SURMODICS INC
Form 10-Q
August 06, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2010

or

o **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	41-1356149
(State of incorporation)	(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) 829-2700

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 þ No o

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 o No o

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

The number of shares of the registrant s Common Stock, $.05 par value per share, outstanding as of August 2, 2010 was 17,409,044.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SurModics, Inc. and Subsidiaries Condensed Consolidated Balance Sheets

(In thousands, except share data)	June 30, 2010	September 30, 2009
	(Unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 8,617	$ 11,636
Short-term investments	13,101	8,932
Accounts receivable, net of allowance for doubtful accounts of $442 and $82 as of June 30, 2010 and September 30, 2009, respectively	10,752	11,320
Inventories	3,506	3,330
Deferred tax asset	722	353
Prepaids and other	4,139	1,443
Total current assets	40,837	37,014
Property and equipment, net	66,964	66,915
Long-term investments	33,033	27,300
Deferred tax asset	1,876	2,548
Intangible assets , net	16,238	17,458
Goodwill	21,820	21,070
Other assets, net	10,093	13,257
Total assets	$ 190,861	$ 185,562
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 3,543	$ 3,468
Accrued liabilities	2,601	2,563
Accrued income taxes payable		186
Deferred revenue	744	905
Other current liabilities	1,018	862
Total current liabilities	7,906	7,984
Deferred revenue, less current portion	3,665	623
Other long-term liabilities	4,665	4,583
Total liabilities	16,236	13,190
Commitments and contingencies		
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; 17,415,313 and 17,471,472 shares issued and outstanding	871	874
Additional paid-in capital	68,738	66,005
Accumulated other comprehensive income	452	1,504
Retained earnings	104,564	103,989
Total stockholders equity	174,625	172,372
Total liabilities and stockholders equity	$ 190,861	$ 185,562

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

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SurModics, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2010	2009	2010	2009
(In thousands, except per share data)	*(unaudited)*		*(unaudited)*	
Revenue				
Royalties and license fees	$ 9,356	$ 8,200	$ 26,333	$ 65,999
Product sales	5,769	5,130	15,586	13,762
Research and development	3,483	4,856	12,430	22,566
Total revenue	18,608	18,186	54,349	102,327
Operating costs and expenses				
Product costs	2,388	1,988	6,820	5,341
Customer research and development	4,642	3,184	12,748	10,257
Other research and development	4,223	4,443	13,507	15,207
Selling, general and administrative	4,944	3,910	13,667	12,996
Purchased in-process research and development				3,200
Restructuring charges			1,306	1,798
Asset impairment charges	191		2,265	
Total operating costs and expenses	16,388	13,525	50,313	48,799
Income from operations	2,220	4,661	4,036	53,528
Other (loss) income				
Investment income	241	384	819	1,515
Impairment loss on investments	(2,577)		(2,577)	
Other income, net	298	410	301	281
Other (loss) income	(2,038)	794	(1,457)	1,796
Income before income taxes	182	5,455	2,579	55,324
Income tax provision	(1,098)	(1,916)	(2,005)	(20,484)
Net (loss) income	$ (916)	$ 3,539	$ 574	$ 34,840
Basic net (loss) income per share	$ (0.05)	$ 0.20	$ 0.03	$ 2.00
Diluted net (loss) income per share	$ (0.05)	$ 0.20	$ 0.03	$ 1.99
Weighted average shares outstanding				
Basic	17,360	17,356	17,373	17,458
Dilutive effect of outstanding stock options and non-vested stock		23	12	34
Diluted	17,360	17,379	17,385	17,492

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

SurModics, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

	Nine Months Ended June,	
	2010	**2009**
(In thousands)	*(unaudited)*	
Operating Activities:		
Net income	$ 574	$ 34,840
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,950	4,352
Gain on equity method investment and sales of investments	(300)	(200)
Amortization of premium on investments	101	104
Stock-based compensation	4,192	4,988
Purchased in-process research and development		3,200
Restructuring charges	1,306	1,798
Deferred taxes	990	8,616
Asset impairment charges	2,265	
Impairment loss on investments	2,577	
Tax benefits from exercise of stock options	(72)	241
Other	3	(250)
Change in operating assets and liabilities:		
Accounts receivable	568	2,675
Inventories	(176)	(458)
Accounts payable and accrued liabilities	(775)	(3,261)
Income taxes	(2,796)	3,302
Deferred revenue	2,881	(35,816)
Prepaids and other	(575)	638
Net cash provided by operating activities	16,713	24,769
Investing Activities:		
Purchases of property and equipment	(7,196)	(21,660)
Purchases of available-for-sale investments	(32,834)	(28,465)
Sales/maturities of investments	23,009	40,407
Business acquisition	(750)	(8,585)
Purchase of licenses and patents		(631)
Other investing activities	(500)	(189)
Net cash used in investing activities	(18,271)	(19,123)
Financing Activities:		
Tax benefits from exercise of stock options	72	(241)
Issuance of common stock	892	655
Repurchase of common stock	(2,032)	(14,998)
Purchase of common stock to pay employee taxes	(393)	(458)
Repayment of notes payable		(236)
Net cash used in financing activities	(1,461)	(15,278)

Net change in cash and cash equivalents	(3,019)	(9,632)
Cash and Cash equivalents		
Beginning of period	11,636	15,376
End of period	$ 8,617	$ 5,744
Supplemental Information:		
Cash paid for income taxes	$ 3,811	$ 8,764
Noncash transaction acquisition of property, plant, and equipment on account	$ 1,096	$ 2,467
Noncash transaction acquisition of intangible assets on account	$ 210	$ 210

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, 2010
(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 (GAAP) and reflect all adjustments, consisting solely of normal recurring adjustments, needed to fairly present the financial results for the periods presented. These financial statements include some amounts that are based on management s best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of earnings in the period in which the change is identified. The results of operations for the three-month and nine-month periods ended June 30, 2010 are not necessarily indicative of the results that may be expected for the entire 2010 fiscal year.

In accordance with the rules and regulations of the United States Securities and Exchange Commission, 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 year ended September 30, 2009, and footnotes thereto included in the Company s Form 10-K/A as filed with the United States Securities and Exchange Commission on December 14, 2009.

In September 2008, following a strategic review of Merck & Co., Inc. s (Merck) business and product development portfolio, Merck gave notice to SurModics of Merck s intent to terminate a collaborative research and license agreement (Merck Agreement) and separate supply agreement entered into in June 2007. The termination was effective December 16, 2008. The Company recognized revenue of approximately $45 million in the first nine months of fiscal 2009 principally from amounts that previously had been deferred and amortized under the then-existing accounting treatment required for revenue arrangements with multiple deliverables and a $9 million milestone payment associated with the termination of the triamcinolone acetonide development program under the Merck Agreement. The fiscal 2009 nine month revenue associated with the Merck Agreement is reflected in royalties and license fees ($37.6 million) and in research and development fees ($7.5 million).

Subsequent events have been evaluated through the date the financial statements were issued.

(2) Key Accounting Policies and Recent Accounting Pronouncements

Revenue recognition

This revenue recognition section includes the Company s historical policies as well as adoption of any applicable accounting guidance that has been issued during fiscal 2010.

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.

The Company s revenue is derived from three primary sources: (1) royalties and license fees from licensing its proprietary drug delivery and surface modification technologies to customers; (2) the sale of polymers and reagent chemicals, stabilization products, antigens, substrates and microarray slides to the diagnostics and biomedical research industries; and (3) research and development fees generated on customer projects.

Royalties and licenses 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. This revenue recognition model is similar to usage fee accounting. Minimum royalty fees are recognized in the period earned, provided that collectability is reasonably assured. For stand-alone license agreements, up-front license fees are recognized over economic life of the technology.

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Milestone payments. Revenue related to a performance milestone is recognized based 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 past effort/performance;

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

The milestone payment is reasonable in comparison to all of the deliverables and payment terms in the arrangement; 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 economic life of the technology.

Product sales. Product sales to third parties are recognized at the time of shipment, provided that an order has been received, the price is fixed or determinable, collectability of the resulting receivable is reasonably assured and returns can be reasonably estimated. 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 agreement.

Arrangements with multiple deliverables. Prior to October 1, 2009, arrangements such as license and development agreements were analyzed to determine whether the deliverables, which often include a license and performance obligations such as research and development, could be separated, or whether they must be accounted for as a single unit of accounting in accordance with accounting guidance. If the fair value of the undelivered performance obligations could be determined, such obligations would then be accounted for separately. If the license was considered to either (i) not have stand-alone value or (ii) have stand-alone value but the fair value of any of the undelivered performance obligations could not be determined, the arrangement would then be accounted for as a single unit of accounting, and the license payments and payments for performance obligations would be recognized as revenue over the estimated period of when the performance obligations are performed, or the economic life of the technology licensed to the customer. When the Company determined that an arrangement should be accounted for as a single unit of accounting, it recognized the related revenue on a time-based accounting model.

