SURMODICS INC
Form 10-Q/A
May 06, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
FORM 10-Q/A
(Amendment No. 1)

(Mark One)

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

For the quarterly period ended December 31, 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) 500-7000

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes 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 February 1, 2011 was 17,488,245.

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SurModics, Inc.

EXPLANATORY NOTE

This Amendment No. 1 on Form 10-Q/A (Form 10-Q/A) to the Company s Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2010, as originally filed with the Securities and Exchange Commission (the SEC) on February 4, 2011 (the Original Filing), is being filed to reflect a restatement of its condensed consolidated financial statements as of December 31, 2010, as discussed in Note 1 to the financial statements included at Item 1.

In connection with the Company s preparation of the Original Filing, the Company determined that the conditions associated with a $4.9 million milestone payment obligation had not been met, and as a result, no liability was recorded. In connection with the preparation of the Company s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2011, the Company determined that it should have recorded the $4.9 million milestone payment obligation in the fiscal quarter ended December 31, 2010, and an associated increase to goodwill in the Pharmaceuticals reporting unit, as the conditions associated with that milestone were determined to have been satisfied as of December 31, 2010. As a result, in this Form 10-Q/A, the Company is restating its condensed consolidated financial statements and related disclosures to recognize the obligation, and the related goodwill impairment charge and tax adjustments.

Although this Form 10-Q/A supersedes the Original Filing in its entirety, this Form 10-Q/A only amends and restates Items 1, 2 and 4 of Part I solely as a result of, and to reflect, the restatement, and no other information in the Original Filing is amended hereby. While the foregoing items have been updated, this amended report does not reflect any other events occurring after the filing of the Form 10-Q on February 4, 2011. In addition, pursuant to the rules of the SEC, Item 6 of Part II of the Original Filing has been amended to contain currently-dated certifications from our Chief Executive Officer and Chief Financial Officer, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002. The certifications of our Chief Executive Officer and Chief Financial Officer are attached to this Form 10-Q/A as Exhibits 31.1, 31.2, 32.1 and 32.2, respectively.

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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)	**December 31, 2010 (As Restated)**	**September 30, 2010**
	(Unaudited)	
ASSETS		
Current Assets		
Cash and cash equivalents	$ 14,309	$ 11,391
Short-term investments	10,149	9,105
Accounts receivable, net of allowance for doubtful accounts of $350 and $461 as of December 31 and September 30, 2010, respectively	8,764	8,987
Inventories	3,111	3,047
Deferred tax asset	678	247
Prepaids and other	2,814	4,701
Total current assets	$ 39,825	$ 37,478
Property and equipment, net	65,043	65,395
Long-term investments	35,247	36,290
Deferred tax asset	3,443	2,606
Intangible assets , net	14,869	15,257
Goodwill	8,010	8,010
Other assets, net	5,048	5,243
Total assets	$ 171,485	$ 170,279
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 2,850	$ 3,341
Accrued liabilities:		
Compensation	1,516	930
Accrued other	6,403	1,753
Deferred revenue	1,793	562
Other current liabilities	1,474	1,061
Total current liabilities	14,036	7,647
Deferred revenue, less current portion	3,773	3,598
Other long-term liabilities	4,702	4,675
Total liabilities	$ 22,511	$ 15,920

Commitments and contingencies (Note 15)		
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; 17,488,634 and 17,423,601 shares issued and outstanding	874	871
Additional paid-in capital	70,672	69,702
Accumulated other comprehensive income	699	886
Retained earnings	76,729	82,900
Total stockholders equity	148,974	154,359
Total liabilities and stockholders equity	$ 171,485	$ 170,279

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

(In thousands, except net (loss) income per share)	Three Months Ended December 31, 2010 (As Restated)	2009
	(Unaudited)	
Revenue		
Royalties and license fees	$ 7,566	$ 9,198
Product sales	4,792	4,548
Research and development	2,810	3,635
Total revenue	15,168	17,381
Operating costs and expenses		
Product	1,825	1,957
Customer research and development	4,731	3,323
Other research and development	2,132	4,719
Selling, general and administrative	5,214	4,614
Goodwill impairment	5,650	
Restructuring charges	1,236	
Total operating costs and expenses	20,788	14,613
(Loss) income from operations	(5,620)	2,768
Other income		
Investment income, net	185	297
Other income, net	36	
Other income, net	221	297
(Loss) income before income taxes	(5,399)	3,065
Income tax provision	(772)	(1,148)
Net (loss) income	$ (6,171)	$ 1,917
Basic net (loss) income per share	$ (0.36)	$ 0.11
Diluted net (loss) income per share	$ (0.36)	$ 0.11
Weighted average shares outstanding		
Basic	17,383	17,396
Dilutive effect of outstanding stock options and non-vested stock		44
Diluted	17,383	17,440

