
Comprehensive income	\$ 3,891	\$ 3,644	\$ 9,059	\$ 9,665

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>Nine Months Ended</b>	
	<b>June 30,</b>	
	<b>2015</b>	<b>2014</b>
	<i>(Unaudited)</i>	
<i>(in thousands)</i>		
<b>Operating Activities:</b>		
Net income	\$ 10,590	\$ 9,687
Adjustments to reconcile net income to net cash provided by operating activities from continuing operations:		
Loss from discontinued operations		76
Depreciation and amortization	2,083	2,054
Stock-based compensation	1,841	3,043
Deferred taxes	450	(98)
Gain on sales of available-for-sale securities and strategic investments	(496)	(835)
Excess tax benefit from stock-based compensation plans	(436)	(452)
Other	(42)	
Change in operating assets and liabilities, excluding the impact from discontinued operations:		
Accounts receivable	(1,244)	156
Inventories	(647)	428
Prepays and other	66	(114)
Accounts payable and accrued liabilities	132	(919)
Income taxes	(221)	(560)
<b>Net cash provided by operating activities from continuing operations</b>	<b>12,076</b>	<b>12,466</b>
<b>Investing Activities:</b>		
Purchases of property and equipment	(396)	(1,165)
Cash proceeds from sales of property and equipment	42	
Purchases of available-for-sale securities	(3,377)	(132,648)
Sales and maturities of available-for-sale securities	22,199	157,970
Cash received from sales of strategic investments	21	708
Cash transferred to discontinued operations	(45)	(239)
<b>Net cash provided by investing activities from continuing operations</b>	<b>18,444</b>	<b>24,626</b>
<b>Financing Activities:</b>		
Excess tax benefit from stock-based compensation plans	436	452
Issuance of common stock	451	348
Repurchase of common stock	(20,000)	(12,544)
Purchase of common stock to pay employee taxes	(810)	(1,114)
<b>Net cash used in financing activities from continuing operations</b>	<b>(19,923)</b>	<b>(12,858)</b>

Net cash provided by continuing operations	10,597	24,234
<b>Discontinued Operations:</b>		
Net cash used in operating activities	(45)	(239)
Net cash provided by financing activities	45	239
Net cash provided by discontinued operations		
Net change in cash and cash equivalents	10,597	24,234
Cash and Cash Equivalents:		
Beginning of period	43,511	15,495
End of period	\$ 54,108	\$ 39,729
<b>Supplemental Information:</b>		
Cash paid for income taxes	\$ 4,651	\$ 4,860
Noncash transactions acquisition of property and equipment on account	\$ 113	\$ 224
Noncash transactions issuance of performance shares, restricted and deferred stock units	\$ 2,250	\$ 3,007
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 June 30, 2015**

**(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 net income in the period in which the change in estimate is identified. The results of operations for the three and nine months ended June 30, 2015 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 by SurModics, 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. The original pronouncement was effective for the Company beginning in fiscal 2018 (October 1, 2017), and early adoption was not permitted. On July 9, 2015 the FASB approved a one-year deferral of the effective date for the revenue recognition standard. As a result of the one-year deferral, the revenue recognition standard is effective for the Company beginning in fiscal 2019 (October 1, 2018), however, the Company may adopt this guidance as of the original effective date. This guidance can be adopted by the Company either retrospectively (October 1, 2016) or as a cumulative-effect adjustment as of the date of adoption. The Company is currently evaluating the impact that the adoption of 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 SMP, LLC ( 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 and nine months ended June 30, 2015. In June 2014, the Company resolved the previously disclosed litigation involving SRI, two of SRI's former employees and SurModics Pharmaceuticals. In connection with the resolution of the litigation, the Company recorded an additional expense within discontinued operations, of \$0.1 million in the three and nine months ended June 30, 2014. Total assets and liabilities of discontinued operations were zero as of June 30, 2015 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. This investment was sold in the second quarter of fiscal 2015 generating a realized gain of \$0.5 million. 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 for the quarter ended June 30, 2015 consisted of money market funds and commercial paper instruments. For the year ended September 30, 2014 the Company's Level 2 assets consisted 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 June 30, 2015 and 2014 or September 30, 2014 and there was no Level 3 activity during the first nine months of fiscal 2015 or fiscal 2014.

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In valuing assets and liabilities, the Company is required to maximize the use of quoted market prices and minimize the use of unobservable inputs.

*Assets and Liabilities Measured at Fair Value on a Recurring Basis*

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.

During the quarter ended June 30, 2015, the Company liquidated its investment portfolio to support corporate initiatives. As a result, the ending balance of available-for-sale investments as of June 30, 2015 was zero. The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of June 30, 2015:

<i>(Dollars in thousands)</i>	<b>Quoted Prices in Active Markets for Identical Instruments (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>	<b>Total Fair Value as of June 30, 2015</b>
<b>Assets:</b>				
Cash equivalents	\$	\$ 50,075	\$	\$ 50,075
<b>Total assets measured at fair value</b>	<b>\$</b>	<b>\$ 50,075</b>	<b>\$</b>	<b>\$ 50,075</b>

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 Active Markets for Identical Instruments (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>	<b>Total Fair Value as of September 30, 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>				
U.S. government and government agency obligations		7,394		7,394
Mortgage-backed securities		5,545		5,545

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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 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 highly active or active markets underlying the securities.

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Investments consist principally of U.S. government and government agency obligations, mortgage-backed securities and corporate and municipal debt securities and are classified as available-for-sale at 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. 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.