The Company had one significant multiple element arrangement prior to October 1, 2009 that was accounted for as a single unit of accounting resulting in deferral and recognition of all related payments received for license and research and development activities using a time-based model. This arrangement was terminated during the first quarter of fiscal 2009 as described in Note 1 above.

In October 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards for multiple deliverable revenue arrangements to:

(i) provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

(ii) require an entity to 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) eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

The Company elected to early adopt this accounting guidance at the beginning of its first quarter of fiscal 2010, on a prospective basis, for applicable transactions originating or materially modified after October 1, 2009. In connection with the adoption of the amended accounting standard the Company also changed its policy prospectively for multiple element arrangements, whereby 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.

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

The Company evaluates 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 certain instances, the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements which may be a result of the Company infrequently selling each element separately. When VSOE cannot be established, the Company establishes 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 characteristics.

Net sales as reported and pro forma net sales that would have been reported for the three-month and nine-month periods ended June 30, 2010, if the transactions entered into or materially modified after September 30, 2009 were subject to the Company s accounting policies under the previous accounting guidance, are shown in the following table (*in thousands*):

	Three months ended June 30, 2010		Nine months ended June 30, 2010	
	As Reported	Pro Forma Basis as if the Previous Accounting Guidance Were in Effect	As Reported	Pro Forma Basis as if the Previous Accounting Guidance Were in Effect
Total multiple element arrangement revenue	$ 534	$ 104	$ 3,939	$ 274

The impact to revenue for the three-month and nine-month periods ended June 30, 2010 associated with adoption of the new accounting guidance was primarily related to research and development activities. The Company s accounting policies under the previous accounting guidance would have resulted in partial recognition of the research and development revenue in the current periods with the remainder deferred and recognized over the economic life of the technology. Under the new accounting guidance, the Company is recognizing research and development revenue as the activities are performed. The Company notes that this new accounting guidance will result in current revenue recognition of research and development activities in the period the activities are performed with the revenue generated changing from period to period based on the stage of project development. The amount of revenue that is recognized could be material in any reporting period.

In April 2010, the FASB issued updated authoritative accounting guidance which provides a consistent framework for applying the milestone method of revenue recognition in arrangements that include research or development deliverables. The amendments are effective on a prospective basis for milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010 with early adoption permitted. The Company is evaluating the guidance and does not expect the adoption to have a material impact on the Company s consolidated financial statements.

Other accounting areas

In April 2008, the FASB issued authoritative accounting guidance which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of intangible assets under goodwill and other intangible asset accounting. The authoritative guidance is intended to improve the consistency between the useful life of a recognized intangible asset under goodwill and intangible asset accounting and the period of the expected cash flows used to measure the fair value of the asset under business combination accounting and other GAAP. The adoption of the authoritative guidance did not have a material impact on the Company s consolidated financial statements.

In September 2006, the FASB issued authoritative accounting guidance associated with fair value measurements. This guidance defines fair value, establishes a consistent framework for measuring fair value, gives guidance regarding methods used for measuring fair value and expands disclosures about fair value measurements. These provisions were implemented in fiscal 2009. See Note 3 for additional information regarding fair value measurements. However, in February 2008, the FASB issued guidance that delayed the effective date from fiscal 2009 to fiscal 2010 for all nonfinancial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The adoption of the authoritative guidance did not have a material impact on the Company s consolidated financial statements.

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) Fair Value Measurements

Effective October 1, 2008, the Company adopted the new accounting guidance on fair value measurements. The new guidance 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 asset consists of its investment in OctoPlus, N.V. (see Note 7 for further information). The fair market value of this investment is based on the quoted price of OctoPlus shares traded on the Amsterdam Stock Exchange.

Level 2 Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

The Company s Level 2 assets consist of money market funds, U.S. Treasury securities, corporate bonds, municipal bonds, U.S. agency securities, agency and municipal securities, certain asset-backed securities 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.

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.

The Company s Level 3 assets include other U.S. government agency securities corporate, securities and mortgage-backed securities. The fair market values of these investments were determined by broker pricing where not all significant inputs were observable.

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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. The Company did not significantly change its valuation techniques from prior periods.

Transfers of assets from Level 2 to Level 3 classifications are made when there is a lack of observable market data resulting from a decrease in market activity for the affected securities.

The Company s policy is to recognize transfers in and out of Level 3 using the value at the beginning of the reporting period.

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. The following table presents information about the Company s financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2010 *(in thousands)*:

	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value as of June 30, 2010
Assets:				
Cash equivalents	$	$ 7,193	$	$ 7,193
Available for sale debt securities				
US government obligations		22,138	788	22,926
Mortgage backed securities		5,551	143	5,694
Municipal bonds		3,276		3,276
Asset back securities		1,125		1,125
Corporate bonds		7,962		7,962
Other assets	2,082			2,082
Total assets measured at fair value	$ 2,082	$ 47,245	$ 931	$ 50,258

Short-term and long-term investments disclosed in the condensed consolidated balance sheets include held-to-maturity investments totaling $5.2 million as of June 30, 2010. Held-to-maturity investments are carried at an amortized cost.

Changes in Level 3 Instruments Measured at Fair Value on a Recurring Basis

The following tables provide a reconciliation of fiscal 2010 financial assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) based on accounting guidance that is applicable for periods ended June 30, 2010 *(in thousands)*:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) For the three months ended June 30, 2010 Available -for-Sale Debt Securities		
	U.S. government	Mortgage Backed	Total

	obligations		
Balance, March 31, 2010	$ 924	$ 145	$ 1,069
Transfers into Level 3			
Total realized and unrealized gains (losses):			
Included in other comprehensive (loss) income	(33)	1	(32)
Purchases, issuances, sales and settlements, net	(103)	(3)	(106)
Balance, June 30, 2010	$ 788	$ 143	$ 931

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	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) For the nine months ended June 30, 2010 Available -for-Sale Debt Securities		
	U.S. government obligations	Mortgage Backed	Total
Balance, September 30, 2009	$ 1,130	$ 73	$ 1,203
Transfers into Level 3		147	147
Transfers out of Level 3	(36)	(73)	(109)
Total realized and unrealized gains (losses):			
Included in other comprehensive (loss) income	(39)	4	(35)
Purchases, issuances, sales and settlements, net:	(267)	(8)	(275)
Balance, June 30, 2010	$ 788	$ 143	$ 931

As of June 30, 2010, marketable securities measured at fair value using Level 3 inputs were comprised of $0.8 million of U.S. government agency securities and $0.1 million of mortgage-backed securities within the Company s available-for-sale investment portfolio. These securities were measured using observable market data and Level 3 inputs as a result of the lack of market activity and liquidity. The fair value of these securities was based on the Company s assessment of the underlying collateral and the creditworthiness of the particular issuer of the securities.

The following tables provide a reconciliation of fiscal 2009 financial assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) based on accounting guidance that is applicable for periods ended June 30, 2009 *(in thousands)*:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) For the three months ended June 30, 2009 Available -for-Sale Debt Securities		
	U.S. government obligations	Mortgage Backed	Total
Balance, March 31, 2009	$ 47	$	$ 47
Transfers into Level 3	400	79	479
Total realized and unrealized gains (losses):			
Included in other comprehensive (loss) income	(6)		(6)
Purchases, issuances, sales and settlements, net	(80)	(1)	(81)
Balance, June 30, 2009	$ 361	$ 78	$ 439

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)
For the nine months ended June 30, 2009
Available -for-Sale Debt Securities

	U.S. government obligations	Corporate	Mortgage Backed	Total
Balance, September 30, 2008	$ 74	$ 190	$	$ 264
Transfers into Level 3	400		79	479
Transfers out of Level 3	(581)	(199)		(780)
Total realized and unrealized gains (losses):				
Included in other comprehensive (loss) income	10	9		19
Purchases, issuances, sales and settlements, net:	458		(1)	457
Balance, June 30, 2009	$ 361	$	$ 78	$ 439

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Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis

The Company s investments in non-marketable securities of private companies are accounted for using the cost method as the Company does not exert significant influence over the investees operating or financial activities. These investments as well as held-to-maturity securities are measured at fair value on a non-recurring basis when they are deemed to be other-than-temporarily impaired. In determining whether a decline in value of non-marketable equity investments in private companies has occurred and is other-than-temporary, an assessment is made by considering available evidence, including the general market conditions in the investee s industry, the investee s product development status and subsequent rounds of financing and the related valuation and/or the Company s participation in such financings. The Company also assesses the investee s ability to meet business milestones and the financial condition and near-term prospects of the individual investee, including the rate at which the investee is using its cash and the investee s need for possible additional funding at a lower valuation. The valuation methodology for determining the decline in value of non-marketable equity securities is based on inputs that require management judgment and are Level 3 inputs. The Company wrote down two investments totaling $2.6 million in the three-month period ended June 30, 2010, as the investments were deemed to be other-than-temporarily impaired. A pending round of financing at a substantially lower valuation at one of the private companies resulted in impairment loss of $2.4 million. The second company sold off assets in light of current market conditions and this action resulted in impairment loss of $0.2 million. See Note 7 for additional information.

