

SURMODICS INC
Form 10-Q
February 04, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2013

or

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

For the transition period from _____ to _____

Commission File Number: 0-23837

SurModics, Inc.

(Exact name of registrant as specified in its charter)

MINNESOTA
(State of incorporation)

41-1356149
(I.R.S. Employer

Identification No.)

9924 West 74th Street

Eden Prairie, Minnesota 55344

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (952) 500-7000

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of the registrant's Common Stock, \$.05 par value per share, outstanding as of January 31, 2014 was 13,518,835.

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

Item 1. Financial Statements

SurModics, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

| | December 31, 2013 | September 30, 2013 |
|---|----------------------|-----------------------|
| <i>(in thousands, except share and per share data)</i> | | |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 10,516 | \$ 15,495 |
| Available-for-sale securities | 12,481 | 10,212 |
| Accounts receivable, net of allowance for doubtful accounts of \$67 and \$26 as of December 31, 2013 and September 30, 2013, respectively | 5,110 | 5,332 |
| Inventories | 2,832 | 3,328 |
| Deferred tax assets | 303 | 506 |
| Prepays and other | 592 | 860 |
| Current assets of discontinued operations | 46 | 46 |
| Total Current Assets | 31,880 | 35,779 |
| Property and equipment, net | 12,486 | 12,845 |
| Available-for-sale securities | 30,149 | 32,397 |
| Deferred tax assets | 5,863 | 6,038 |
| Intangible assets, net | 3,502 | 3,688 |
| Goodwill | 8,010 | 8,010 |
| Other assets, net | 3,166 | 3,166 |
| Total Assets | \$ 95,056 | \$ 101,923 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 1,366 | \$ 954 |
| Accrued liabilities: | | |
| Compensation | 844 | 2,271 |
| Accrued other | 1,202 | 1,149 |
| Share repurchase accrual | 513 | 1,004 |
| Deferred revenue | 42 | 43 |
| Restructuring and other current liabilities | 228 | 416 |
| Current liabilities of discontinued operations | 126 | 139 |
| Total Current Liabilities | 4,321 | 5,976 |
| Deferred revenue, less current portion | 151 | 160 |
| Other long-term liabilities | 1,636 | 1,970 |

| | | |
|--|-----------|------------|
| Total Liabilities | 6,108 | 8,106 |
| Commitments and Contingencies (Note 17) | | |
| Stockholders' Equity: | | |
| Series A Preferred stock- \$.05 par value, 450,000 shares authorized; no shares issued and outstanding | | |
| Common stock- \$.05 par value, 45,000,000 shares authorized; 13,622,451 and 13,891,402 shares issued and outstanding, respectively | 681 | 695 |
| Additional paid-in capital | | 2,028 |
| Accumulated other comprehensive income | 25 | 58 |
| Retained earnings | 88,242 | 91,036 |
| Total Stockholders' Equity | 88,948 | 93,817 |
| Total Liabilities and Stockholders' Equity | \$ 95,056 | \$ 101,923 |

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

Table of Contents**SurModics, Inc. and Subsidiaries**

Condensed Consolidated Statements of Income

| | Three Months Ended December 31, 2013 2012 (Unaudited) | |
|--|---|-----------------|
| <i>(In thousands, except per share data)</i> | | |
| Revenue: | | |
| Royalties and license fees | \$ 7,465 | \$ 7,516 |
| Product sales | 5,400 | 5,353 |
| Research and development | 1,018 | 982 |
| Total revenue | 13,883 | 13,851 |
| Operating costs and expenses: | | |
| Product costs | 2,004 | 1,959 |
| Research and development | 3,699 | 3,362 |
| Selling, general and administrative | 3,851 | 3,653 |
| Total operating costs and expenses | 9,554 | 8,974 |
| Operating income | 4,329 | 4,877 |
| Other income: | | |
| Investment income, net | 86 | 72 |
| Gain on sale of strategic investment | 681 | 1,174 |
| Other investment capital gains | | 2 |
| Other income | 767 | 1,248 |
| Income before income taxes | 5,096 | 6,125 |
| Income tax provision | (1,466) | (1,877) |
| Net income | \$ 3,630 | \$ 4,248 |
| Basic net income per share | \$ 0.26 | \$ 0.29 |
| Diluted net income per share | \$ 0.26 | \$ 0.29 |
| Weighted average number of shares outstanding: | | |
| Basic | 13,756 | 14,655 |
| Diluted | 14,009 | 14,863 |