During the quarter ended June 30, 2015 the Company liquidated its investment portfolio to support corporate initiatives, as a result the ending balance of available-for-sale investments as of June 30, 2015 was zero. The amortized cost, unrealized holding gains and losses, and fair value of available-for-sale securities as of September 30, 2014 were as follows:

<i>(Dollars in thousands)</i>	September 30, 2014			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
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
<b>Total</b>	<b>\$ 18,347</b>	<b>\$ 1,617</b>	<b>\$ (101)</b>	<b>\$ 19,863</b>

As of 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 did not have the intent to sell, nor was it more likely than not that the Company would be required to sell, before recovery of their amortized cost. The following table summarizes sales of available-for-sale debt securities:

<i>(Dollars in thousands)</i>	Three Months Ended June 30,		Nine Months Ended June 30,	
	2015	2014	2015	2014
Proceeds from sales	\$ 19,071	\$ 65,455	\$ 21,722	\$ 157,970
Gross realized gains	\$ 26	\$	\$ 26	\$ 126

Gross realized losses	\$	(65)	\$	\$	(73)	\$	(1)
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**Table of Contents****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>June 30, 2015</b>	<b>September 30, 2014</b>
Raw materials	\$ 1,328	\$ 1,056
Finished products	2,136	1,761
<b>Total</b>	<b>\$ 3,464</b>	<b>\$ 2,817</b>

**7. Other Assets**

Other assets consist principally of strategic investments as follows:

<i>(Dollars in thousands)</i>	<b>June 30, 2015</b>	<b>September 30, 2014</b>
CeloNova BioSciences, Inc.	\$ 1,500	\$ 1,500
ViaCyte, Inc.	479	479
<b>Other assets, net</b>	<b>\$ 1,979</b>	<b>\$ 1,979</b>

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 an additional other-than-temporary impairment loss on this investment totaling \$0.1 million based on a then 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 ViaCyte'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 June 30, 2015 and 2014, the Company recorded amortization expense of \$0.2 million for each period. For the nine months ended June 30, 2015 and 2014, the Company recorded amortization expense of \$0.6 million for each period.

Intangible assets consisted of the following:

	<b>June 30, 2015</b>			
<i>(Dollars in thousands)</i>	<b>Weighted Average Original Life (Years)</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net</b>
<b>Definite-lived intangible assets:</b>				
Customer lists	9.0	\$ 4,857	\$ (4,218)	\$ 639
Core technology	8.0	530	(524)	6
Patents and other	16.8	2,256	(1,092)	1,164
Subtotal		7,643	(5,834)	1,809
<b>Unamortized intangible assets:</b>				
Trademarks		580		580
Total		\$ 8,223	\$ (5,834)	\$ 2,389

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<i>(Dollars in thousands)</i>	September 30, 2014				
	Weighted Average Original Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net	
<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	
Subtotal		7,643	(5,277)	2,366	
<b>Unamortized intangible assets:</b>					
Trademarks		580		580	
Total		\$ 8,223	\$ (5,277)	\$ 2,946	

Based on the intangible assets in service as of June 30, 2015, 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	\$ 175
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.

The \$8.0 million of goodwill at June 30, 2015 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 nine months of fiscal 2015 associated with the In Vitro Diagnostics reporting unit to indicate that the goodwill has been impaired.

**10. Stock-based Compensation**

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 June 30,</b>		<b>Nine Months Ended June 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Product costs	\$ 5	\$ 4	\$ 18	\$ 13
Research and development	56	38	171	136
Selling, general and administrative	568	538	1,652	2,894
Total	\$ 629	\$ 580	\$ 1,841	\$ 3,043

As of June 30, 2015, approximately \$2.4 million of total unrecognized compensation costs related to non-vested awards is expected to be recognized over a weighted average period of approximately 2.1 years. The unrecognized compensation costs above include \$0.4 million, remaining to be expensed over the life of the awards, based on payout levels associated with performance share awards that are currently anticipated to be fully expensed because the performance conditions are expected to exceed minimum threshold levels.

**Table of Contents***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 June 30, 2015 and 2014 were \$8.85 and \$8.69, respectively. The weighted average per share fair values of stock options granted during the nine months ended June 30, 2015 and 2014 were \$7.25 and \$8.72, respectively. The assumptions used as inputs in the model were as follows:

	Three Months Ended		Nine Months Ended	
	June 30,		June 30,	
	2015	2014	2015	2014
Risk-free interest rates	1.2%	1.6%	1.4%	1.2%
Expected life (years)	4.4	4.8	4.5	4.6
Expected volatility	38.5%	43.9%	43.2%	44.5%
Dividend yield	0.0%	0.0%	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 was determined based on the Company's experience. Expected volatility was based on the Company's stock price movement over a period approximating the expected term. Based on management's judgment, dividend rates were expected to be zero for the expected life of the options. The Company also estimates forfeitures of options granted, which were 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 and nine months ended June 30, 2015 was \$0.3 million and \$1.7 million, respectively. The total pre-tax intrinsic value of options exercised during the three months and nine months ended June 30, 2014 was \$0.2 million and \$1.3 million, respectively. The intrinsic value represents the difference between the exercise price and the fair market value of the Company's common stock on the last day of the respective fiscal period end.

The Company modified stock option awards granted to Board members in February 2014, which resulted in acceleration of the stock option vesting period. The modification changed the vesting period to pro-rata over a 12-month service period and resulted in an increase to stock option related expense of \$0.6 million in the three and nine months ended June 30, 2014.

*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 the key employees if they are employed by the Company at the end of the vesting period. Compensation expense has been recognized for the estimated fair value of the common shares and is being recognized over the vesting term. The stock-based compensation table above includes Restricted Stock expenses

recognized related to these awards, which totaled \$0.1 million for the three months ended June 30, 2015, and \$0.2 million for the nine months ended June 30, 2015 and totaled less than \$0.1 million and \$0.2 million, respectively, for the three months and nine months ended June 30, 2014. In February 2014, the Company granted an award of \$0.2 million to the former Chairman of its Board of Directors in connection with his retirement from the Board and in recognition of his contributions to the Company during his years of service.