(4) Investments

Investments consist principally of U.S. government and government agency obligations and mortgage-backed securities and are classified as available-for-sale or held-to-maturity at June 30, 2010 and September 30, 2009. Available-for-sale investments are reported at fair value with unrealized gains and losses net of tax excluded from operations and reported as a separate component of stockholders equity, except for other-than-temporary impairments, which are reported as a charge to current operations. 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 (loss) income. This adjustment results in a new cost basis for the investment. Investments which management has the intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost. If there is an other-than-temporary impairment in the fair value of any individual security classified as held-to-maturity, the Company will write down the security to fair value, with a corresponding adjustment to other (loss) income. Interest on debt securities, including amortization of premiums and accretion of discounts, is included in other (loss) income . Realized gains and losses from the sales of debt securities, which are included in other (loss) income, are determined using the specific identification method.

The original cost, unrealized holding gains and losses, and fair value of available-for-sale investments as of June 30, 2010 and September 30, 2009 were as follows (*in thousands*):

	June 30, 2010			
	Original Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
U.S. government obligations	$ 22,690	$ 275	$ (39)	$ 22,926
Mortgage-backed securities	5,603	153	(62)	5,694
Municipal bonds	3,198	78		3,276
Asset-backed securities	1,182	8	(65)	1,125
Corporate bonds	7,952	10		7,962
Total	$ 40,625	$ 524	$ (166)	$ 40,983

September 30, 2009

	Original Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government obligations	$ 10,837	$ 253	$	$ 11,090
Mortgage-backed securities	7,938	177	(106)	8,009
Municipal bonds	7,210	232		7,442
Asset-backed securities	2,334	65	(143)	2,256
Corporate bonds	1,181	3		1,184
Total	$ 29,500	$ 730	$ (249)	$ 29,981

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The original cost and fair value of investments by contractual maturity at June 30, 2010 were as follows (*in thousands*):

	Amortized Cost	Fair Value
Debt securities due within:		
One year	$ 10,978	$ 11,007
One to five years	22,803	23,157
Five years or more	6,844	6,819
Total	$ 40,625	$ 40,983

The following table summarizes sales of available-for-sale securities for the three-month and nine-month periods ended June 30, 2010 (*in thousands*):

	Three months ended June 30, 2010	Nine months ended June 30, 2010
Proceeds from sales	$ 16,837	$ 22,009
Gross realized gains	$ 299	$ 302
Gross realized losses	$ (2)	$ (2)

At June 30, 2010, the amortized cost and fair market value of held-to-maturity debt securities was $5.2 million and $5.3 million, respectively. Investments in securities designated as held-to-maturity consist of tax-exempt municipal bonds and have maturity dates ranging between one and two years from June 30, 2010. At September 30, 2009, the amortized cost and fair market value of held-to-maturity debt securities were $6.3 million and $6.4 million, respectively. A held-to-maturity security with an amortized cost of $1.0 million matured in the nine-month period ended June 30, 2010.

(5) Acquisitions

PR Pharmaceuticals, Inc. On November 4, 2008, the Company s SurModics Pharmaceuticals, Inc. subsidiary entered into an asset purchase agreement with PR Pharmaceuticals, Inc. (PR Pharma) whereby it acquired certain contracts and assets of PR Pharma for $5.6 million, consisting of $2.9 million in cash on the closing date, additional consideration of $2.4 million upon successful achievement of specified milestones, and $0.3 million in transaction costs. $5.5 million of the total consideration was paid in the nine-month period ended June 30, 2009. PR Pharma is eligible to receive up to an additional $3.6 million in cash upon the successful achievement of milestones for contract signing and invoicing, successful patent issuances and product development. Management believes this acquisition strengthens the Company s portfolio of drug delivery technologies for the pharmaceutical and biotechnology industries. As part of the acquisition, the Company recognized fair value associated with in-process research and development (IPR&D) of $3.2 million. The IPR&D was expensed on the date of acquisition and relates to polymer-based drug delivery technologies. The value assigned to IPR&D is related to projects for which the related products have not achieved commercial feasibility and have no future alternative use. The amount of purchase price allocated to IPR&D was based on estimating the future cash flows of each project and discounting the net cash flows back to their present values. The discount rate used was determined at the time of acquisition in accordance with accepted valuation methods. These methodologies include consideration of the risk of the project not achieving commercial feasibility. The research efforts ranged from 5% to 50% complete at the date of acquisition. The Company used the Relief from Royalty valuation method to assess the fair value of the projects with a risk-adjusted discount rate of 25%. The Company determined the method was appropriate based on the nature of the projects and future cash flow streams. The research and development work performed is billed to customers, in most cases, using standard commercial billing rates, which include a reasonable markup. Accordingly, the Company has no fixed cost obligations to carry projects forward. There have been no significant changes to the development plans for the acquired incomplete projects. Significant net cash inflows would commence with the commercial launch of customer products that are covered by the intellectual property rights and related agreements acquired from PR Pharma.

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(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. Inventories consisted of the following components *(in thousands)*:

	June 30, 2010	September 30, 2009
Raw materials	$ 1,572	$ 1,287
Finished products	1,934	2,043
Total	$ 3,506	$ 3,330

(7) Other Assets

Other assets consist principally of strategic investments. The Company accounts for its strategic investments under the cost method. The Company accounts for its investment in OctoPlus N.V. common stock as an available-for-sale investment rather than a cost method investment following an initial public offering of OctoPlus N.V. common stock in October 2006. Available-for-sale investments are reported at fair value with unrealized gains and losses reported as a separate component of stockholders equity, except for other-than-temporary impairments, which are reported as a charge to current operations, recorded in the other (loss) income section of the condensed consolidated statements of operations. The cost basis in the Company s investment in OctoPlus N.V. was adjusted to $1.7 million in fiscal 2008 based on a significant decline in the stock price of OctoPlus N.V. that was determined to be an other-than-temporary impairment.

The Company had made investments in Paragon Intellectual Properties, LLC (Paragon) and a Paragon subsidiary, Apollo Therapeutics, LLC (Apollo) that were accounted for under the equity method. In October 2008, Paragon announced that it had restructured, along with its subsidiaries, including Apollo, moving from a limited liability company with seven subsidiaries to a single C-corporation named Nexeon MedSystems, Inc. (Nexeon). During fiscal 2009, the Company began accounting for the investment in Nexeon under the cost method as the Company s ownership level is less than 20% and the Company did not exert significant influence over Nexeon s operating or financial activities. The Company made an additional investment of $0.5 million in Nexeon in fiscal 2009.

In August 2009, the Company invested $2.0 million in a medical technology company and made a follow-on investment of $0.5 million in March 2010. The Company recognized an impairment loss on this investment totaling $2.4 million in the three-month period ended June 30, 2010 based on market valuations and a pending financing round for this company. The Company s investment in the medical technology company is accounted for under the cost method, as the Company s ownership interest is less than 20% and the Company did not exert significant influence over the medical technology company s operating or financial activities. Another entity in which the Company had a strategic investment sold the majority of its assets in the three-month period ended June 30, 2010 resulting in an impairment loss of $0.2 million to the Company. These investments are included in the category titled Other in the table below

Other assets consisted of the following components *(in thousands):*

	June 30, 2010	September 30, 2009
Investment in OctoPlus N.V.	$ 2,082	$ 3,700
Investment in Nexeon MedSystems	5,651	5,651
Investment in ThermopeutiX	1,185	1,185
Investment in ViaCyte (formerly Novocell)	559	559
Other	616	2,162

Other assets	$ 10,093	$ 13,257

The Company recognized revenue of $1.3 million and $0.6 million for the three-month period ended June 30, 2010 and 2009, respectively, and recognized revenue of $1.5 million and $1.2 million for the nine-month period ended June 30, 2010 and 2009, respectively, from activity with companies in which it had a strategic investment.

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(8) Intangible Assets

Intangible assets consist principally of acquired patents and technology, customer relationships, licenses, and trademarks. The Company recorded amortization expense of $0.4 million for each of the three-month periods ended June 30, 2010 and 2009. The Company recorded amortization expense of $1.2 million and $1.7 million for the nine-month periods ended June 30, 2010 and 2009, respectively.

Intangible assets consisted of the following *(in thousands):*

	Useful life (in years)	June 30, 2010	September 30, 2009
Customer list	9 11	$ 8,657	$ 8,657
Core technology	8 18	8,330	8,330
Patents and other	2 20	3,076	3,076
Trademarks		600	600
Less accumulated amortization of intangible assets		(4,425)	(3,205)
Intangible assets, net		$ 16,238	$ 17,458

Based on the intangible assets in service as of June 30, 2010, estimated amortization expense for each of the next five fiscal years is as follows (*in thousands*):

Remainder of 2010	$ 407
2011	1,604
2012	1,602
2013	1,602
2014	1,602
2015	1,591

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 the acquired entities over the fair value assigned to the assets purchased and liabilities assumed in connection with the Company s acquisitions. 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.

