

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

	<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>
<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 RSUs 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 no