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

Table of Contents**SurModics, Inc. and Subsidiaries**

Condensed Consolidated Statements of Comprehensive Income

| <i>(In thousands)</i> | Three Months Ended | |
|--|---------------------------|-------------|
| | December 31, | |
| | 2013 | 2012 |
| | <i>(Unaudited)</i> | |
| Net income | \$ 3,630 | \$ 4,248 |
| Other comprehensive (loss) income, net of tax: | | |
| Unrealized holding (losses) gains on available-for-sale securities arising during the period | (33) | 240 |
| Reclassification adjustment for realized gains included in net income | | (3) |
| Other comprehensive (loss) income | (33) | 237 |
| Comprehensive income | \$ 3,597 | \$ 4,485 |

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

Table of Contents**SurModics, Inc. and Subsidiaries**

Condensed Consolidated Statements of Cash Flows

| | Three Months Ended December 31, 2013 2012 (Unaudited) | |
|--|---|----------|
| <i>(in thousands)</i> | | |
| Operating Activities: | | |
| Net income | \$ 3,630 | \$ 4,248 |
| Adjustments to reconcile net income to net cash provided by operating activities from continuing operations: | | |
| Depreciation and amortization | 697 | 722 |
| Stock-based compensation | 813 | 392 |
| Deferred tax | 395 | 27 |
| Gain on sale of strategic investment | (681) | (1,174) |
| Excess tax (benefit) deficiency from stock-based compensation plans | (690) | 4 |
| Other | | (2) |
| Change in operating assets and liabilities: | | |
| Accounts receivable | 222 | 653 |
| Inventories | 496 | 302 |
| Prepays and other | 62 | 111 |
| Accounts payable and accrued liabilities | (1,641) | (1,499) |
| Income taxes | 947 | 1,623 |
| Net cash provided by operating activities from continuing operations | 4,250 | 5,407 |
| Investing Activities: | | |
| Purchases of property and equipment | (56) | (857) |
| Purchases of available-for-sale securities | (2,938) | (843) |
| Sales and maturities of available-for-sale securities | 2,867 | 805 |
| Cash (transferred to) received from discontinued operations | (13) | 75 |
| Cash received from sale of a strategic investment | 681 | 1,258 |
| Net cash provided by investing activities from continuing operations | 541 | 438 |
| Financing Activities: | | |
| Excess tax benefit (deficiency) from stock-based compensation plans | 690 | (4) |
| Issuance of common stock | 61 | 84 |
| Repurchase of common stock | (9,424) | |
| Purchase of common stock to pay employee taxes | (1,097) | |
| Net cash (used in) provided by financing activities from continuing operations | (9,770) | 80 |
| Net cash (used in) provided by continuing operations | (4,979) | 5,925 |

| | | |
|---|------|------|
| Discontinued Operations: | | |
| Net cash (used in) provided by operating activities | (13) | 75 |
| Net cash provided by (used in) financing activities | 13 | (75) |

Net cash provided by discontinued operations

| | | |
|---|---------|-------|
| Net change in cash and cash equivalents | (4,979) | 5,925 |
|---|---------|-------|

Cash and Cash Equivalents:

| | | |
|---------------------|-----------|-----------|
| Beginning of period | 15,495 | 15,540 |
| End of period | \$ 10,516 | \$ 21,465 |

Supplemental Information:

| | | |
|---|----------|--------|
| Cash paid for income taxes | \$ 124 | \$ 228 |
| Noncash transactions acquisition of property and equipment on account | \$ 123 | \$ 209 |
| Noncash transactions share repurchase accrual | \$ 513 | \$ |
| Noncash transactions issuance of performance shares | \$ 2,756 | \$ |

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, 2013

(Unaudited)

1. Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S.) (GAAP) and, in the opinion of management, reflect all adjustments, consisting solely of normal recurring adjustments, needed to fairly present the financial results of SurModics, Inc. and subsidiaries (SurModics or the Company) for the periods presented. These financial statements include some amounts that are based on management s best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of earnings in the period in which the change in estimate is identified. The results of operations for the three months ended December 31, 2013 are not necessarily indicative of the results that may be expected for the entire 2014 fiscal year.