In the nine months of fiscal 2010 a milestone was achieved associated with the July 2007 acquisition of SurModics Pharmaceuticals, Inc. and $0.8 million of additional purchase price was recorded as an increase to goodwill.

(10) Revolving Credit Facility

In February 2009, the Company entered into a two-year $25.0 million unsecured revolving credit facility. Borrowings under the credit facility, if any, will bear interest at a benchmark rate plus an applicable margin based upon the Company s funded debt to EBITDA ratio. In connection with the credit facility, the Company is required to maintain certain financial and nonfinancial covenants. As of June 30, 2010, the Company had no debt outstanding under this credit facility and was in compliance with all covenants.

(11) Stock-based Compensation

The Company has stock-based compensation plans under which it grants stock options and restricted stock awards. 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 as follows *(in thousands):*

	Three months ended June 30,		Nine months ended June 30,	
	2010	**2009**	**2010**	**2009**
Product costs	$ 29	$ 19	$ 95	$ 65
Customer research and development	202	225	505	591
Other research and development	659	522	1,718	1,975
Selling, general and administrative	542	590	1,874	2,357
Total	$ 1,432	$ 1,356	$ 4,192	$ 4,988

As of June 30, 2010, approximately $8.1 million of total unrecognized compensation costs related to non-vested awards could be recognized over the remaining weighted average period of approximately 1.8 years. The $8.1 million of total unrecognized compensation costs include $2.1 million associated with performance share awards that are currently not anticipated to be fully expensed because the performance conditions are not expected to be met.

Stock Option Plans

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 value of stock options granted during the three-month periods ended June 30, 2010 and 2009 was $7.05 and $7.28, respectively. The weighted average per share fair value of stock options granted during the nine-month periods ended June 30, 2010 and 2009 was $6.91 and $8.39, respectively. The assumptions used as inputs in the model were as follows:

	Three months ended June 30,		Nine months ended June 30,	
	2010	**2009**	**2010**	**2009**
Risk-free interest rates	2.2%	2.0%	2.0%	2.2%
Expected life (years)	4.8	4.8	4.8	4.8
Expected volatility	41.2%	40.2%	41.4%	38.2%
Dividend yield	0%	0%	0%	0%

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

The Company s Incentive Stock Options (ISO) are granted at a price of at least 100% of the fair market value of the common stock of the Company on the date of the grant or 110% with respect to optionees who own more than 10% of the total combined voting power of all classes of stock. ISOs generally expire in seven years or upon termination of employment and generally are exercisable at a rate of 20% per year commencing one year after the date of grant. Nonqualified stock options are granted at fair market value on the date of grant. Nonqualified stock options generally expire in 7 to 10 years or upon termination of employment or service as a Board member. Nonqualified stock options granted prior to May 2008 generally become exercisable with respect to 20% of the shares on each of the first five anniversaries following the grant date, and nonqualified stock options granted subsequent to May 2008 generally become exercisable with respect to 25% on each of the first four anniversaries following the grant date.

There were no stock options exercised during the three-month period ended June 30, 2010. The total pre-tax intrinsic value of options exercised during the three-month period ended June 30, 2009 was $145,000. The total pre-tax intrinsic value of options exercised during the nine-month period ended June 30, 2010 was not meaningful as our stock price of $16.41 on June 30, 2010 was below the value of options exercised. During the nine-month period ended June 30, 2009, the total pre-tax intrinsic value of options exercised was $242,000. 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.

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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 will be released to the key employees if they are employed by the Company at the end of the vesting period. The stock-based compensation table above includes Restricted Stock expenses of $0.2 million, and $0.8 million during three-month and nine-month periods ended June 30, 2010, respectively, and $0.3 million and $1.5 million for the three-month and nine-month periods ended June 30, 2009, respectively.

Performance Share Awards

The Company has entered into performance share agreements with certain key employees, covering the issuance of common stock (Performance Shares). The Performance Shares vest upon the achievement of all or a portion of certain performance objectives, which must be achieved during the performance period. Compensation is recognized in each period based on management s best estimate of the achievement level of the grants specified performance objectives and the resulting vesting amounts. The Company did not recognize expense in the three-month period ended June 30, 2010 and recognized expense of $32,000 for the nine-month period ended June 30, 2010 related to the Performance Shares granted. For the three-month and nine-month periods ended June 30, 2009, the Company reversed expenses previously recognized of $144,000 and $173,000, respectively, associated with the Performance Shares granted. The stock-based compensation table above includes the Performance Shares expenses and expense reversal.

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. The number of authorized shares was increased by 200,000 effective with shareholder approval at the February 8, 2010 Annual Meeting. 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, 2010 and 2009, there were $0.2 million of employee contributions, respectively, included in accrued liabilities in the accompanying condensed consolidated balance sheets. Stock compensation expense recognized related to the Stock Purchase Plan for the three-month periods ended June 30, 2010 and 2009 totaled $0.1 million in each period. Stock compensation expense for the nine-month periods ended June 30, 2010 and 2009 totaled $0.2 million in each period. The stock-based compensation table above includes the Stock Purchase Plan expenses.

(12) Restructuring Charges

In March 2010, the Company announced an organizational change designed to support future growth by better meeting customer needs, leveraging its multiple competencies across the organization, and building on its pharmaceutical industry experience. As a result of the reorganization, the Company eliminated 11 positions, or approximately 4% of the Company s workforce. These employee terminations occurred across various functions and the reorganization plan was completed by the end of the third quarter of fiscal 2010. The Company also announced that it was vacating its leased sales office in Irvine, California and a leased warehouse in Birmingham, Alabama, as part of the reorganization plan. The leased space was vacated by March 31, 2010.

The Company recorded total restructuring charges of approximately $1.3 million in connection with the fiscal 2010 reorganization. These pre-tax charges consisted of $0.8 million of severance pay and benefits expenses and $0.5 million of facility-related costs. The restructuring is expected to result in approximately $0.5 million to $1.0 million in annualized cost savings. Cash payments totaled $0.9 million as of June 30, 2010, resulting in a balance of $0.4 million.

In November 2008, the Company announced a functional reorganization to better serve its customers and improve its operating performance. As a result of the reorganization, the Company eliminated 15 positions, or approximately 5% of the Company s workforce. These employee terminations occurred across various functions and the reorganization plan was completed by the end of the first quarter of fiscal 2009. The Company also vacated a leased facility in Eden Prairie, Minnesota, consolidating into its owned office and research facility also in Eden Prairie, as part of the reorganization plan.

The Company recorded total restructuring charges of approximately $1.8 million in connection with the fiscal 2009 reorganization. These pre-tax charges consisted of $0.5 million of severance pay and benefits expenses and

$1.3 million of facility-related costs. The restructuring was expected to result in approximately $2.2 million in annualized cost savings. Cash payments totaled $1.0 million as of June 30, 2010, resulting in a balance of $0.8 million.

The charges above for fiscal 2010 have been presented separately as restructuring charges in the condensed consolidated statements of operations. The remaining balance for both the fiscal 2010 and 2009 restructurings is expected to be paid within the next 42 months. The current portion totaling $1.3 million is recorded as a current liability within other accrued liabilities and the long-term portion totaling $0.3 million is recorded as a long-term liability within other long-term liabilities on the condensed consolidated balance sheets.

The following table summarizes the restructuring accrual activity for the first nine months of fiscal 2010 *(in thousands)*:

	Employee severance and benefits	Facility-related costs	Total
Balance at September 30, 2009	$	$ 955	$ 955
Accruals during the period	818	488	1,306
Cash payments	(814)	(174)	(988)
Balance at June 30, 2010	$ 4	$ 1,269	$ 1,273

(13) Asset impairment charges

In the nine months ended June 30, 2010, the Company recorded a $1.9 million asset impairment charge associated with one of its facilities in Alabama as the Company works to consolidate its multiple facilities in Birmingham, Alabama into its newly opened cGMP manufacturing and development facility. The original charge of $2.1 million was adjusted by $0.2 million in the three-month period ended June 30, 2010 as the facility assets were reclassified from held for sale at March 31, 2010 to held and used at June 30, 2010 based on a decision to retain the facility. The assets were written down to their fair value of $2.3 million, and the net amount is classified as property, plant and equipment on the condensed consolidated balance sheets. Depreciation expense continues to be recognized on these assets using the lower valuation.

In addition the Company recorded a $0.4 million asset impairment charge associated with prototypes and other equipment related to a development project for which no ongoing business is expected in the near term in light of current market conditions.