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 Cash Flows

	Three Months Ended December 31,	
	2010 (As Restated)	**2009**
(in thousands)	*(Unaudited)*	
Operating Activities		
Net (loss) income	$ (6,171)	$ 1,917
Adjustments to reconcile net (loss) income to net cash provided by operating activities		
Depreciation and amortization	1,792	1,744
Amortization of premium on investments	27	35
Stock-based compensation	974	1,535
Deferred tax	(1,142)	2,840
Goodwill impairment charge	5,650	
Excess tax benefit from stock-based compensation plans	2	38
Other	125	
Change in operating assets and liabilities:		
Accounts receivable	223	(341)
Inventories	(64)	(113)
Accounts payable and accrued liabilities	428	(262)
Income taxes	1,950	(2,501)
Deferred revenue	1,406	3,370
Prepaids and other	75	(12)
Net cash provided by operating activities	5,275	8,250
Investing Activities		
Purchases of property and equipment	(1,393)	(3,572)
Purchases of available-for-sale investments	(1,412)	(8,284)
Sales/maturities of investments	1,200	3,970
Payments related to prior business acquisitions	(750)	(750)
Net cash used in investing activities	(2,355)	(8,636)
Financing Activities		
Excess tax benefit from stock-based compensation plans	(2)	(38)
Issuance of common stock		282
Purchase of common stock to pay employee taxes		(365)
Net cash used in financing activities	(2)	(121)
Net change in cash and cash equivalents	2,918	(507)
Cash and Cash Equivalents		

Beginning of period	11,391	11,636
End of period	$ 14,309	$ 11,129
Supplemental Information		
Cash paid for income taxes	$ (36)	$ 809
Noncash transaction acquisition of property, plant, and equipment on account	$ 348	$ 214
Noncash transaction acquisition of intangible assets on account	$	$ 210
Noncash transaction milestone payment obligation	$ 4,900	$

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

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SurModics, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
Period Ended December 31, 2010
(Unaudited)

(1) Basis of Presentation and Restatement

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 in estimate is identified. The results of operations for the three-month period ended December 31, 2010 are not necessarily indicative of the results that may be expected for the entire 2011 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, 2010, and footnotes thereto included in the Company s Form 10-K as filed with the United States Securities and Exchange Commission on December 14, 2010.

Restatement

In the three-month period ended December 31, 2010, the Company originally determined that the conditions associated with a $4.9 million milestone payment obligation related to the 2007 acquisition of SurModics Pharmaceuticals, Inc. (SurModics Pharmaceuticals) had not been met, and as a result, did not record a liability associated with this amount during such period. Subsequent to the issuance of its condensed financial statements for such period, the Company determined that it should have recorded this additional $4.9 million milestone payment obligation and an associated increase to goodwill in the Pharmaceuticals reporting unit. The Company has further determined that this additional goodwill should be impaired, as the operating performance of the Pharmaceuticals reporting unit did not support continuing recognition of the goodwill asset. Accordingly, the condensed consolidated financial statements have been restated to reflect the increased goodwill impairment charge and tax adjustments.

The tables below show the net changes between the financial statements as previously reported and as restated (in thousands).