In accordance with the rules and regulations of the U.S. Securities and Exchange Commission (SEC), the Company has omitted footnote disclosures that would substantially duplicate the disclosures contained in the audited financial statements of the Company. These unaudited condensed consolidated financial statements should be read together with the audited consolidated financial statements for the fiscal year ended September 30, 2013, and footnotes thereto included in the Company s Form 10-K as filed with the Securities and Exchange Commission on December 11, 2013.

2. Key Accounting Policies

Revenue recognition

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

The Company derives its revenue from three primary sources: (1) royalties and license fees from licensing its proprietary drug delivery and surface modification technologies and *in vitro* diagnostic formats to customers; (2) the sale of reagent chemicals to licensees and the sale of stabilization products, antigens, substrates and surface coatings to the diagnostic and biomedical research markets; and (3) research and commercial development fees generated on customer projects.

Royalties and license fees. The Company licenses technology to third parties and collects royalties. Royalty revenue is generated when a customer sells products incorporating the Company s licensed technologies. Royalty revenue is recognized as licensees report it to the Company, and payment is typically submitted concurrently with the report. For stand-alone license agreements, up-front license fees are recognized over the term of the related licensing agreement. Minimum royalty fees are recognized in the period earned.

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

The milestone payment is non-refundable;

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

Accomplishment of the milestone involved substantial effort;

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

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

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

Product sales. Product sales to third parties consist of direct and distributor sales and are recognized at the time of shipment. The Company's sales terms provide no right of return outside of the standard warranty policy. Payment terms are generally set at 30-45 days.

Research and development. The Company performs third-party research and development activities, which are typically provided on a time and materials basis. Generally, revenue for research and development is recorded as performance progresses under the applicable contract.

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Arrangements with multiple deliverables. Revenue arrangements with multiple deliverables requires the Company to:

- (i) disclose whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
- (ii) allocate revenue in an arrangement using estimated selling prices (ESP) of deliverables if a vendor does not have vendor-specific objective evidence of selling price (VSOE) or third-party evidence of selling price (TPE); and
- (iii) allocate revenue using the relative selling price method.

The Company accounts for revenue using a multiple attribution model in which consideration allocated to research and development activities is recognized as performed, and milestone payments are recognized when the milestone events are achieved, when such activities and milestones are deemed substantive. Accordingly, in situations where a unit of accounting includes both a license and research and development activities, and when a license does not have stand-alone value, the Company applies a multiple attribution model in which consideration allocated to the license is recognized ratably, consideration allocated to research and development activities is recognized as performed and milestone payments are recognized when the milestone events are achieved, when such activities and milestones are deemed substantive.

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

The Company is required to evaluate each deliverable in a multiple element arrangement for separability. The Company is then required to allocate revenue to each separate deliverable using a hierarchy of VSOE, TPE, or ESP. In many instances, the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements. This may be a result of the Company infrequently selling each element separately or having a limited history with multiple element arrangements. When VSOE cannot be established, the Company attempts to establish a selling price of each element based on TPE. TPE is determined based on competitor prices for similar deliverables when sold separately.

When the Company is unable to establish a selling price using VSOE or TPE, the Company uses ESP in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. ESP is generally used for highly customized offerings.

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

New Accounting Pronouncements

Accounting Standards to be Adopted

In July 2013, the Financial Accounting Standards Board issued amended guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, similar to a tax loss, or tax credit carryforward exists. The guidance requires an unrecognized tax benefit, or a portion of an unrecognized tax benefit, be presented as a reduction of a deferred tax asset when a net operating loss carryforward, or similar tax loss, or tax credit carryforward exists, with certain exceptions. This accounting guidance is effective prospectively for the Company beginning in the first quarter of fiscal 2015, with early adoption permitted. While the Company is currently evaluating the impact, its adoption is not expected to have a material impact on the Company's financial position, results of operation or cash flows.

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.

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Beginning in the first quarter of fiscal 2012, the results of operations, cash flows, assets and liabilities of SurModics Pharmaceuticals, Inc. (SurModics Pharmaceuticals), which were previously reported in the Pharmaceuticals segment as a separate operating segment, are classified as discontinued operations.