Long-lived assets are measured at fair value on a non-recurring basis. Long-lived assets are not measured at fair value on an ongoing basis but are subject to fair value adjustments only in certain circumstances. These circumstances include assets that are written down to fair value when they are held for sale or are determined to be impaired.

(14) Comprehensive (Loss) Income

The components of comprehensive (loss) income are as follows (*in thousands*):

	Three months ended June 30,		Nine months ended June 30,	
	2010	2009	2010	2009
Net (loss) income	$ (916)	$ 3,539	$ 574	$ 34,840
Other comprehensive (loss) income:				
Unrealized holding gains (losses) on available-for-sale securities arising during the period, net of tax	(260)	980	(869)	1,586
Less reclassification adjustment for realized gains included in net income, net of tax	(179)	(285)	(184)	(479)
Other comprehensive (loss) income	(439)	695	(1,053)	1,107
Comprehensive (loss) income	$ (1,355)	$ 4,234	$ (479)	$ 35,947

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(15) Income Taxes

The Company recorded an income tax provision of $1.1 million and $1.9 million for the three-month periods ended June 30, 2010 and 2009, respectively, representing effective tax rates of 603.3% and 35.1%, respectively. The Company recorded income tax provisions of $2.0 million and $20.5 million for the nine-month periods ended June 30, 2010 and 2009, respectively, representing effective tax rates of 77.7% and 37.0%, respectively. Excluding the impact of the $2.6 million impairment loss on investments in the three-month and nine-month periods ended June 30, 2010 (since the Company does not currently foresee offsetting capital gains that could offset this capital loss, no tax benefit has been recorded), the effective tax rate was 39.8% and 38.9%, respectively. The difference between the U.S. federal statutory tax rate of 35% and the Company s effective tax rate, adjusted for the impact of the impairment loss noted above, reflects state taxes and other permanent items.

The October 2008 adoption of the Emergency Economic Stabilization Act of 2008 retroactively extended the term of the federal tax credit for research activities through calendar 2009. The tax credit for research activities for the nine-month period ended June 30, 2010 was $34,000. During the nine-month period ended June 30, 2009, the Company recognized a discrete benefit of approximately $120,000 related to research activities in the nine-month period ended September 30, 2008.

The total amount of unrecognized tax benefits including interest and penalties that, if recognized, would affect the effective tax rate as of June 30, 2010 and September 30, 2009, respectively, are $2.0 million. Currently, the Company does not expect the liability for unrecognized tax benefits to change significantly in the next twelve months. Interest and penalties related to the unrecognized tax benefits are recorded in income tax expense.

The Company files income tax returns, including returns for its subsidiaries, in the United States (U.S.) federal jurisdiction and in various state jurisdictions. Uncertain tax positions are related to tax years that remain subject to examination. U.S. tax returns for fiscal years ended September 30, 2007, 2008 and 2009 remain subject to examination by federal tax authorities. Tax returns for state and local jurisdictions for fiscal years ended September 30, 2003 through 2009 remain subject to examination by state and local tax authorities.

(16) Operating Segments

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.

In March 2010, the Company announced it changed its operational structure to better align functional expertise, which also resulted in the elimination of the Company s business units. The Company evaluates revenue results and opportunities on the basis of the clinical market areas in which the Company s customers participate as noted in the table below. The Therapeutic market includes revenue from: (1) Cardiovascular, which provides drug delivery and surface modification technologies to customers in the cardiovascular market; (2) Ophthalmology, which is focused on the advancement of treatments for eye diseases, such as age-related macular degeneration (AMD) and diabetic macular edema (DME), two of the leading causes of blindness; and (3) Other Markets, which is focused on a variety of clinical markets principally in the pharmaceutical and biotechnology industries. The Diagnostic market includes revenue from the Company s microarray slide technologies, stabilization products, antigens and substrates for immunoassay diagnostics tests, and its *in vitro* diagnostic format technology.

The Company has one reportable segment as its sales and marketing efforts and its expenses are managed on a company-wide basis. The table below presents revenue from the markets, with Therapeutic broken out further by focus area, for the three-month and nine-month periods in fiscal 2010 and 2009, (*in thousands*):

	Three months ended June 30,		**Nine months ended June 30, 2010**	
	2010	**2009**	**2010**	**2009**
Therapeutic				
Cardiovascular	$ 11,036	$ 10,063	$ 30,994	$ 30,036
Ophthalmology	1,099	1,770	7,001	50,252
Other Markets	3,260	3,500	8,033	10,197

Total Therapeutic	15,395	15,333	46,028	90,485
Diagnostic	3,213	2,853	8,321	11,842
Total revenue	$ 18,608	$ 18,186	$ 54,349	$ 102,327

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(17) Commitments and Contingencies

Litigation. From time to time, the Company has been, and may become, involved in various legal actions involving its operations, products and technologies, including intellectual property and employment disputes. The outcomes of these legal actions are not within the Company s complete control and may not be known for prolonged periods of time. In some actions, the claimants seek damages, as well as other relief, including injunctions barring the sale of products that are the subject of the lawsuit, which, if granted, could require significant expenditures or result in lost revenues. The Company records a liability in the consolidated financial statements for these actions when a loss is known or considered probable and the amount can be reasonably estimated. If the reasonable estimate of a known or probable loss is a range, and no amount within the range is a better estimate, the minimum amount of the range is accrued. If a loss is possible but not known or probable, and can be reasonably estimated, the estimated loss or range of loss is disclosed. In most cases, significant judgment is required to estimate the amount and timing of a loss to be recorded.

InnoRx, Inc. In January 2005, the Company entered into a merger agreement whereby SurModics acquired all of the assets of InnoRx, Inc. (InnoRx), an early stage company developing drug delivery devices and therapies for the ophthalmology market. SurModics will be required to issue up to approximately 480,059 additional shares of its common stock to the stockholders of InnoRx upon the successful completion of the remaining development and commercial milestones involving InnoRx technology acquired in the transaction.

BioFX Laboratories, Inc. In August 2007, the Company acquired 100% of the capital stock of BioFX Laboratories, Inc. (BioFX), a provider of substrates to the *in vitro* diagnostics industry. The sellers of BioFX are still eligible to receive up to $3.5 million in additional consideration based on specific revenue targets through calendar 2011.

SurModics Pharmaceuticals, Inc. In July 2007, the Company acquired 100% of the capital stock of Brookwood Pharmaceuticals Inc. (now known as SurModics Pharmaceuticals, Inc.) (SurModics Pharmaceuticals), a drug delivery company that provides proprietary polymer-based technologies to companies developing pharmaceutical products. The sellers of SurModics Pharmaceuticals are still eligible to receive up to $15.5 million in additional consideration based on successful achievement of specific milestones through calendar 2011.

Alabama Jobs Commitment. In April 2008, the Company purchased a 286,000 square foot office and warehouse facility to support Current Good Manufacturing Practices manufacturing needs of customers and the anticipated growth of the SurModics Pharmaceuticals business. At the same time, SurModics Pharmaceuticals entered into an agreement with various governmental authorities to obtain financial incentives associated with creation of jobs in Alabama. Some of the governmental agencies have recapture rights in connection with the financial incentives if a specific number of full-time employees are not hired by June 2012, with an extension to June 2013 if circumstances or events occur that are beyond the control of SurModics Pharmaceuticals or could not have been reasonably anticipated by SurModics Pharmaceuticals. As of June 30, 2010, SurModics Pharmaceuticals has received $1.7 million in connection with the agreement, and the Company has recorded the payment in other long-term liabilities. If the additional jobs are created, the Company will recognize the $1.7 million as an offset to operating expenses in the period the contingency is resolved.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition, results of operations and trends for the future should be read together with our unaudited condensed consolidated financial statements and related notes appearing elsewhere in this report. Any discussion and analysis regarding trends in our future financial condition and results of operations are forward-looking statements that involve risks, uncertainties and assumptions, as more fully identified in Forward-Looking Statements. Our actual future financial condition and results of operations may differ materially from those anticipated in the forward-looking statements.

Overview

SurModics is a leading provider of drug delivery and surface modification technologies to the healthcare industry. In March 2010 we announced a change in our operational structure to better align functional expertise, which resulted in the elimination of the Company s business units. This new structure is designed to support future growth by better meeting customer needs, leveraging our multiple competencies across our organization, and building on our pharmaceutical industry experience.

The organization change did not impact the Company s continued market focus. The Therapeutic market includes revenue from: (1) Cardiovascular, which provides drug delivery and surface modification technologies to customers in the cardiovascular market; (2) Ophthalmology, which is focused on the advancement of treatments for eye diseases, such as age-related macular degeneration (AMD) and diabetic macular edema (DME), two of the leading causes of blindness; and (3) Other Markets, which is focused on a variety of clinical markets principally in the pharmaceutical and biotechnology industries. The Diagnostic market includes revenue from the Company s microarray slide technologies, our stabilization products, antigens and substrates for immunoassay diagnostic tests, and our *in vitro* diagnostic format technology.

