SURMODICS INC
Form 10-Q
May 07, 2010

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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 March 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) 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 May 3, 2010 was 17,409,835.

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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)	**March 31, 2010**	**September 30, 2009**
	(Unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 11,174	$ 11,636
Short-term investments	8,170	8,932
Accounts receivable, net of allowance for doubtful accounts of $195 and $82 as of March 31, 2010 and September 30, 2009, respectively	12,805	11,320
Inventories	3,312	3,330
Deferred tax asset	721	353
Prepaids and other	2,514	1,443
Total current assets	38,696	37,014
Property and equipment, net	64,249	66,915
Long-term investments	32,467	27,300
Deferred tax asset	1,752	2,548
Intangible assets , net	16,644	17,458
Goodwill	21,820	21,070
Other assets, net	14,886	13,257
Total assets	$ 190,514	$ 185,562
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 2,004	$ 3,468
Accrued liabilities	2,219	2,563
Accrued income taxes payable		186
Deferred revenue	1,054	905
Other current liabilities	1,797	862
Total current liabilities	7,074	7,984
Deferred revenue, less current portion	4,047	623
Other long-term liabilities	4,811	4,583
Total liabilities	15,932	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; 17,416,335 and 17,471,472 shares issued and outstanding	871	874
Additional paid-in capital	67,341	66,005
Accumulated other comprehensive income	890	1,504
Retained earnings	105,480	103,989
Total stockholders equity	174,582	172,372
Total liabilities and stockholders equity	$ 190,514	$ 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 March 31,		Six Months Ended March 31,	
	2010	2009	2010	2009
(In thousands, except per share data)	*(unaudited)*		*(unaudited)*	
Revenue				
Royalties and license fees	$ 7,779	$ 10,052	$ 16,977	$ 57,799
Product sales	5,269	4,776	9,817	8,632
Research and development	5,312	6,097	8,947	17,710
Total revenue	18,360	20,925	35,741	84,141
Operating costs and expenses				
Product costs	2,475	1,838	4,432	3,353
Customer research and development	4,783	3,368	8,106	7,073
Other research and development	4,565	5,116	9,284	10,764
Selling, general and administrative	4,109	4,403	8,723	9,086
Purchased in-process research and development				3,200
Restructuring charges	1,306		1,306	1,798
Asset impairment charge	2,074		2,074	
Total operating costs and expenses	19,312	14,725	33,925	35,274
(Loss) income from operations	(952)	6,200	1,816	48,867
Other income				
Investment income	281	397	578	1,131
Other income (loss), net	3	20	3	(129)
Other income	284	417	581	1,002
(Loss) income before income taxes	(668)	6,617	2,397	49,869
Income tax benefit (provision)	241	(2,401)	(907)	(18,568)
Net (loss) income	$ (427)	$ 4,216	$ 1,490	$ 31,301
Basic net (loss) income per share	$ (0.02)	$ 0.24	$ 0.09	$ 1.79
Diluted net (loss) income per share	$ (0.02)	$ 0.24	$ 0.09	$ 1.78
Weighted average shares outstanding				
Basic	17,369	17,320	17,378	17,509
Dilutive effect of outstanding stock options and nonvested stock		29	23	45
Diluted	17,369	17,349	17,401	17,554

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

(In thousands)	Six Months Ended March 31, 2010	2009
	(unaudited)	
Operating Activities:		
Net income	$ 1,490	$ 31,301
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,852	2,999
Loss (gain) on equity method investment and sales of investments	(3)	221
Amortization of premium on investments	68	69
Stock-based compensation	2,760	3,632
Purchased in-process research and development		3,200
Restructuring charges	1,306	1,798
Asset impairment charge	2,074	
Deferred taxes	856	9,203
Tax benefits from exercise of stock options	(90)	273
Change in operating assets and liabilities:		
Accounts receivable	(1,485)	1,721
Inventories	18	(454)
Accounts payable and accrued liabilities	(956)	(2,529)
Income taxes	(1,129)	1,427
Deferred revenue	3,573	(36,118)
Prepaids and other	19	119
Net cash provided by operating activities	12,353	16,862
Investing Activities:		
Purchases of property and equipment	(5,614)	(11,269)
Purchases of available-for-sale investments	(10,696)	(12,280)
Sales/maturities of investments	6,172	16,373
Business acquisition	(750)	(4,040)
Other investing activities	(501)	(202)
Net cash used in investing activities	(11,389)	(11,418)
Financing Activities:		
Tax benefit from exercise of stock options	90	(273)
Issuance of common stock	892	655
Repurchase of common stock	(2,032)	(14,998)
Purchase of common stock to pay employee taxes	(376)	(436)
Repayment of notes payable		(236)
Net cash used in financing activities	(1,426)	(15,288)