On November 1, 2011, the Company entered into a definitive agreement (the Purchase Agreement) to sell substantially all of the assets of its wholly-owned subsidiary, SurModics Pharmaceuticals, to Evonik Degussa Corporation (Evonik). Under the terms of the Purchase Agreement, the entire portfolio of products and services of SurModics Pharmaceuticals, including the Company's Current Good Manufacturing Practices (cGMP) development and manufacturing facility located in Birmingham, Alabama, were sold. The Company retained all accounts receivable and the majority of liabilities associated with SurModics Pharmaceuticals incurred prior to closing. The sale (the Pharma Sale) closed on November 17, 2011. The total consideration received from the Pharma Sale was \$30.0 million in cash. As part of the Pharma Sale, SurModics agreed not to compete in the restricted business (as defined in the Purchase Agreement) for a period of five years and to indemnify Evonik against specified losses in connection with SurModics Pharmaceuticals, including certain contingent consideration obligations related to the acquisition by SurModics Pharmaceuticals of the portfolio of intellectual property and drug delivery projects from PR Pharmaceuticals, Inc. (PR Pharma) SurModics retained responsibility for repayment obligations related to an agreement with various governmental authorities associated with creation of jobs in Alabama. These obligations were settled or terminated in fiscal 2013 with payments totaling \$325,000 repaid to the governmental authorities and a gain of \$1.3 million recognized in the fiscal year ended September 30, 2013.

There was no condensed consolidated statement of income impact associated with discontinued operations for the three months ended December 31, 2013 and 2012.

The major classes of assets and liabilities of discontinued operations as of December 31, 2013 and September 30, 2013 were as follows:

| <i>(Dollars in thousands)</i> | December 31, 2013 | September 30, 2013 |
|---|------------------------------|-------------------------------|
| Other current assets | \$ 46 | \$ 46 |
| Current assets of discontinued operations | 46 | 46 |
| Total assets of discontinued operations | \$ 46 | \$ 46 |
| Other current liabilities payable | \$ 126 | \$ 139 |
| Current liabilities of discontinued operations | 126 | 139 |
| Total liabilities of discontinued operations | \$ 126 | \$ 139 |

The assets and liabilities of discontinued operations as of December 31, 2013 are based on accruals associated with the Southern Research Institute (SRI) litigation matter and a related deferred tax asset balance. See Note 17 for further discussion of the SRI litigation matter.

4. Fair Value Measurements

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

Fair Value Hierarchy

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

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

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.

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The Company's Level 2 assets consist of money market funds, U.S. government and government agency obligations, mortgage-backed securities, municipal bonds, asset-backed securities and corporate bonds. Fair market values for these assets are based on quoted vendor prices and broker pricing where all significant inputs are observable. The Company performs limited tests of the quoted vendor prices based on available U.S. government security pricing on government websites as a means of validating the third party pricing. To ensure the accuracy of quoted vendor prices and broker pricing, the Company performs regular reviews of investment returns to industry benchmarks and sample tests of individual securities to validate quoted vendor prices with other available market data.

Level 3 Unobservable inputs to the valuation methodology that are supported by little or no market activity and that are significant to the measurement of the fair value of the assets or liabilities. Level 3 assets and liabilities include those whose fair value measurements are determined using pricing models, discounted cash flow methodologies or similar valuation techniques, as well as significant management judgment or estimation.

There were no Level 3 assets at December 31, 2013, September 30, 2013 or December 31, 2012 and there was no Level 3 activity in each of the first quarter of fiscal 2014 and fiscal 2013.

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 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 assets and liabilities measured at fair value on a recurring basis as of December 31, 2013:

| <i>(Dollars in thousands)</i> | 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, 2013 |
|---|--|--|--|---|
| Assets: | | | | |
| Cash equivalents | \$ | \$ 9,202 | \$ | \$ 9,202 |
| Available-for-sale debt securities: | | | | |
| U.S. government and government agency obligations | | 21,767 | | 21,767 |
| Mortgage-backed securities | | 7,977 | | 7,977 |
| Municipal bonds | | 2,877 | | 2,877 |
| Asset-backed securities | | 5,348 | | 5,348 |
| Corporate bonds | | 4,661 | | 4,661 |
| Total assets measured at fair value | \$ | \$ 51,832 | \$ | \$ 51,832 |

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The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2013:

| <i>(Dollars in thousands)</i> | 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, 2013 |
|---|--|--|--|--|
| Assets: | | | | |
| Cash equivalents | \$ | \$ 4,402 | \$ | \$ 4,402 |
| Available-for-sale debt securities: | | | | |
| U.S. government and government agency obligations | | 22,890 | | 22,890 |
| Mortgage-backed securities | | 8,216 | | 8,216 |
| Municipal bonds | | 3,059 | | 3,059 |
| Asset-backed securities | | 3,537 | | 3,537 |
| Corporate bonds | | 4,907 | | 4,907 |
| Total assets measured at fair value | \$ | \$ 47,011 | \$ | \$ 47,011 |

Valuation Techniques

The valuation techniques used to measure the fair value of assets are as follows:

Cash equivalents These assets are classified as Level 2 and are carried at historical cost which is a reasonable estimate of fair value because of the relatively short time between origination of the instrument and its expected realization.