The Company s revenue is derived from three primary sources: (1) royalties and license fees from licensing our proprietary drug delivery and surface modification technologies 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 polymers and reagent chemicals, stabilization products, antigens, substrates and microarray slides to the diagnostics and biomedical research industry; and (3) research and development fees generated on customer projects. Revenue fluctuates from quarter to quarter depending on, among other factors: our customers success in selling products incorporating our technologies; the timing of introductions of licensed products by customers; the timing of introductions of products that compete with our customers products; the number and activity level associated with customer development projects; the number and terms of new license agreements that are finalized; the value of reagent chemicals and other products sold to customers; and the timing of future acquisitions we complete, if any.

For financial accounting and reporting purposes, we report our results in one reportable segment. We made this determination because we manage our sales and marketing efforts and our expenses on a company-wide basis. In addition, a significant percentage of our employees provide support services (including research and development) to a variety of customers; and technology and products are marketed to the same or similar customers.

In June 2007, we signed a collaborative research and license agreement with Merck & Co., Inc. (Merck) to pursue the joint development and commercialization of the I-vation™ sustained drug delivery system with triamcinolone acetonide and other products that combine Merck proprietary drug compounds with the I-vation system for the treatment of serious retinal diseases. Under the terms of our agreement with Merck, we received an up-front license fee of $20 million and had the potential to receive up to an additional $288 million in fees and development milestones associated with the successful product development and attainment of appropriate U.S. and EU regulatory approvals for these new combination products.

In September 2008, Merck gave notice that it was terminating the collaborative research and license agreement, as well as the supply agreement entered into in June 2007, following a strategic review of Merck s business and product development portfolio. The termination was effective December 16, 2008. SurModics recognized revenue previously deferred, totaling $34.8 million, under the accounting treatment required for revenue arrangements with multiple deliverables. In addition, we received and recognized a $9 million milestone payment from Merck associated with the termination of the triamcinolone acetonide development program in the first quarter of fiscal 2009.

On October 5, 2009, we entered into a License and Development Agreement with F. Hoffmann-La Roche, Ltd. (Roche) and Genentech, Inc., a wholly owned member of the Roche Group (Genentech). Under the terms of the agreement, Roche and Genentech have an exclusive license to develop and commercialize a sustained drug delivery formulation of Lucentis® (ranibizumab injection) utilizing SurModics proprietary biodegradable microparticles drug delivery technologies. We received an up-front licensing fee of $3.5 million and are eligible to receive potential payments of up to approximately $200 million in fees and milestone payments in the event of the successful development and commercialization of multiple products, as well as payment for development work done on these products. In addition, Roche and Genentech could request that SurModics provide manufacturing services. In the event a commercial product is developed, we would also receive royalties on sales of such product.

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 sensitive to result in materially different results under different assumptions and conditions. See Note 2 to the condensed consolidated financial statements for disclosures related to key accounting policies and recently adopted accounting pronouncements.

Our revenue recognition accounting policy regarding arrangements with multiple deliverables was changed effective October 1, 2009, as a direct effect of the early adoption of the new accounting guidance regarding multiple element arrangements. We have applied the new accounting guidance on a prospective basis for applicable transactions that originated or were materially modified after October 1, 2009.

For a detailed description of our other critical accounting policies, see the notes to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended September 30, 2009.

Results of Operations Three Months Ended June 30

(Dollars in thousands)	**Three Months Ended June 30, 2010**	**2009**	**Increase (Decrease)**	**Change %**
Revenue:				
Therapeutic				
Cardiovascular	$ 11,036	$ 10,063	$ 973	10%
Ophthalmology	1,099	1,770	(671)	(38)%
Other Markets	3,260	3,500	(240)	(7)%
Total Therapeutic	15,395	15,333	62	%
Diagnostic	3,213	2,853	360	13%
Total revenue	$ 18,608	$ 18,186	$ 422	2%

Revenue. Revenue during the third quarter of fiscal 2010 was $18.6 million, an increase of $0.4 million or 2%, compared with the third quarter of fiscal 2009. The increases in Therapeutic and Diagnostic revenue, as detailed in the table above, are further explained in the narrative below.

Therapeutic. Revenue in Therapeutic was $15.4 million in the third quarter of fiscal 2010, slightly higher compared with $15.3 million in the third quarter of fiscal 2009. The increase in total revenue was driven by higher royalties and license fees and product sales, offset by lower research and development (R&D) revenue. Therapeutic revenue is further characterized by the market-focused areas detailed above.

Cardiovascular derives a substantial amount of revenue from royalties and license fees and product sales attributable to Cordis Corporation, a Johnson & Johnson company, on its CYPHER® Sirolimus-eluting Coronary Stent. The CYPHER® stent incorporates a proprietary SurModics polymer coating that delivers a therapeutic drug designed to reduce the occurrence of restenosis in coronary artery lesions. The CYPHER® stent faces continuing competition from Boston Scientific, Medtronic and Abbott Laboratories. Stents from these companies compete directly with the CYPHER® stent both domestically and internationally. Future royalty and reagent sales revenue could decrease as a result of lower CYPHER® stent sales from ongoing and expected future competition. We anticipate that royalty revenue from the CYPHER® stent may be volatile throughout fiscal 2010 and beyond as the various marketers of drug-eluting stents compete in the marketplace and as other companies enter the marketplace.

We also receive a royalty on the Medtronic Endeavor® and Endeavor® Resolute drug-eluting stent delivery systems incorporating our hydrophilic technology, which is sold in the United States and internationally and commenced sales in Japan in May 2009.

Cardiovascular revenue increased $1.0 million, or 10%, in the third quarter of fiscal 2010, compared with the third quarter of fiscal 2009 with the increase principally from license fees which included recognition of one-time fees of $1.25 million, offset by a modest decrease in royalties. Royalties from our broad portfolio of royalty generating customers nearly offset the decrease in royalty revenue from Cordis reflecting a 29% decrease in Cordis CYPHER® stent sales.

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Ophthalmology revenue decreased $0.7 million, or 38%, in the third quarter of fiscal 2010, compared with the third quarter of fiscal 2009. The decrease principally reflects lower R&D revenue as certain customer programs required a lower level of SurModics involvement.

Other Markets revenue decreased 7% in the third quarter of fiscal 2010, compared with the third quarter of fiscal 2009 principally as a result of lower product sales. Other Markets revenue is derived from more than 50 customers.

Diagnostic. Revenue in Diagnostic was $3.2 million in the third quarter of fiscal 2010, an increase of 13% compared with $2.9 million in the prior-year period. This increase was attributable to higher sales of our component *in vitro* diagnostic products.

Product costs. Product costs were $2.4 million in the third quarter of fiscal 2010, compared with $2.0 million in the prior-year period. The $0.4 million increase principally reflects the impact of overall product sales increases. Overall product margins averaged 59%, compared with 61% reported last year.

Customer research and development expenses. Customer research and development (Customer R&D) expenses were $4.6 million, an increase of 46% compared with the third quarter of fiscal 2009. The increase principally reflects the impact of higher fixed overhead costs attributable to our Alabama research and development operations. The margin on R&D revenue were negative 33% in the third quarter of fiscal 2010, compared with positive margin of 34% for the third quarter of fiscal 2009.

Other research and development expenses. Other research and development (Other R&D) expenses were $4.2 million for the third quarter of fiscal 2010, a decrease of 5% compared with the third quarter of fiscal 2009. The decrease principally reflects lower allocated overhead costs.

Selling, general and administrative expenses. Selling, general and administrative (SG&A) expenses were $4.9 million for the three months ended June 30, 2010, which were $1.0 million, or 26% higher, compared with $3.9 million in the prior-year period. Higher outside service costs, bad debt expense and increased costs at our Alabama operations were the principal contributors to the increase.

Asset impairment charges. In the third quarter ended June 30, 2010, we recorded net asset impairment charges of $0.2 million. We recognized an impairment charge of $0.4 million associated with prototypes and other equipment related to a development project for which no ongoing business is expected in the near term in light of current market conditions. We also reversed $0.2 million of previously recorded asset impairment charges associated with a facility in Alabama. The facility was presented as an asset held for sale and was recorded at fair value less estimated selling costs during the second quarter of fiscal 2010, resulting in an asset impairment charge of $2.1 million. During the current quarter we re-classified the facility to held and used property following further analysis of various factors associated with the consolidation of facilities, which resulted in the property being recorded at its current fair value, which was $0.2 million higher than the fair value less estimated selling costs at the time we determined it to be available for sale in the second quarter of fiscal 2010 and recorded the initial asset impairment charge.