#### *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 ). 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 objectives 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) and fiscal 2014 (2014 – 2016), and are 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

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and resulted in the 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. Compensation expense was recognized in each period based on management's best estimate of the achievement level of actual and forecasted results, as appropriate, compared with the specified performance objectives for Performance Shares. For the three and nine months ended June 30, 2015, the Company recognized expense of \$0.2 million and \$0.5 million, respectively. For the three and nine months ended June 30, 2014, the Company recognized expense of \$0.2 million and \$0.7 million, respectively. The stock-based compensation table above includes the Performance Shares expense.

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.

The aggregate number of shares that could be awarded to our executives if the minimum, target and maximum performance goals are met, based on 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 June 30, 2015 there was \$0.1 million of employee contributions and as of June 30, 2014 there was less than \$0.1 million of employee contributions included in accrued liabilities in the condensed consolidated balance sheets. Stock compensation expense recognized related to the Stock Purchase Plan for the three and nine months ended June 30, 2015 and 2014 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 nine months ended June 30, 2015, 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 June 30, 2015 and there were forfeitures of 3,068 shares and issuances of 7,681 shares in the nine months ended June 30, 2015. The Company realized forfeitures of 3,417 RSU's and issuances 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 and \$0.2 million in the three and nine months ended June 30, 2015, respectively, and \$0.1 million and \$0.3 million in the three and nine months ended June 30, 2014, respectively. The RSU awards were modified in the second quarter of fiscal 2014 to vest pro-rata over a 12-month service period. This modification resulted in an additional expense of \$0.2 million in the

three and nine months ended June 30, 2014.

Directors can also elect to receive their cash retainers for services to the Board of Directors and its committees in the form of fully vested deferred stock units ( DSU ). Certain directors elected this option beginning on January 1, 2013, with deferral elections made on an annual basis, which has resulted in 1,547 and 4,433 DSUs issued with a total fair value of less than \$0.1 million in both the three and nine months ended June 30, 2015. The stock-based compensation table above includes DSU expenses recognized related to these awards, which totaled less than \$0.1 million in both the three months and nine months ended June 30, 2015 as well as the three and nine months ended June 30, 2014.

#### **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.

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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 to comply with nonfinancial covenants. As of June 30, 2015, the Company has no debt outstanding and was in compliance with all financial covenants.

**12. Net Income Per Share Data**

Basic net income per common share is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common and common equivalent shares outstanding during the period. The Company's 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 net income per share (in thousands):

	<b>Three Months Ended June 30,</b>		<b>Nine Months Ended June 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Net income from continuing operations available to common shareholders	\$ 3,924	\$ 3,674	\$ 10,590	\$ 9,763
Basic weighted average shares outstanding	13,002	13,585	13,057	13,639
Dilutive effect of outstanding stock options, non-vested restricted stock, restricted stock units, deferred stock units and performance shares	277	228	267	252
Diluted weighted average shares outstanding	13,279	13,813	13,324	13,891

The calculation of weighted average diluted shares outstanding excludes outstanding stock options associated with the right to purchase 0.2 million and 0.6 million shares of common stock for the three months ended June 30, 2015 and 2014, respectively, and 0.3 million and 0.4 million for the nine months ended June 30, 2015 and 2014, respectively, as their inclusion would have had an antidilutive effect on diluted net 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. As part of the accelerated share repurchase (ASR) program discussed below, the Company repurchased 758,143 shares of common stock on November 11, 2014 and 89,721 shares of common stock on July 8, 2015, the date that the ASR program was completed. As adjusted for the final ASR program settlement, \$10.0 million remained available for future repurchases under the current authorization.

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 a \$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 payment was also reported as a reduction in retained earnings. The specific number of shares that the Company ultimately purchased under the ASR agreement was based on the volume weighted average price ( VWAP ) of the Company's common stock during the purchase period, less an agreed upon discount. In the aggregate, the Company purchased 847,864 shares under the ASR program for an average price of \$23.59 per share. 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 of June 30, 2015.

During the first nine months of fiscal 2014, the Company repurchased 485,577 shares of common stock for a total of \$11.5 million under the then-existing share repurchase authorization of the Board. This entire authorized amount under the then existing authorization was used as of June 30, 2014.

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**Table of Contents****13. Income Taxes**

The Company recorded income tax provisions associated with income from continuing operations of \$1.9 million and \$1.7 million for the three months ended June 30, 2015 and 2014, respectively, representing effective tax rates of 32.9% and 32.0%, respectively. The Company recorded income tax provisions associated with income from continuing operations of \$4.9 million and \$4.4 million for the nine months ended June 30, 2015 and 2014, respectively, representing effective tax rates of 31.5% and 31.1%, respectively. The difference between the U.S. federal statutory tax rate of 35.0% and the Company's effective tax rate for the three and nine months ended June 30, 2015 and 2014 reflects the impact of state income taxes, permanent tax items such as valuation allowance releases associated with net gains from our strategic investments and our available-for-sale securities portfolio, discrete tax benefits and the Section 199 manufacturing deduction. Discrete tax benefits aggregated less than \$0.1 million and \$0.3 million for the three and nine months ended June 30, 2015, respectively, as well as the same respective periods ended June 30, 2014.

The discrete tax items in the fiscal 2015 nine-month period includes a \$0.2 million income 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 previously expired in December 2013.

The nine months ended June 30, 2015 income tax provision includes the impact of a \$0.5 million gain from the sale of Intersect ENT with an offsetting reversal of a capital loss carryforward valuation allowance. The nine months ended June 30, 2014 income tax provision includes the impact of gains related to two Vessix Vascular, Inc. contingent consideration payments totaling \$0.7 million and gains related to certain debt securities in our available-for-sale securities portfolio of \$0.1 million. Each of these gains has had a tax expense recognized which has been fully offset by the reversal of capital loss carryforward valuation allowances.