Available-for-sale debt securities These securities are classified as Level 2 and include various types of debt securities. These securities are valued based on quoted vendor prices in active markets underlying the securities.

5. Investments

Investments consist principally of U.S. government and government agency obligations, mortgage-backed securities, municipal bonds, asset-backed securities and corporate bonds and they are classified as available-for-sale at December 31, 2013 and September 30, 2013. Available-for-sale securities are reported at fair value with unrealized gains and losses, net of tax, excluded from the condensed consolidated statements of income and reported in the condensed consolidated statements of comprehensive income as well as a separate component of stockholders' equity in the condensed consolidated balance sheets, except for other-than-temporary impairments, which are reported as a charge to current earnings. A loss would be recognized when there is an other-than-temporary impairment in the fair value of any individual security classified as available-for-sale, with the associated net unrealized loss reclassified out of accumulated other comprehensive income with a corresponding adjustment to other income. This adjustment

results in a new cost basis for the investment. Interest earned on debt securities, including amortization of premiums and accretion of discounts, is included in other income. Realized gains and losses from the sales of debt securities, which are included in other income, are determined using the specific identification method.

The amortized cost, unrealized holding gains and losses, and fair value of available-for-sale securities as of December 31, 2013 and September 30, 2013 were as follows:

| <i>(Dollars in thousands)</i> | December 31, 2013 | | | Fair Value |
|---|-------------------|------------------|-------------------|------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | |
| U.S. government and government agency obligations | \$ 21,783 | \$ 22 | \$ (38) | \$ 21,767 |
| Mortgage-backed securities | 7,939 | 101 | (63) | 7,977 |
| Municipal bonds | 2,865 | 17 | (5) | 2,877 |
| Asset-backed securities | 5,348 | 8 | (8) | 5,348 |
| Corporate bonds | 4,657 | 24 | (20) | 4,661 |
| Total | \$ 42,592 | \$ 172 | \$ (134) | \$ 42,630 |

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| <i>(Dollars in thousands)</i> | September 30, 2013 | | | Fair Value |
|---|--------------------|------------------|-------------------|------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | |
| U.S. government and government agency obligations | \$ 22,889 | \$ 28 | \$ (27) | \$ 22,890 |
| Mortgage-backed securities | 8,149 | 118 | (51) | 8,216 |
| Municipal bonds | 3,049 | 15 | (5) | 3,059 |
| Asset-backed securities | 3,539 | 6 | (8) | 3,537 |
| Corporate bonds | 4,896 | 17 | (6) | 4,907 |
| Total | \$ 42,522 | \$ 184 | \$ (97) | \$ 42,609 |

As of December 31, 2013 and September 30, 2013, the Company concluded that the unrealized losses related to the available-for-sale securities shown above were not other-than-temporary as the Company does not have the intent to sell, nor is it more likely than not that the Company will be required to sell, before recovery of their amortized cost.

The amortized cost and fair value of investments by contractual maturity at December 31, 2013 were as follows:

| <i>(Dollars in thousands)</i> | Amortized Cost | Fair Value |
|-------------------------------|----------------|------------|
| Debt securities due within: | | |
| One year | \$ 12,470 | \$ 12,481 |
| One to five years | 21,046 | 21,046 |
| Five years or more | 9,076 | 9,103 |
| Total | \$ 42,592 | \$ 42,630 |

The following table summarizes sales of available-for-sale securities :

| <i>(Dollars in thousands)</i> | Three months ended December 31, | |
|-------------------------------|------------------------------------|--------|
| | 2013 | 2012 |
| Proceeds from sales | \$ 2,867 | \$ 805 |
| Gross realized gains | \$ | \$ 4 |
| Gross realized losses | \$ | \$ |

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:

| <i>(Dollars in thousands)</i> | December 31, 2013 | September 30, 2013 |
|-------------------------------|----------------------|-----------------------|
|-------------------------------|----------------------|-----------------------|