Net change in cash and cash equivalents	(462)	(9,844)
Cash and Cash equivalents		
Beginning of period	11,636	15,376
End of period	$ 11,174	$ 5,532
Supplemental Information		
Cash paid for income taxes	$ 1,180	$ 7,869
Noncash transaction accrued contingent consideration or accrued earnout payments in connection with business acquisitions	$	$ 4,530
Noncash transaction acquisition of property, plant, and equipment on account	$ 195	$ 3,977
Noncash transaction acquisition of intangible assets on account	$ 210	$ 631

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 March 31, 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 six-month periods ended March 31, 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 six 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 six 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 the term of the related licensing agreement.

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;

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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 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. 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.

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

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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 six-month periods ended March 31, 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 March 31, 2010		Six months ended March 31, 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	$ 2,355	$ 114	$ 3,377	$ 170

The impact to revenue for the three-month and six-month periods ended March 31, 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.

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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 and 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.

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.

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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 March 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 March 31, 2010
Assets:				
Cash equivalents	$	$ 8,092	$	$ 8,092
Available for sale debt securities				
US government obligations		19,233	924	20,157
Mortgage backed securities		6,356	145	6,501
Municipal bonds		5,153		5,153
Asset back securities		1,862		1,862
Corporate bonds		1,780		1,780
Other assets	2,714			2,714
Total assets measured at fair value	$ 2,714	$ 42,476	$ 1,069	$ 46,259

Short-term and long-term investments disclosed in the condensed consolidated balance sheets include held-to-maturity investments totaling $5.2 million as of March 31, 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 March 31, 2010 *(in thousands)*:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) For the three months ended March 31, 2010		
	Available -for-Sale Debt Securities		
	U.S. government obligations	Mortgage Backed	Total
Balance, December 31, 2009	$ 1,002	$ 75	$ 1,077
Transfers into Level 3		70	70
Total realized and unrealized gains (losses):			
Included in other comprehensive (loss) income	(6)	3	(3)
Purchases, issuances, sales and settlements, net	(72)	(3)	(75)

Balance, March 31, 2010	$ 924	$ 145	$ 1,069

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) For the six months ended March 31, 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		148	148
Transfers out of Level 3	(36)	(73)	(109)
Total realized and unrealized gains (losses):			
Included in other comprehensive (loss) income	(6)	3	(3)
Purchases, issuances, sales and settlements, net:	(164)	(6)	(170)
Balance, March 31, 2010	$ 924	$ 145	$ 1,069

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As of March 31, 2010, marketable securities measured at fair value using Level 3 inputs were comprised of $0.9 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) *(in thousands)*:

	Three Months Ended March 31, 2009	Six Months Ended March 31, 2009
Balance, beginning of period	$ 838	$ 264
Total realized and unrealized gains:		
Included in other comprehensive (loss) income		25
Purchases, issuances and settlements, net	(13)	536
Transfer in (out) of Level 3	(778)	(778)
Balance, end of period	$ 47	$ 47

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 or equity method. 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.

(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 March 31, 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 income (loss). 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 income (loss). Interest on debt securities, including amortization of premiums and accretion of discounts, is included in other income (loss). Realized gains and losses from the sales of debt securities, which are included in other income (loss), are determined using the specific identification method.

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The original cost, unrealized holding gains and losses, and fair value of available-for-sale investments as of March 31, 2010 and September 30, 2009 were as follows (*in thousands*):

	March 31, 2010			
	Original Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government obligations	$ 19,921	$ 249	$ (13)	$ 20,157
Mortgage-backed securities	6,421	155	(74)	6,502
Municipal bonds	4,983	171	(2)	5,152
Asset-backed securities	1,925	38	(101)	1,862
Corporate bonds	1,778	3	(1)	1,780
Total	$ 35,028	$ 616	$ (191)	$ 35,453

	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

The original cost and fair value of investments by contractual maturity at March 31, 2010 were as follows (*in thousands*):

	Amortized Cost	Fair Value
Debt securities due within:		
One year	$ 5,984	$ 6,022
One to five years	21,991	22,411
Five years or more	7,053	7,020
Total	$ 35,028	$ 35,453

The following table summarizes sales of available-for-sale securities for the three-month and six-month periods ended March 31, 2010 (*in thousands*):

	Three Months Ended March 31, 2010	Six Months Ended March 31, 2010
Proceeds from sales	$ 2,202	$ 5,172
Gross realized gains	$ 3	$ 3
Gross realized losses	$	$

At March 31, 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 March 31, 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 six-month period ended March 31, 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. $3.7 million of the total consideration was paid in the six-month period ended March 31, 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

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(IPR&D) of $3.2 million. The IPR&D was expensed on the date of acquisition and relates to polymer-based drug delivery systems. 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.