Other (loss) income. Other (loss) income was a loss of $2.0 million in the third quarter of fiscal 2010, compared with income of $0.8 million in the third quarter of fiscal 2009. The decrease primarily reflects an impairment loss on investments of $2.6 million in two of our strategic investments. Partially offsetting the fiscal 2010 impairment loss was income from investments of $0.2 million, compared with $0.4 million in the third quarter of fiscal 2009. There were realized gains from our investment portfolio of $0.3 million and $0.4 million in fiscal 2010 and 2009, respectively.

Income tax expense. The Company recorded an income tax expense of $1.1 million in the third quarter of fiscal 2010, compared with $1.9 million in the prior-year period. The effective tax rate was 603.3%, compared with 35.1% in the prior-year period. Excluding the impact of the $2.6 million in investment impairment losses (since we do not currently foresee offsetting capital gains that could offset these capital losses, no tax benefit has been recorded), the effective rate was 39.8%. The increase in the adjusted effective tax rate was primarily attributable to state income taxes, lower incentive stock option deductions and income tax reserve adjustments.

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Results of Operations Nine Months Ended June 30

(Dollars in thousands)	Nine Months Ended June 30, 2010	2009	Increase (Decrease)	Change %
Revenue:				
Therapeutic				
Cardiovascular	$ 30,994	$ 30,036	$ 958	3%
Ophthalmology	7,001	50,252	(43,251)	(86)%
Other Markets	8,033	10,197	(2,164)	(21)%
Total Therapeutic	46,028	90,485	(44,457)	(49)%
Diagnostic	8,321	11,842	(3,521)	(30)%
Total revenue	$ 54,349	$ 102,327	$ (47,978)	(47)%

Revenue. Revenue for the first nine months of fiscal 2010 was $54.3 million, a decrease of $48.0 million or 47% compared with the first nine months of fiscal 2009. The decreases in Therapeutic and Diagnostic revenue, as detailed in the table above, are further explained in the narrative below.

Therapeutic. Revenue in Therapeutic was $46.0 million in the first nine months of fiscal 2010, a decrease of 49% compared with $90.5 million in the first nine months of fiscal 2009. The decrease in total revenue reflects the recognition of revenue of approximately $45 million associated with the terminated Merck collaborative research and license agreement, which was terminated effective in the first quarter of fiscal 2009. Excluding this significant event-specific item in fiscal 2009, revenue increased $0.5 million in the first nine months of fiscal 2010 compared with the comparable prior period. Therapeutic revenue is further characterized by the market-focused areas detailed above.

Cardiovascular revenue increased 3% in the first nine months of fiscal 2010 compared with the first nine months of fiscal 2009. Increased royalties and license fees and product sales were partially offset by a decrease in R&D revenue. Royalty revenue from Cordis decreased, reflecting a 23% decrease in Cordis CYPHER® stent sales.

Ophthalmology revenue decreased $43.3 million, or 86%, in the first nine months of fiscal 2010, compared with the first nine months of fiscal 2009. The significant decrease relates to the recognition of previously deferred revenue associated with the terminated collaborative research and license agreement with Merck. In September 2008, following a strategic review of Merck s business and product development portfolio, Merck gave notice that it was terminating the collaborative research and license agreement as well as the supply agreement entered into in June 2007. The termination became effective in December 2008. In the first nine months of fiscal 2009, we recognized the revenue previously deferred totaling $34.8 million, and we received and recognized a $9 million milestone payment from Merck associated with the termination of the triamcinolone acetonide development program.

Ophthalmology revenue, when excluding the Merck event-specific items in the first nine months of fiscal 2009, increased by $1.7 million, or 33%, principally as a result of higher R&D revenue.

Other Markets revenue decreased $2.2 million, or 21%, in the first nine months of fiscal 2010, compared with the first nine months of fiscal 2009. Lower R&D revenue was the main contributor to the decrease. Select customers have delayed, slowed or canceled development projects as a result of various factors, including current economic conditions.

Diagnostic. Revenue in Diagnostic was $8.3 million in the first nine months of fiscal 2010, a decrease of 30% compared with $11.8 million in the prior-year period. The decrease was attributable to $3.8 million lower royalties and license fees. In past periods, Diagnostic derived a significant percentage of revenue from royalties generated under our diagnostic format patent license agreement with Abbott Laboratories. Our agreement with Abbott

Laboratories ceased following the expiration of licensed patents, which occurred in December 2008. Product sales increased 4% over prior-period levels.

Product costs. Product costs were $6.8 million in the first nine months of fiscal 2010, compared with $5.3 million in the prior-year period. The $1.5 million increase in product costs principally reflects higher product sales. Overall product margins averaged 56%, compared with 61% reported in the first nine months of fiscal 2009. The decrease in product margins reflects a shift in the mix of products sold and cost increases related to certain product lines.

Customer research and development expenses. Customer R&D expenses were $12.7 million, an increase of 24% compared with the first nine months of fiscal 2009. The increase principally reflects the impact of increased fixed overhead costs (depreciation, utilities and other building-related costs) attributable to our Alabama research and development operations. Our new cGMP facility was placed in service in fiscal 2010, leading to higher operating costs. Customer R&D margins were negative 3%, compared with positive 32% in the first nine months of fiscal 2009.

Other research and development expenses. Other R&D expenses were $13.5 million for the first nine months of fiscal 2010, a decrease of 11% compared with the first nine months of fiscal 2009. The decrease principally reflects lower labor costs as a result of more employees dedicated to customer research and development activities, a decrease in our overall R&D headcount and lower overhead costs being allocated to Other R&D, offset by higher material expenses.

Selling, general and administrative expenses. SG&A expenses were $13.7 million for the nine months ended June 30, 2010, a 5% increase compared with $13.0 million in the prior-year period. Higher costs incurred for outside services, an increase in the allowance for doubtful accounts and our new Alabama facility costs allocated to SG&A were the primary contributors to higher expenses.

Purchased in-process research and development. In November 2008, we acquired certain assets comprised of intellectual property and collaborative programs from PR Pharmaceuticals, Inc. The fair value of $3.2 million associated with the in-process research and development intangible asset was determined by management and recognized as an expense in the nine months ended June 30, 2009.

Restructuring charges. In March 2010, we announced an organizational change designed to support future growth by better meeting customer needs, leveraging our multiple competencies across the organization, and building on our pharmaceutical industry experience.

SurModics recorded total restructuring charges of approximately $1.3 million in connection with the fiscal 2010 reorganization. These pre-tax charges consisted of $0.8 million of severance pay and benefits expenses and $0.5 million of facility-related costs.

In November 2008, we announced a functional reorganization to better serve our customers and improve our operating performance and recorded total restructuring charges of approximately $1.8 million in connection with the 2009 reorganization. These pre-tax charges consisted of $0.5 million of severance pay and benefits expenses and $1.3 million of facility-related costs.

Asset impairment charges. In the nine months ended June 30, 2010, we recorded a $1.9 million asset impairment charge associated with one of our facilities in Alabama. We also recognized a $0.4 million asset impairment charge associated with prototypes and other equipment related to a development project for which no ongoing business is expected in the near term in light of current market conditions.

Other (loss) income. Other (loss) income was a loss of $1.5 million in the first nine months of fiscal 2010, compared with income of $1.8 million in the first nine months of fiscal 2009. The decrease primarily reflects impairment loss on investments of $2.6 million in fiscal 2010 in two of our strategic investments. Partially offsetting the fiscal 2010 impairment loss was income from investments of $0.8 million, compared with investment income of $1.5 million in the prior-year period. The decrease in investment income primarily reflects lower investment balances. We also recognized gains from our investment portfolio of $0.3 million and $0.8 million in fiscal 2010 and 2009, respectively. Our fiscal 2009 realized gains were partially offset by our *pro rata* net loss on equity method investments.

Income tax expense. The income tax provision was $2.0 million in the first nine months of fiscal 2010, compared with $20.5 million in the prior-year period. The effective tax rate was 77.7%, compared with 37.0% in the prior-year period. Excluding the impact of the $2.6 million in investment impairment losses, the effective rate was 38.9%. The increase over the federal statutory rate of 35% was primarily related to lower incentive stock option deductions and state income taxes.

Liquidity and Capital Resources

As of June 30, 2010, the Company had working capital of $32.9 million, of which $21.7 million consisted of cash, cash equivalents and short-term investments. Working capital increased $3.9 million from September 30, 2009, principally reflecting higher short-term investments and prepaid and other current assets offset by lower accounts receivable balances. Our cash, cash equivalents and short-term and long-term investments totaled $54.8 million at June 30, 2010, an increase of $6.9 million from $47.9 million at September 30, 2009. The Company s investments principally consist of U.S. government and government agency obligations and investment grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are five years or less. The Company s policy requires that no more than 5% of investments be held in any one credit 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 meeting or exceeding a benchmark (Merrill Lynch 1-3 Year Government-Corporate Index) total rate of return. Management plans to continue to direct its investment advisors to manage the Company s investments primarily for the safety of principal for the foreseeable future, as it assesses other investment opportunities and uses of its investments.