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| | | | | |
|-------------------|----|-------|----|-------|
| Raw materials | \$ | 1,231 | \$ | 1,378 |
| Finished products | | 1,601 | | 1,950 |
| Total | \$ | 2,832 | \$ | 3,328 |

Table of Contents**7. Other Assets**

Other assets consist principally of strategic investments as follows:

| <i>(Dollars in thousands)</i> | December 31, 2013 | September 30, 2013 |
|-------------------------------|------------------------------|-------------------------------|
| CeloNova BioSciences, Inc. | \$ 1,500 | \$ 1,500 |
| ThermopeutiX, Inc. | 1,185 | 1,185 |
| ViaCyte, Inc. | 479 | 479 |
| Other | 2 | 2 |
| Other assets, net | \$ 3,166 | \$ 3,166 |

The Company accounts for all of its strategic investments under the cost method as of December 31, 2013 and September 30, 2013.

In February 2011, the stent technology of Nexeon MedSystems, Inc. (Nexeon) was acquired by CeloNova BioSciences, Inc. (CeloNova). Prior to the acquisition by CeloNova, Nexeon created a wholly-owned subsidiary, Nexeon Stent, to hold the company's stent-related assets. Nexeon distributed to its stockholders the Nexeon Stent stock which was exchanged for Series B-1 preferred shares of CeloNova. CeloNova is a privately-held Texas-based medical technology company that is marketing a variety of medical products. The Company's investment in CeloNova, which is accounted for under the cost method, represents less than a 2% ownership interest. The Company does not exert significant influence over CeloNova's operating or financial activities.

The Company has invested a total of \$1.2 million in ThermopeutiX, Inc. (ThermopeutiX), a California-based early stage company developing novel medical devices for the treatment of vascular and neurovascular diseases. In addition to the investment, SurModics has licensed its hydrophilic and hemocompatible coating technologies to ThermopeutiX for use with its devices. The Company's investment in ThermopeutiX, which is accounted for under the cost method, represents an ownership interest of less than 20%. The Company does not exert significant influence over ThermopeutiX's operating or financial activities.

The Company has invested a total of \$5.3 million in ViaCyte, Inc. (ViaCyte), a privately-held California-based biotechnology firm that is developing a unique treatment for diabetes using coated islet cells, the cells that produce insulin in the human body. In fiscal 2006, the Company determined that its investment in ViaCyte was impaired and that the impairment was other than temporary. Accordingly, the Company recorded an impairment loss of \$4.7 million. In the second quarter of fiscal 2013, the Company recorded an additional other-than-temporary impairment loss on this investment totaling \$0.1 million based on a current financing round and market valuations. The balance of the investment of \$0.5 million, which is accounted for under the cost method, represents less than a 1% ownership interest. The Company does not exert significant influence over ViaCyte's operating or financial activities.

The Company had invested a total of \$2.5 million in Vessix Vascular, Inc. (Vessix) and recognized an other-than-temporary impairment loss on this investment totaling \$2.4 million in fiscal 2010, based on market valuations and a pending financing round for Vessix. Vessix was purchased by Boston Scientific Corporation in November 2012. The Company recorded a gain of approximately \$1.2 million in gain on sale of strategic investments section within the condensed consolidated statements of income, on the sale of this investment in the first quarter of fiscal 2013. In the first quarter of fiscal 2014, the Company recorded a \$0.7 million gain upon achievement by Vessix

of a clinical milestone. Total potential maximum additional proceeds of \$3.5 million may be received in the remainder of fiscal 2014 through fiscal 2017 depending on Vessix's achievement of future sales milestones. No amounts have been recorded associated with these future milestones given the level of uncertainty that exists. Any potential additional income will be recognized once the milestones are achieved.

The total carrying value of cost method investments is reviewed quarterly for changes in circumstances or the occurrence of events that suggest the Company's investment may not be recoverable. The fair value of cost method investments is not adjusted if there are no identified events or changes in circumstances that may have a material adverse effect on the fair value of the investment.

For the three months ended December 31, 2013 and 2012, the Company recognized revenue of less than \$0.1 million for each period 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. For the three months ended December 31, 2013 and 2012, the Company recorded amortization expense of \$0.2 million for each period.