(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)*:

	March 31, 2010	September 30, 2009
Raw materials	$ 1,386	$ 1,287
Finished products	1,926	2,043
Total	$ 3,312	$ 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 income (loss) 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 has made equity investments in Paragon Intellectual Properties, LLC (Paragon) and a Paragon subsidiary, Apollo Therapeutics, LLC (Apollo). 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). The Company accounted for the investments in Paragon and Apollo under the equity method in the first quarter of fiscal 2009, as both entities reported results to us on a one-quarter lag. Commencing in the second quarter of fiscal 2009, the Company accounted for the investment in Nexeon under the cost method as the Company s ownership level is less than 20%. 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 s investment is accounted for under the cost method, as the Company s ownership interest is less than 20%. This investment is included in the category titled Other in the table below.

In March 2010, the Company recorded a $2.1 million asset impairment charge associated with 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 Company intends to sell a facility within the next twelve months. The remaining asset value, totaling $2.1 million, has been reclassified from property, plant and equipment to assets held for sale and is included in the category titled Other in the table below.

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

	March 31, 2010	September 30, 2009
Investment in OctoPlus N.V.	$ 2,713	$ 3,700
Investment in Nexeon MedSystems	5,651	5,651
Investment in ThermopeutiX	1,185	1,185
Investment in Novocell	559	559
Other	4,778	2,162
Other assets	$ 14,886	$ 13,257

The Company recognized revenue of $0.1 million and $0.2 million for the three-month period ended March 31, 2010 and 2009, respectively, and recognized revenue of $0.2 million and $0.5 million for the six-month period ended March 31, 2010 and 2009, respectively, from activity with companies in which it had a strategic investment.

(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 the three-month periods ended March 31, 2010 and 2009, respectively. The Company recorded amortization expense of $0.8 million and $1.2 million for the six-month periods ended March 31, 2010 and 2009, respectively.

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

	Useful life (in years)	March 31, 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		(4,019)	(3,205)
Intangible assets, net		$ 16,644	$ 17,458

Based on the intangible assets in service as of March 31, 2010, estimated amortization expense for each of the next five fiscal years is as follows (*in thousands*):

Remainder of 2010	$ 814
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 six 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.

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(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 March 31, 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 March 31,		Six months ended March 31, 2010	
	2010	**2009**	**2010**	**2009**
Product costs	$ 31	$ 22	66	$ 46
Customer research and development	150	200	303	366
Other research and development	444	710	1,059	1,453
Selling, general and administrative	600	789	1,332	1,767
Total	$ 1,225	$ 1,721	$ 2,760	$ 3,632

As of March 31, 2010, approximately $10.6 million of total unrecognized compensation costs related to non-vested awards could be recognized over the remaining weighted average period of approximately 2.2 years. The $10.6 million of total unrecognized compensation costs include $3.5 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 March 31, 2010 and 2009 was $6.44 and $7.12, respectively. The weighted average per share fair value of stock options granted during the six-month periods ended March 31, 2010 and 2009 was $6.91 and $8.41, respectively. The assumptions used as inputs in the model were as follows:

	Three months ended March 31,		Six months ended March 31, 2010	
	2010	**2009**	**2010**	**2009**
Risk-free interest rates	2.1%	1.7%	2.0%	2.2%
Expected life (years)	4.8	4.9	4.8	4.8
Expected volatility	41.4%	39.8%	41.4%	38.1%
Dividend yield	0%	0%	0%	0%

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

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 such that the entire option is fully vested five years after date of grant, 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 such that the entire option is fully vested four years after the grant date.

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The total pre-tax intrinsic value of options exercised during the three-month periods ended March 31, 2010 and 2009 was $69,000 and $70,000, respectively. During the six-month periods ended March 31, 2010 and 2009, the total pre-tax intrinsic value of options exercised was $4,000 and $65,000, respectively. The intrinsic value represents the difference between the exercise price and the fair market value of the Company s common stock on the last day of the respective fiscal period end.