The Company did not have any discontinued operations activity in the three and nine months ended June 30, 2015. The Company recorded an income tax benefit from discontinued operations of less than \$0.1 million in each of the three and nine months ended June 30, 2014 which resulted in an effective tax rate associated with discontinued operations of 34.8% in each period.

The total amount of unrecognized tax benefits, including interest and penalties that, if recognized, would affect the effective tax rate as of June 30, 2015 and September 30, 2014, respectively, are \$1.0 million and \$0.9 million. 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 2012 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 ) totaled less than \$0.1 million and \$0.5 million, respectively, on a pre-tax basis for the three and nine months ended June 30, 2015. There were no amounts reclassified out of AOCI for the three months ended June 30, 2014. The amounts reclassified out of AOCI totaled \$0.1 million, on a pre-tax basis, for the nine months ended June 30, 2014. The amounts reclassified out of AOCI are

associated with unrealized gains or losses on available-for-sale securities that were realized on the sale of the securities and are presented in other income, 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, 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 and depreciation and amortization, as follows:

<i>(Dollars in thousands)</i>	<b>Three Months Ended June 30,</b>		<b>Nine Months Ended June 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
<b>Revenue:</b>				
Medical Device	\$ 11,629	\$ 10,821	\$ 32,827	\$ 31,852
In Vitro Diagnostics	4,285	3,795	11,708	10,251
Total revenue	\$ 15,914	\$ 14,616	\$ 44,535	\$ 42,103
<b>Operating income:</b>				
Medical Device	\$ 6,295	\$ 5,855	\$ 16,507	\$ 16,466
In Vitro Diagnostics	1,191	974	3,220	2,277
Total segment operating income	7,486	6,829	19,727	18,743
Corporate	(1,629)	(1,496)	(4,903)	(5,601)
Total operating income	\$ 5,857	\$ 5,333	\$ 14,824	\$ 13,142
<b>Depreciation and amortization:</b>				
Medical Device	\$ 288	\$ 281	\$ 852	\$ 862
In Vitro Diagnostics	215	214	645	641
Corporate	191	179	586	551
Total depreciation and amortization	\$ 694	\$ 674	\$ 2,083	\$ 2,054

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 operating segment is not presented because the Company does not provide its chief operating decision maker assets by operating 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 contract, 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 condensed 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.

During the second quarter of fiscal 2015, a customer notified the Company that it believes it overpaid approximately \$5.7 million in hydrophilic coating royalties to the Company from January 2009 through September 2014. The customer also seeks interest on its alleged overpayments. In accordance with the underlying agreement between the Company and the customer, the Company has requested certain factual documentation from the customer related to the claim. The Company has not yet received adequate documentation from the customer to assess the customer's claim. As of June 30, 2015, the Company has not recorded an accrual for this claim. Any potential loss is not estimable based on information available to the Company as of June 30, 2015 or subsequent to quarter end.

*InnoRx, Inc.* In January 2005, the Company entered into a merger agreement whereby the Company acquired all of the assets of InnoRx, Inc. ( InnoRx ), an early stage company developing drug delivery devices and therapies for the ophthalmology market. The Company 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 June 30, 2015 as the milestones have not been achieved and the probability of achievement is low.

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*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 included peripheral, coronary and neurovascular biodurable stent products. The license requires an annual minimum payment of 200,000 euros (equivalent to \$222,000 using a euro to US dollar exchange rate of 1.10944 as of June 30, 2015) until the last patent expires which is currently estimated to be September 2027. The total minimum future payments associated with this license are approximately \$2.7 million. The license is currently utilized by one of the Company's 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 our audited condensed consolidated financial statements and related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations each 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 was driven by growth from our Medical Device hydrophilic coatings royalty revenue and product sales as well as contract coating services which are included in research and development revenue. Medical Device segment revenue continued its growth in the first nine months of fiscal 2015. Our In Vitro Diagnostics segment realized significant revenue improvement in the first nine months of fiscal 2015. In particular, the In Vitro Diagnostics segment revenue increased 14% in the first nine months of fiscal year 2015 compared with the same prior-year period. The current year-to-date period benefited from a lower prior-year comparison as the In Vitro Diagnostics revenue had declined 21% in the second quarter of fiscal 2014 as the result of customer inventory rebalancing activities.

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, 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 protein stabilization reagent products, substrates, antigens 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 our 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 each quarter; 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 proprietary surface modification 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 is 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. The royalty obligation in our typical license agreement is generally for a specified number of years or the life of the applicable license patents, whichever is longer. A majority of the customer products utilizing our third 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

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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.

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. One of our most significant internal R&D programs involves our SurModics SurVeil Drug Coated Balloon, a development stage product being designed 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 calendar year 2015. Ultimately, our ability to initiate a first-in-human study of the SurModics *SurVeil* Drug Coated Balloon on any particular time frame depends on our obtaining the necessary regulatory approval in the country where we will conduct the study, a process that is often costly and time-consuming. There can be no assurance that we will be successful in obtaining regulatory approval to initiate a first-in-human study for this product.

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 and Nine Months Ended June 30**

**Revenue.** Revenue during the third quarter of fiscal 2015 was \$15.9 million, an increase of \$1.3 million, or 8.9%, compared with the third quarter of fiscal 2014. Revenue during the first nine months of fiscal 2015 was \$44.5 million, an increase of \$2.4 million, or 5.8%, compared with the same period of fiscal 2014. The increase in revenue, as detailed in the table below, is further explained in the narrative below.