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Intangible assets consisted of the following:

| <i>(Dollars in thousands)</i> | December 31, 2013 | | | |
|--|---|----------------------------------|-------------------------------------|------------|
| | Weighted Average Original Life (Years) | Gross Carrying Amount | Accumulated Amortization | Net |
| Definite-lived intangible assets: | | | | |
| Customer lists | 9.0 | \$ 4,857 | \$ (3,409) | \$ 1,448 |
| Core technology | 8.0 | 530 | (425) | 105 |
| Patents and other | 16.8 | 2,256 | (887) | 1,369 |
| Subtotal | | 7,643 | (4,721) | 2,922 |
| Unamortized intangible assets: | | | | |
| Trademarks | | 580 | | 580 |
| Total | | \$ 8,223 | \$ (4,721) | \$ 3,502 |

| <i>(Dollars in thousands)</i> | September 30, 2013 | | | |
|--|---|----------------------------------|-------------------------------------|------------|
| | Weighted Average Original Life (Years) | Gross Carrying Amount | Accumulated Amortization | Net |
| Definite-lived intangible assets: | | | | |
| Customer lists | 9.0 | \$ 4,857 | \$ (3,274) | \$ 1,583 |
| Core technology | 8.0 | 530 | (409) | 121 |
| Patents and other | 16.8 | 2,256 | (852) | 1,404 |
| Subtotal | | 7,643 | (4,535) | 3,108 |
| Unamortized intangible assets: | | | | |
| Trademarks | | 580 | | 580 |
| Total | | \$ 8,223 | \$ (4,535) | \$ 3,688 |

Based on the intangible assets in service as of December 31, 2013, estimated amortization expense for the remainder of fiscal 2014 and each of the next five fiscal years is as follows (*Dollars in thousands*):

| | |
|-------------------|--------|
| Remainder of 2014 | \$ 557 |
| 2015 | 731 |
| 2016 | 594 |
| 2017 | 183 |
| 2018 | 137 |
| 2019 | 137 |

Future amortization amounts presented above are estimates. Actual future amortization expense may be different, as a result of future acquisitions, impairments, changes in amortization periods, or other factors.

9. Goodwill

Goodwill represents the excess of the cost of an acquired entity over the fair value assigned to the assets purchased and liabilities assumed in connection with a business acquisition. Goodwill is not amortized but is subject, at a minimum, to annual tests for impairment in accordance with accounting guidance for goodwill. The carrying amount of goodwill is evaluated annually, and between annual evaluations if events occur or circumstances change indicating that the carrying amount of goodwill may be impaired.

The \$8.0 million of goodwill at December 31, 2013 and September 30, 2013 is related to the In Vitro Diagnostics reporting unit and represents the gross value from the acquisition of BioFX Laboratories, Inc. (BioFX) in 2007. The goodwill was not impaired based on the outcome of the fiscal 2013 annual impairment test, and there have been no events or circumstances that have occurred in the first quarter of fiscal 2014 associated with the In Vitro Diagnostics reporting unit to indicate that the goodwill may be impaired.

10. Stock-based Compensation

The Company has stock-based compensation plans under which it grants stock options, restricted stock awards, performance share awards and restricted stock units. Accounting guidance requires all share-based payments to be recognized as an operating expense, based on their fair values, over the requisite service period.

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The Company's stock-based compensation expenses were allocated to the following expense categories:

| <i>(Dollars in thousands)</i> | Three months ended | |
|-------------------------------------|---------------------------|-------------|
| | December 31, | |
| | 2013 | 2012 |
| Product costs | \$ 4 | \$ 3 |
| Research and development | 52 | 23 |
| Selling, general and administrative | 757 | 366 |
| Total | \$ 813 | \$ 392 |

As of December 31, 2013, approximately \$5.1 million of total unrecognized compensation costs related to non-vested awards is expected to be recognized over a weighted average period of approximately 2.4 years. The unrecognized compensation costs above include \$1.6 million based on payout levels associated with performance share awards that are currently anticipated to be fully expensed because the performance conditions are expected to be met at or above target levels.