Table 1 Condensed Consolidated Balance Sheets

	As Reported December 31, 2010	Adjustment December 31, 2010	As Restated December 31, 2010
Prepaid and other	$ 3,662	$ (848)	$ 2,814
Total current assets	40,673	(848)	39,825
Total assets	172,333	(848)	171,485
Accrued other liabilities	1,503	4,900	6,403
Total current liabilities	9,136	4,900	14,036
Other long-term liabilities	4,656	46	4,702
Total liabilities	17,565	4,946	22,511
Retained earnings	82,523	(5,794)	76,729
Total stockholders equity	154,768	(5,794)	148,974
Total liabilities and stockholders equity	$ 172,333	$ (848)	$ 171,485

Table 2 Condensed Consolidated Statements of Operations

	As Reported Three months ended December 31, 2010	Adjustment	As Restated Three months ended December 31, 2010
Goodwill impairment	$ 750	$ 4,900	$ 5,650
Total operating costs and expenses	15,888	4,900	20,788
(Loss) income from operations	(720)	(4,900)	(5,620)
(Loss) income before income taxes	(499)	(4,900)	(5,399)
Income tax benefit (provision)	122	(894)	772
Net loss	$ (377)	$ (5,794)	$ (6,171)
Basic net (loss) income per share	$ (0.02)	$ (0.34)	$ (0.36)
Diluted net (loss) income per share	$ (0.02)	$ (0.34)	$ (0.36)

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Table 3 Condensed Consolidated Statements of Cash Flows

	As Reported Three months ended December 31, 2010	Adjustment	As Restated Three months ended December 31, 2010
Net (loss) income	$ (377)	$ (5,794)	$ (6,171)
Goodwill impairment charge	750	4,900	5,650
Income taxes	$ 1,056	$ 894	$ 1,950
Supplemental Information			
Noncash transaction milestone payment obligation	$ 0	$ 4,900	$ 4,900

(2) Key Accounting Policies

Revenue recognition

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

The Company 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. For stand-alone license agreements, up-front license fees are recognized over the term of the related licensing agreement. Minimum royalty fees are recognized in the period earned and collectability is reasonably assured.

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

The milestone payment is non-refundable;

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

Accomplishment of the milestone involved substantial effort;

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

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

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

Product sales. Product sales to third parties 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 contract.

Arrangements with multiple deliverables. 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 enters into license and development arrangements that may consist of multiple deliverables that could include license 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 would 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 a contract 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.

Under the accounting guidance, the Company is still required to evaluate each deliverable in a multiple element arrangement for separability. The Company is then required to allocate revenue to each separate deliverable using a hierarchy of VSOE, TPE, or ESP. In many instances, the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements. This may be a result of the Company infrequently selling each element separately or having a limited history with multiple element arrangements. When VSOE cannot be established, the Company attempts to establish 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 selling price using VSOE or TPE, the Company uses ESP in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. ESP is generally used for highly customized offerings.

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

New Accounting Pronouncements

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

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

Fair Value Hierarchy

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

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

The Company s Level 1 asset consists of its investment in OctoPlus, N.V. (see Note 6 for further information). The fair market value of this investment is based on the quoted price of OctoPlus shares traded on the Euronext 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 an other U.S. government agency security and two mortgage-backed securities. The fair market values of these investments were determined by broker pricing where not all significant inputs were observable.

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.

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 December 31, 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 December 31, 2010
Assets:				
Cash equivalents	$	$ 12,628	$	$ 12,628
Available for sale debt securities				
US government obligations		28,698	695	29,393
Mortgage backed securities		4,263	685	4,948
Municipal bonds		3,079		3,079
Asset backed securities		1,273		1,273
Corporate bonds		2,607		2,607
Other assets	2,496			2,496
Total assets measured at fair value	$ 2,496	$ 52,548	$ 1,380	$ 56,424

Short-term and long-term investments disclosed in the condensed consolidated balance sheets include held-to-maturity investments totaling $4.1 million as of December 31, 2010. Held-to-maturity investments are carried at an amortized cost.

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The following table presents information about the Company s financial assets and liabilities measured at fair value on a recurring basis as of September 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 September 30, 2010
Assets:				
Cash equivalents	$	$ 10,128	$	$ 10,128
Available for sale debt securities				
US government obligations		25,626	704	26,330
Mortgage backed securities		4,757	69	4,826
Municipal bonds		3,150		3,150
Asset backed securities		1,113		1,113
Corporate bonds		5,852		5,852
Other assets	2,624			2,624
Total assets measured at fair value	$ 2,624	$ 50,626	$ 773	$ 54,023

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

The following table is a reconciliation of financial assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) *(in thousands)*:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) For Three Months Ended December 31, 2010