<i>(Dollars in thousands)</i>	Three Months Ended June 30, %			Nine Months Ended June 30, %		
	2015	2014	Change	2015	2014	Change
Revenue						
Medical Device	\$ 11,629	\$ 10,821	7.5%	\$ 32,827	\$ 31,852	3.1%
In Vitro Diagnostics	4,285	3,795	12.9%	11,708	10,251	14.2%
Total Revenue	\$ 15,914	\$ 14,616	8.9%	\$ 44,535	\$ 42,103	5.8%

*Medical Device.* Medical Device revenue was \$11.6 million in the quarter ended June 30, 2015, an increase of 7.5% compared with \$10.8 million for the same prior-year quarter. Medical Device revenue was \$32.8 million in the first nine months of fiscal 2015, an increase of 3.1%, compared with \$31.9 million for the same prior-year period. The \$0.8 million increase in revenue for the third quarter of fiscal 2015 was attributable to higher R&D revenue (\$0.3 million) and royalty revenue (\$0.5 million). The \$1.0 million increase for the nine months of fiscal 2015 was attributable to higher R&D revenue (\$0.6 million) and royalty revenue (\$0.6 million), partially offset by lower license fee revenue (\$0.2 million). The increase in R&D revenue in both fiscal 2015 periods resulted

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from increased demand for contract coating services. Hydrophilic royalty revenue increased in the fiscal 2015 periods as the result of a one-time royalty catch up payment from a customer of \$0.7 million which was related to periods prior to the fiscal 2015 third quarter and of that, \$0.6 million related to periods prior to fiscal 2015. We continue to realize diversification in our hydrophilic royalty revenue as for the third consecutive quarter peripheral royalties were our leading royalty segment. We realized a 1.2% increase in product sales in the current quarter which reflected a rebound from the decline in reagent sales experienced in the second quarter of fiscal 2015 when a limited number of customers implemented inventory rebalancing. Year-to-date product sales were essentially flat with the prior-year period.

*In Vitro Diagnostics.* In Vitro Diagnostics revenue was \$4.3 million in the quarter ended June 30, 2015, an increase of 12.9% compared with \$3.8 million for the same prior-year quarter. In Vitro Diagnostics revenue was \$11.7 million in the first nine months of fiscal 2015, an increase of 14.2% compared with \$10.3 million for the prior-year period. The revenue increase of \$0.5 million and \$1.5 million for the three and nine months ended June 30, 2015, respectively compared to prior-year periods, reflects higher sales of micro-array slides (\$0.1 million and \$0.6 million, respectively) and stabilization products (\$0.7 million and \$1.0 million, respectively). The current year-to-date period benefited from a lower prior-year comparison as the In Vitro Diagnostics revenue had declined 21% in the second quarter of fiscal 2014 as the result of customer inventory rebalancing activities.

**Costs and Operating Expenses**

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

<i>(Dollars in thousands)</i>	<b>Three Months Ended June 30,</b>				<b>Nine Months Ended June 30,</b>			
	<b>2015</b>		<b>2014</b>		<b>2015</b>		<b>2014</b>	
	<b>Amount</b>	<b>% Total Revenue</b>	<b>Amount</b>	<b>% Total Revenue</b>	<b>Amount</b>	<b>% Total Revenue</b>	<b>Amount</b>	<b>% Total Revenue</b>
Product costs	\$ 2,174	14%	\$ 2,037	14%	\$ 6,031	14%	\$ 5,737	14%
Research and development	3,860	24	3,655	25	11,839	27	11,488	27
Selling, general and administrative	4,023	25	3,591	25	11,841	27	11,736	28

**Product costs.** Product costs were \$2.2 million and \$6.0 million, or 14% of total revenue in both the three and nine months ended June 30, 2015, compared with \$2.0 million and \$5.7 million, or 14% of total revenue in each of the respective prior-year periods. Product gross margins were 67% in both the three and nine months ended June 30, 2015, compared with 66% in both respective prior-year periods. The increase in product gross margins in the current-year periods compared with the same prior-year periods is the result of lower scrap expense, improved manufacturing leverage from higher production levels and a change in product mix.

**Research and development (R&D) expenses.** R&D expenses were \$3.9 million and \$11.8 million, or 24% and 27% of total revenue, in the third quarter and first nine months of fiscal 2015, respectively, compared with \$3.7 million and \$11.5 million, or 25% and 27% of total revenue, respectively, in both prior-year periods. The fiscal 2015 third quarter and nine month increases in total R&D expenses from the fiscal 2014 periods were primarily the result of higher spending for our drug-coated balloon development activities. We expect R&D expenses to increase 5% to 7% for fiscal 2015 compared with fiscal 2014 as we continue to invest in our drug-coated balloon development activities.

**Selling, general and administrative (SG&A) expenses.** SG&A expenses were \$4.0 million and \$11.8 million in the third quarter and first nine months of fiscal 2015, respectively, or 25% and 27% of total revenue, compared with \$3.6 million and \$11.7 million, or 25% and 28% of total revenue, in both of the respective prior-year periods. The SG&A

expense increase of \$0.4 million in the third quarter of fiscal 2015 compared with the same prior-year quarter resulted from \$0.2 million of higher professional services expenses for legal matters as well as \$0.2 million in higher compensation and benefit costs. The increase in professional services was largely attributable to higher legal costs associated with a lawsuit brought by the IVD business against one of its competitors. This lawsuit had been pending since the third quarter of fiscal 2014 and was favorably resolved in July 2015 for a nominal amount. The SG&A expense increase of \$0.1 million for the nine months of fiscal 2015 was driven by \$0.8 million of higher professional services expenses for legal, financial and strategic matters; \$0.3 million of increased compensation costs as well as \$0.2 million of higher other operating costs, offset partially by \$1.2 million of lower stock-based compensation. The decrease in this expense was primarily from the accelerated vesting of non-employee Board of Director stock awards and granting of an award to the former Chairman of the Company's Board in recognition of his contributions to the Company during his years of service on the Board.