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 $0.5 million during three-month and six-month periods ended March 31, 2010, respectively, and $0.5 million and $1.1 million for the three-month and six-month periods ended March 31, 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 an expense in the three-month period ended March 31, 2010 and recognized expense of $32,000 for the six-month period ended March 31, 2010 related to the Performance Shares granted. For the three-month and six-month periods ended March 31, 2009, the Company recognized expenses of $10,000 and reduced expenses by $29,000, 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 March 31, 2010 and 2009, there were $0.1 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 March 31, 2010 and 2009 totaled $0.1 million in each period. Stock compensation expense for the six-month periods ended March 31, 2010 and 2009 totaled $0.1 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 second 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 $0.1 million as of March 31, 2010, resulting in a balance of $1.2 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.

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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 $0.9 million as of March 31, 2010 resulting in a balance of $0.9 million.

The charges above for fiscal 2010 have been presented separately as restructuring charges in the condensed consolidated statements of operations. The remaining balance is expected to be paid within the next 45 months. As such, the current portion totaling $1.8 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 six 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	(89)	(74)	(163)
Balance at March 31, 2010	$ 729	$ 1,369	$ 2,098

(13) Asset impairment charge

In the second quarter ended March 31, 2010, the Company recorded a $2.1 million asset impairment charge associated with 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 Company intends to sell a facility within the next twelve months. 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. The assets that are held for sale were written down to their fair value of $2.3 million, less selling costs of $0.2 million, and the net amount has been reclassified from property, plant and equipment and included within other assets on the condensed consolidated balance sheets.

(14) Comprehensive Income

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

	Three months ended March 31,		Six months ended March 31,	
	2010	2009	2010	2009
Net (loss) income	$ (427)	$ 4,216	$ 1,490	$ 31,301
Other comprehensive (loss) income:				
Unrealized holding gains (losses) on available-for-sale securities arising during the period, net of tax	(100)	79	(612)	613
Less reclassification adjustment for realized gains included in net income, net of tax	(2)		(2)	(201)
Other comprehensive (loss) income	(102)	79	(614)	412
Comprehensive (loss) income	$ (529)	$ 4,295	$ 876	$ 31,713

(15) Income Taxes

The Company recorded an income tax benefit of $0.2 million and an income tax provision of $2.4 million for the three-month periods ended March 31, 2010 and 2009, respectively, representing effective tax rates of 36.1% and 36.3%, respectively. The Company recorded income tax provisions of $0.9 million and $18.6 million for the six-month periods ended March 31, 2010 and 2009, respectively, representing effective tax rates of 37.8% and 37.2%, respectively. The difference between the U.S. federal statutory tax rate of 35% and the Company s effective tax rate 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 six-month period ended

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March 31, 2010 was $39,000, unchanged from the amount recognized in the three-month period ended December 31, 2009. During the six-month period ended March 31, 2009, the Company recognized a discrete benefit of approximately $120,000 related to 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 March 31, 2010 and September 30, 2009, respectively, are $2.1 million and $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, 2006, 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 six-month periods in fiscal 2010 and 2009, (*in thousands*):

	Three months ended March 31,		Six months ended March 31, 2010	
	2010	2009	2010	2009
Therapeutic				
Cardiovascular	$ 9,244	$ 9,570	$ 19,958	$ 19,973
Ophthalmology	3,405	3,710	5,902	48,842
Other Markets	2,889	2,925	4,772	6,697
Total Therapeutic	15,538	16,205	30,632	75,152
Diagnostic	2,822	4,720	5,109	8,989
Total revenue	$ 18,360	$ 20,925	$ 35,741	$ 84,141

(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.

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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 March 31, 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.

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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 will have an exclusive license to develop and commercialize a sustained drug delivery formulation of Lucentis® (ranibizumab injection) utilizing SurModics proprietary biodegradable microparticles drug delivery system. 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 will 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 March 31

(Dollars in thousands)	Three Months Ended March 31, 2010	2009	Increase (Decrease)	Change %
Revenue:				
Therapeutic				
Cardiovascular	$ 9,244	$ 9,570	$ (326)	(3)%
Ophthalmology	3,405	3,710	(305)	(8)%

Other Markets	2,889	2,925	(36)	(1)%
Total Therapeutic	15,538	16,205	(667)	(4)%
Diagnostic	2,822	4,720	(1,898)	(40)%
Total revenue	$ 18,360	$ 20,925	$ (2,565)	(12)%

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Revenue. Revenue during the second quarter of fiscal 2010 was $18.4 million, a decrease of $2.6 million or 12%, compared with the second quarter of fiscal 2009. The decreases in Therapeutic and Diagnostic revenue, as detailed in the table above, are further explained in the narrative below.