We had cash flows from operating activities of approximately $16.7 million in the first nine months of fiscal 2010, compared with $24.8 million in the first nine months of fiscal 2009. The decrease primarily reflects lower operating results, adjusted for one-time events, and receipt of a $3.5 million up-front license fee from Genentech, compared with fiscal 2009 when we received a $9 million contract termination payment from Merck.

In November 2007, our Board of Directors authorized the repurchase of $35.0 million of the Company s common stock in open-market transactions, private transactions, tender offers, or other transactions. The repurchase authorization does not have a fixed expiration date. During the nine months ended June 30, 2010, the Company repurchased 102,533 shares for $2.0 million at an average price of $19.81 per share, leaving $5.3 million remaining available for future share repurchases under the repurchase program.

As of June 30, 2010, we had no debt under our $25 million unsecured revolving credit facility. As of June 30, 2010, the Company was in compliance with all covenants.

We do not have any other credit agreements and believe that our existing cash, cash equivalents and investments, together with cash flow from operations, will provide liquidity sufficient to meet the below stated needs and fund our operations for the next twelve months. 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 the Company s ability to access capital in a timely manner and on attractive terms, if at all. Our anticipated liquidity needs for the remainder of fiscal 2010 include, but are not limited to, the following: capital expenditures related to the Alabama cGMP facility in the range of $1.5 million to $2.0 million; general capital expenditures in the range of $1.5 million to $2.0 million; contingent consideration payments, if any, related to our acquisitions of SurModics Pharmaceuticals, BioFX Laboratories, Inc., as well as the purchase of certain assets from PR Pharmaceuticals, Inc.; and any amounts associated with the repurchase of common stock under the authorization discussed above.

Off-Balance Sheet Arrangements

As of June 30, 2010, the Company did not have any off-balance sheet arrangements with any unconsolidated entities.

Forward-Looking Statements

Certain statements contained in this report, or in other reports of the Company and other written and oral statements made from time to time by the Company, do not relate strictly to historical or current facts. As such, they are considered forward-looking statements that provide current expectations or forecasts of future events. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements can be identified by the use of terminology such as anticipate, believe, could, estimate, expect, forecast, intend, may, plan, possible, project, will and similar words or expressions that is not a historical fact, including estimates, projections, future trends and the outcome of events that have not yet occurred, are forward-looking statements. The Company s forward-looking statements generally relate to its growth strategy, financial prospects, product development programs, sales efforts, revenue expectations and the impact of the Cordis and Genentech agreements, as well as other significant customer agreements, and capital and liquidity expectations and needs. You should carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions. Consequently, no forward-looking statement can be guaranteed and actual results may vary materially. The Company undertakes no obligation to update any forward-looking statement.

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

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

general economic conditions which are beyond our control, including the impact of recession, business investment and changes in consumer confidence;

frequent intellectual property litigation in the medical device and pharmaceutical industries that may directly or indirectly adversely affect our customers ability to market their products incorporating our technologies;

our ability to protect our own intellectual property;

healthcare reform efforts, including reduced reimbursement rates and new taxes on medical devices and pharmaceutical products that may adversely affect our customers ability to cost-effectively market and sell devices incorporating our technologies or affect the prices they receive for such products thereby affecting the Company s revenue;

the Company s ability to attract new licensees and to enter into agreements for additional product applications with existing licensees, the willingness of potential licensees to sign license agreements under the terms offered by the Company, changes in the development and marketing priorities of our licensees and development partners and the Company s ability to maintain satisfactory relationships with its licensees;

the Company s ability to increase the number of market segments and applications that use its technologies through its sales and marketing and research and development efforts;

the decrease in available financing for the Company s customers and for new ventures which could potentially become customers can reduce the Company s potential opportunities;

market acceptance of products sold by customers incorporating our technologies and the timing of new product introductions by licensees;

market acceptance of products sold by customers competitors and the timing and pricing of new product introductions by customers competitors;

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

efficacy or safety concerns with respect to products marketed by us and our licensees, whether scientifically justified or not, that may lead to product recalls, withdrawals or declining sales;

the ability to secure raw materials for reagents the Company sells;

the Company s ability to successfully manage clinical trials and related foreign and domestic regulatory processes for the I-vation intravitreal implant or other products under development by the Company, whether delays, difficulties or failures in achieving acceptable clinical results or obtaining foreign or FDA marketing clearances or approvals postpone or preclude product commercialization of the intravitreal implant or other products, and whether the intravitreal implant and any other products remain viable commercial prospects;

product liability claims against which we are not indemnified or that are not covered by insurance;

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

the trend of consolidation in the medical device and pharmaceutical industries, resulting in more significant, complex and long term contracts than in the past and potentially greater pricing pressures;

the Company s ability to identify suitable businesses to acquire or with whom to form strategic relationships to expand its technology development and commercialization, its ability to successfully integrate the operations of companies it may acquire from time to time and its ability to create synergies from acquisitions and other strategic relationships;

the Company s ability to successfully internally perform certain product development activities and governmental and regulatory compliance activities which the Company has not previously undertaken in any significant manner;

acts of God or terrorism which impact the Company s personnel or facilities; and

other factors described below in Risk Factors and other sections of SurModics Annual Report on Form 10-K, which you are encouraged to read carefully.

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company s investment policy requires the Company to invest in high credit quality issuers and limits the amount of credit exposure to any one issuer. The Company s investments principally consist of U.S. government and government agency obligations and investment-grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are five years or less. Because of the credit criteria of the Company s investment policies, the primary market risk associated with these investments is interest rate risk. The Company does not use derivative financial instruments to manage interest rate risk or to speculate on future changes in interest rates. A one percentage point increase in interest rates would result in an approximate $0.7 million decrease in the fair value of the Company s available-for-sale and held-to-maturity securities as of June 30, 2010, but no material impact on the results of operations or cash flows. Management believes that a reasonable change in raw material prices would not have a material impact on future earnings or cash flows because the Company s inventory exposure is not material.

Although we conduct business in foreign countries, all sales transactions are denominated in U.S. dollars. 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

As of the end of the period covered by this report, the Company conducted an evaluation under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer regarding the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures 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 principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosures.

Changes in Internal Controls

There was no change in the Company s internal control over financial reporting that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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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, 2009.

Item 1A. Risk Factors.

There have been no material changes from risk factors as previously disclosed in the Company s Form 10-K for the fiscal year ended September 30, 2009 in response to Item 1A to Part I of Form 10-K.

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, 2010, 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.

Period	(a) Total Number of Shares Purchased(1)	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs(2)
04/01/10 04/30/10	0	NA	0	$ 5,302,113
05/01/10 05/31/10	896	$ 17.93	0	$ 5,302,113
06/01/10 06/30/10	0	NA	0	$ 5,302,113
Total	896	$ 17.93	0	$ 5,302,113

(1) The purchases in this column included 896 shares repurchased by the Company to satisfy tax withholding obligations in connection with so-called stock swap exercises related to the vesting of restricted stock awards.

(2)

On November 15, 2007, our Board of Directors announced the authorization of the repurchase of $35 million of outstanding common stock. As of June 30, 2010, we have repurchased a cumulative 1,024,181 shares at an average price of $29.00 per share. Under the current authorization the Company has $5.3 million available for authorized share repurchases as of June 30, 2010. The repurchase authorization does not have an expiration date.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Removed and Reserved.

Item 5. Other Information.

Asset impairment charges

In the third quarter ended June 30, 2010, the Company recorded net asset impairment charges of $0.2 million. The Company recognized an impairment charge of $0.4 million associated with prototypes and other equipment related to a development project for which no ongoing business is expected in the near term in light of current market conditions. The Company also recorded an adjustment to expenses of $0.2 million associated with our facilities in Alabama as we further analyzed various factors associated with the consolidation of one facility and determined to not continue with the sale of the facility at this time, and as such, the estimated selling expenses to sell the facility have been adjusted.

Impairment loss on investments

The Company wrote down two investments totaling $2.6 million in the third quarter ended June 30, 2010, as the investments were deemed to be other-than-temporarily impaired. A pending round of financing at a substantially lower valuation at one of the private companies resulted in an impairment loss of $2.4 million. The second company sold a majority of its assets in light of current market conditions and this action resulted in an impairment loss of $0.2 million.

Item 6. Exhibits.

Exhibit	Description
3.1	Restated Articles of Incorporation, as amended incorporated by reference to Exhibit 3.1 of the Company s Quarterly Report on Form 10-QSB for the quarter ended December 31, 1999, SEC File No. 0-23837.
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.
31.1*	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* 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.

Dated: August 6, 2010

SurModics, Inc.

By: /s/ Philip D. Ankeny
Philip D. Ankeny
Senior Vice President and
Chief Financial Officer

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
EXHIBIT INDEX TO FORM 10-Q
For the Quarter Ended June 30, 2010
SURMODICS, INC.

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