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

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Investment income, net	\$ 36	\$ 42	\$ 149	\$ 194
Gain on sale of strategic investments		28		709
Other investment capital (losses) gains	(40)		496	125
Other (loss) income, net	\$ (4)	\$ 70	\$ 645	\$ 1,028

Other (loss) income was less than \$0.1 million in the three months ended June 30, 2015 and \$0.6 million in the nine months ended June 30, 2015, compared with \$0.1 million and \$1.0 million for the respective prior-year periods.

Capital losses from investments in the three months ended June 30, 2015 increased as compared to the prior-year period as we liquidated our investment portfolio to support corporate initiatives.

We recorded a gain of \$0.5 million in the nine months ended June 30, 2015 associated with the second quarter sale of our investment in Intersect ENT. We recorded a gain of \$0.7 million in the nine months ended June 30, 2014 associated with contingent clinical and sales milestone payments resulting from the fiscal 2013 sale of our ownership interest in Vessix Vascular, Inc. ( Vessix ).

**Income tax provision.** The reconciliation of the statutory U.S. federal tax rate of 35.0% and our effective tax rate for the three and nine months ended June 30, 2015 and 2014 is as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Statutory U.S. federal income tax rate	35.0%	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	0.4	0.6	0.4	0.6
Gains on available-for-sale securities and strategic investments	(0.9)	(2.9)	(0.9)	(2.8)
Discrete item 2014 retroactive R&D federal tax credit			(2.1)	
Discrete item state tax reserve release				(1.7)
Other	(1.5)	(0.7)	(0.9)	
Effective tax rate	33.0%	32.0%	31.5%	31.1%

The difference between the U.S. federal statutory tax rate of 35.0% and our effective tax rate reflects the impact of state income taxes, permanent tax items including the Section 199 manufacturing deduction, valuation allowance changes for utilization of capital losses and discrete tax items. The income tax provision was \$1.9 million and \$4.9 million, respectively, for the three and nine months ended June 30, 2015 resulting in respective effective tax rates of 33.0% and 31.5%. The income tax provision was \$1.7 million and \$4.4 million for the three and nine months ended June 30, 2014, respectively, resulting in respective effective tax rates of 32.0% and 31.1%.

The most significant variability in our effective tax rate is the result of changes in capital loss valuation allowances resulting from gain on the sale of strategic investments and contingent milestone consideration payments and other-than-temporary impairment losses associated with certain strategic investments. We have historically recorded other-than-temporary impairment losses with no income tax effect as it has not been more likely than not that we would generate sufficient capital gains to realize these benefits. Consequently, the Intersect ENT, Vessix and available-for-sale securities gains realized during fiscal 2015 or 2014 resulted in a reduction in our capital loss carryforward valuation allowances resulting in no associated financial statement income tax effects.

There have also been discrete benefits recognized in each nine-month period that consist largely of state income tax reserve reversals related to the expiration of statutory filing requirements. In addition, the nine months ended June 30, 2015 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 previously expired in December 2013.

During the nine months ended June 30, 2015, the effective tax rate was reduced by 0.9% for a gain associated with the sale of our investment in Intersect ENT, for which the income tax expense recognized was fully offset by the reversal of a capital loss valuation allowance. During the nine months ended June 30, 2014, the effective tax rate was reduced by 2.8% primarily related to a gain associated with a Vessix milestone contingent consideration payment, for which the income tax expense recognized was fully offset by the reversal of a capital loss valuation allowance.

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

<i>(Dollars in thousands)</i>	Three Months Ended June 30,			Nine Months Ended June 30,		
	2015	2014	% Change	2015	2014	% Change
Operating income:						
Medical Device	\$ 6,295	\$ 5,855	8%	\$ 16,507	\$ 16,466	0%
In Vitro Diagnostics	1,191	974	22%	3,220	2,277	41%
Total segment operating income	7,486	6,829		19,727	18,743	
Corporate	(1,629)	(1,496)	9%	(4,903)	(5,601)	(12)%
Operating income	\$ 5,857	\$ 5,333	10%	\$ 14,824	\$ 13,142	13%

*Medical Device.* Operating income was \$6.3 million in the third quarter of fiscal 2015, compared with \$5.9 million in the third quarter of fiscal 2014. Operating income was \$16.5 million in both the first nine months of fiscal 2015 and 2014.

The increase in operating income of \$0.4 million in the three months ended June 30, 2015, compared with the prior-year period, resulted primarily from higher revenue offset by higher compensation costs (\$0.1 million). The increase in revenue was attributable to higher R&D revenue (\$0.3 million) and royalty revenue (\$0.5 million). The royalty revenue increase was the result of a one-time royalty catch up payment from a customer of which \$0.7 million related to periods prior to the fiscal 2015 third quarter.

The increase in operating income of less than \$0.1 million for the nine months ended June 30, 2015, compared with the prior-year period, resulted primarily from higher R&D revenue (\$0.6 million) and higher royalty revenue (\$0.6 million) driven by a one-time royalty catch up payment from a customer related to periods prior to fiscal 2015, offset by higher expenses associated with the drug-coated balloon development activities (\$0.5 million), higher compensation expense (\$0.4 million) and lower royalty and license fees revenue (\$0.2 million).

*In Vitro Diagnostics.* Operating income was \$1.2 million in the third quarter of fiscal 2015, compared with \$1.0 million in the third quarter of fiscal 2014. Operating income was \$3.2 million in the first nine months of fiscal 2015, compared with \$2.3 million in the same period of fiscal 2014.

The increase in operating income of \$0.2 million in the three months ended June 30, 2015 was a result of the gross margin impact from \$0.5 million of higher revenue. Product gross margins were 65.2% and 62.2% for the three months ended June 30, 2015 and 2014, respectively. The higher product margins were primarily a result of reduced scrap expense, increased operating leverage and product mix. Operating expenses increased by \$0.2 million in the three months ended June 30, 2015 compared with the prior-year period. The increase in operating expenses was largely attributable to higher legal costs associated with a lawsuit brought by the IVD business against one of its competitors. This lawsuit had been pending since the third quarter of fiscal 2014 and was favorably resolved in July 2015 for a nominal amount.

The increase in operating income of \$1.0 million in the nine months ended June 30, 2015 was a result of the gross margin impact of \$1.5 million of higher product sales. Product gross margins were 65.1% and 61.9% for the nine months ended June 30, 2015 and 2014, respectively. The higher product margins were primarily a result of reduced scrap expense, increased operating leverage and product mix. Operating expenses increased \$0.4 million in the nine months ended June 30, 2015 compared with the prior-year period attributable to higher legal costs (\$0.7 million), offset partially by lower compensation expense (\$0.1 million), lower royalty expense (\$0.1 million) and lower marketing costs (\$0.1 million).

*Corporate.* The Corporate category includes expenses for administrative corporate functions, such as executive, corporate accounting, legal, human resources and Board of Directors related fees and expenses, which 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 and thus not allocated to our operating segments. The unallocated Corporate operating loss was \$1.6 million and \$1.5 million in the three months ended June 30, 2015 and 2014, respectively, and \$4.9 million and \$5.6 million in the nine months ended June 30, 2015 and 2014, respectively. Stock-based compensation expenses decreased \$1.2 million in the nine months ended June 30, 2015, compared with the comparable prior-year period. The decrease in this expense was primarily from the accelerated vesting of non-employee Board of Director stock awards and granting of an award to the former Chairman of the Company's Board in recognition of his contributions to the Company during his years of service on the Board. Other increases in both periods mainly relate to compensation expenses. The decrease in stock-based compensation was offset primarily by increases in compensation and legal expenses.

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As of June 30, 2015, we had working capital of \$61.1 million, an increase of \$9.8 million from September 30, 2014. Working capital is defined by us as current assets minus current liabilities. The increase from the prior-year end is a result of several factors including cash provided from operating activities as well as an increase in current assets in the current quarter as a result of the Company's decision to liquidate our investment portfolio in the third quarter of 2015 to support our corporate initiatives. As a result of this decision, all of our investments were liquidated and included in current assets within cash equivalents as of June 30, 2015. Our cash, cash equivalents and available-for-sale securities totaled \$54.1 million at June 30, 2015, a decrease of \$9.3 million from \$63.4 million at September 30, 2014, principally associated with the \$20.0 million initial payment related to our accelerated share repurchase program in the first quarter of fiscal 2015 partially offset principally by cash provided by operating activities from continuing operations of \$12.1 million.

After the liquidation of our investment portfolio, our investments consist of money market or commercial paper investments. The Company's 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 the Company's 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 repurchases 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 the 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, depositary shares, common stock and security warrants in one or more offerings up to an aggregate initial offering price of \$175 million. As of June 30, 2015, we have not completed any securities offerings associated with the registration statement.

We generated cash flows from operating activities from continuing operations of approximately \$12.1 million and \$12.5 million in the nine months ended June 30, 2015 and 2014, respectively. The following table depicts our cash flows provided by operating activities from continuing operations:

<i>(Dollars in thousands)</i>	<b>Nine Months Ended</b>	
	<b>June 30,</b>	
	<b>2015</b>	<b>2014</b>
Net income	\$ 10,590	\$ 9,687
Loss from discontinued operations		76

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Depreciation and amortization	2,083	2,054
Stock-based compensation	1,841	3,043
Deferred taxes	450	(98)
Net other operating activities	(974)	(1,287)
Net change in other operating assets and liabilities	(1,914)	(1,009)
Net cash provided by operating activities from continuing operations	\$ 12,076	\$ 12,466

*Operating Activities.* Net cash flow from operating activities has provided us with significant sources of liquidity. We generated cash flows from operating activities from continuing operations of \$12.1 million and \$12.5 million for the nine months ended June 30, 2015 and 2014, respectively. During the first nine months of fiscal 2015 and 2014, operating cash flow was primarily generated by net income as adjusted for non-cash expenses (benefits) for depreciation and amortization, stock-based compensation and deferred taxes; reduced by net other operating activities which include gains on sales of available-for-sale securities and strategic investments and the excess tax benefit from stock-based compensation.

Operating assets and liabilities in the fiscal 2015 nine-month period used \$1.9 million of cash as the result of increased accounts receivable balances (\$1.2 million) resulting from increased revenue and the timing of cash collections, including a one-time royalty catch-up payment of \$0.7 million; inventories (\$0.6 million) resulting from planned increases in finished goods as well as the timing of shipments; offset by increases in accounts payable and accrued liabilities (\$0.1 million) principally from a liability recorded for

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customer related payments (\$0.4 million) which was offset by lower severance accruals (\$0.1 million) and an increase in amount of accounts payable balance used for capital purchases (\$0.1 million) as of June 30, 2015 as compared to September 30, 2014.

Operating assets and liabilities in the fiscal 2014 nine-month period used \$1.0 million of cash as the result of increased prepaid and other balances (\$0.1 million) primarily resulting from timing of payments on insurance premiums; decreases in accounts payable and accrued liabilities (\$0.9 million) principally from the payment of fiscal 2013 bonuses in fiscal 2014 (\$1.9 million) and secondarily as the result of changes in accrued liabilities (\$1.3 million) related to invoice accruals at year end and the accrual for treasury stock purchases; and increased income tax payments (\$0.6 million), offset by cash generated from reduced accounts receivable balances (\$0.2 million) resulting from the timing of cash collections and inventories balances (\$0.4 million).

*Investing Activities.* Our investing activities from continuing operations provided cash of \$18.4 million in the first nine months of fiscal 2015 compared with \$24.6 million in the first nine months of fiscal 2014. We invested \$0.4 million in property and equipment in the first nine months of fiscal 2015 compared with \$1.2 million in the prior-year period. We anticipate spending \$1.5 million to \$2.0 million on building improvements and equipment purchases for the remainder of fiscal 2015. Sales of our available-for-sale securities less the amounts reinvested in securities provided cash of \$18.8 million. As noted above, we liquidated our investment securities during the quarter ended June 30, 2015 to support our corporate initiatives. We received cash of \$0.5 million from the sale of our investment in Intersect ENT in the first nine months of fiscal 2015 as compared with \$0.7 million from contingent milestone payments associated with the sale of our ownership interest in Vessix Vascular in the first nine months of fiscal 2014. In each of the first nine months of fiscal 2015 and 2014, we invested cash associated with our discontinued operations of less than \$0.1 million.

*Financing Activities.* We used cash in financing activities from continuing operations of \$19.9 million and \$12.9 million in the first nine months of fiscal 2015 and 2014, respectively. Fiscal 2015 activity includes an accelerated share repurchase program initiated in the first quarter which is more fully described in the below paragraphs. We also used cash of \$0.8 million in fiscal 2015 to purchase common stock to pay employee taxes resulting primarily from the issuance of common shares associated with our fiscal 2012-2014 performance share program.

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. As part of the accelerated share repurchase (ASR) program discussed below, the Company repurchased 758,143 shares of common stock on November 11, 2014 and 89,721 of common stock on July 8, 2015, the date that the ASR program was completed. As adjusted for the final ASR program settlement, \$10.0 million remained available for future repurchases under the current authorization.

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 a \$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 payment was also reported as a reduction in retained earnings. The specific number of shares that the Company ultimately purchased under the ASR agreement was based on the volume weighted average price (VWAP) of the Company's common stock during the purchase period, less an agreed upon discount. In the aggregate, the Company purchased 847,864 shares under the ASR program for an average price of \$23.59 per share. 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 of June 30, 2015.

During the first nine months of fiscal 2014, the Company repurchased 485,577 shares of common stock for a total of \$11.5 million under the then-existing share repurchase authorization of the Board. This entire authorized amount under the then existing authorization was used as of June 30, 2014. We also used cash of \$1.1 million in the first nine months 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 and cash equivalents, which totaled \$54.1 million as of June 30, 2015, together with cash flow from operations, our \$20.0 million credit facility and \$175.0 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 SurModics' 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 \$1.1 million to \$1.5 million, \$10.0 million associated with the remaining authorized amount available for share repurchases discussed previously.

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*Discontinued Operations.* Our Pharmaceuticals discontinued operation used operating cash of less than \$0.1 million in each of the first nine months of fiscal 2015 and 2014. Cash generated from financing activities of less than \$0.1 million in the first nine months of fiscal 2015 and 2014 related to transfers of cash from 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 plc ( Medtronic ) was our largest customer comprising 19% of our consolidated revenue for fiscal 2014 and increased from this level to 26% in the first nine months of fiscal 2015 primarily resulting from the Medtronic merger with Covidien PLC ( Covidien ) on January 26, 2015. Medtronic has several separately licensed products that generate royalty revenue for SurModics, none of which represented more than 6% of SurModics' total revenue. No other individual customer using licensed technology constitutes more than 10% of SurModics' total revenue.

**Off-Balance Sheet Arrangements**

As of June 30, 2015, the Company 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, the impact of Medtronic, as well as other significant customers, including new diagnostic kit customers and our ability to initiate a first-in-human study of the SurModics *SurVeil* Drug Coated Balloon on any particular time frame. 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, including our largest customer, Medtronic, 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 or ourselves;

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

our ability to successfully develop, obtain regulatory approval for, and commercialize our SurModics *SurVeil* Drug Coated Balloon product;

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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;

our ability to successfully convert our customers from an early generation of our PhotoLink® hydrophilic technology protected by a family of patents expected to expire in November 2015 (in the U.S.) and October 2016 (in certain other countries) to one of our advanced generation technologies and to offset any decline in revenues from customers that we are unlikely to convert; 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 our 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, agency and commercial 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. Because of the credit criteria of our investment policies, the primary market risk associated with these investments is interest rate risk. We do not use derivative financial instruments to manage interest rate risk or to speculate on future changes in interest rates. For the quarter ended June 30, 2015 we held no available-for-sale securities, therefore interest rate fluctuations would have an insignificant 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 the Company's 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 June 30, 2015. 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 management, 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 June 30, 2015 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 June 30, 2015, 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</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>
4/1/15 - 4/30/15	0	N/A	0	\$ 14,000,000
5/1/15 - 5/31/15	7,984	\$ 25.94	0	\$ 14,000,000
6/1/15 - 6/30/15	0	N/A	0	\$ 14,000,000
<b>Total</b>	<b>7,984</b>	<b>\$ 25.94</b>	<b>0</b>	<b>\$ 14,000,000</b>

- (1) The purchases in this column were shares repurchased by the Company to pay the exercise price in connection with so-called stock swap exercises related to the exercise of non-employee director stock options and to pay the tax withholding obligations related to the vesting of employee restricted stock awards.
- (2) 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. As part of the accelerated share repurchase ( ASR ) program discussed below, the Company repurchased 758,143 shares of common stock on November 11, 2014 and 89,721 of common stock on July 8, 2015, the date that the ASR program was completed. As adjusted for the final ASR program settlement, \$10.0 million remained available for future repurchases under the current authorization.

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 a \$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 payment was also reported as a reduction in retained earnings. The specific number of shares that the Company ultimately purchased under the ASR agreement was based on the volume weighted average price ( VWAP ) of the Company's common stock during the purchase period, less an agreed upon discount. In the aggregate the Company purchased 847,864 shares under the ASR program for an average price of \$23.59 per share. 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 of June 30, 2015.

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**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.
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.
31.2*	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
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 June 30, 2015, filed on August 6, 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.

August 6, 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 June 30, 2015**  
**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
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