Stock Option Awards

The Company uses the Black-Scholes option pricing model to determine the weighted average grant date fair value of stock options granted. The weighted average per share fair values of stock options granted during the three months ended December 31, 2013 and 2012 were \$8.80 and \$8.48, respectively. The assumptions used as inputs in the model were as follows:

| | Three months ended | |
|--------------------------|---------------------------|-------------|
| | December 31, | |
| | 2013 | 2012 |
| Risk-free interest rates | 1.2% | 0.6% |
| Expected life (years) | 4.6 | 4.8 |
| Expected volatility | 45.1% | 49.2% |
| Dividend yield | 0.0% | 0.0% |

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

Non-qualified stock options are granted at fair market value on the date of grant. Non-qualified stock options expire in seven to ten years or upon termination of employment or service as a Board member. Non-qualified stock options granted prior to May 2008 generally become exercisable with respect to 20% of the shares on each of the first five anniversaries following the grant date, and non-qualified stock options granted subsequent to April 2008 generally become exercisable with respect to 25% of the shares on each of the first four anniversaries following the grant date.

The total pre-tax intrinsic value of options exercised during the three months ended December 31, 2013 and 2012 was \$0.5 million and less than \$0.1 million, respectively. The intrinsic value represents the difference between the average 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 is released to the key employees if they are employed by the Company at the end of the vesting period. Compensation has been recognized for the estimated fair value of the common shares and is being charged to income over the vesting term. The stock-based compensation table above includes Restricted Stock expenses recognized related to these awards, which totaled less than \$0.1 million and \$0.1 million during the three months ended December 31, 2013 and 2012, 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. Performance objectives selected by the Organization and Compensation

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Committee of the Board of Directors (the Committee) were cumulative earnings per share and cumulative revenue for the three-year performance periods for fiscal 2011 (2011-2013), fiscal 2012 (2012-2014), fiscal 2013 (2013-2015) and fiscal 2014 (2014-2016). Assuming that the minimum performance level is attained, the number of shares that may actually vest will vary based on performance from 20% (minimum) to 200% (maximum). Shares will be issued to participants as soon as practicable following the end of the performance periods subject to Committee approval and verification of results. The fiscal 2011 awards were finalized in the three months ended December 31, 2013 and resulted in issuance of 122,053 shares (maximum was 137,066 shares) based on the performance objective results. The compensation cost related to the number of shares to be granted under each performance period is fixed on the grant date, which is the date the performance period begins. Compensation is recognized in each period based on management's best estimate of the achievement level of the specified performance objectives for Performance Shares. For the three months ended December 31, 2013 and 2012, the Company recognized expense of \$0.3 million and \$0.2 million, respectively. The stock-based compensation table above includes the Performance Shares expenses.

The fair values of the Performance Shares, at target, were \$0.9 million, \$0.9 million and \$0.8 million for grants awarded in fiscal 2014, 2013 and 2012, respectively.

The aggregate number of shares that could be awarded to key employees if the minimum, target and maximum performance goals are met, based upon the fair value at the date of grant is as follows:

| Performance Period | Minimum Shares | Target Shares | Maximum Shares |
|--------------------|----------------|---------------|----------------|
| Fiscal 2012 - 2014 | 12,499 | 62,497 | 124,994 |
| Fiscal 2013 - 2015 | 8,551 | 42,753 | 85,506 |
| Fiscal 2014 - 2016 | 7,861 | 39,303 | 78,606 |

1999 Employee Stock Purchase Plan

Under the 1999 Employee Stock Purchase Plan (Stock Purchase Plan), the Company is authorized to issue up to 400,000 shares of common stock. All full-time and part-time employees can choose to have up to 10% of their annual compensation withheld, with a limit of \$25,000, to purchase the Company's common stock at purchase prices defined within the provisions of the Stock Purchase Plan. As of December 31, 2013 and 2012, there were \$0.1 million and less than \$0.1 million, respectively, of employee contributions in each period included in accrued liabilities in the condensed consolidated balance sheets. Stock compensation expense recognized related to the Stock Purchase Plan for the three months ended December 31, 2013 and 2012 totaled less than \$0.1 million in each period. The stock-based compensation table above includes the Stock Purchase Plan expenses.

Restricted Stock Units

The Company has awarded 22,400 restricted stock units (RSU) in fiscal 2014 and 2013 under the 2009 Equity Incentive Plan to non-employee directors. The RSU awards vest annually at a rate of 33%. RSU awards are not considered issued or outstanding common stock of the Company until they vest. The estimated fair value of the RSU awards was calculated based on the closing market price of SurModics' common stock on the date of grant. Compensation has been recognized for the estimated fair value of the common shares and is being charged to income over the vesting term. Directors can also elect to receive their cash retainers for services to the Board of Directors and its committees in the form of RSUs. Certain directors elected this option beginning on January 1, 2013 which has resulted in 7,821 units issued with a total value of \$184,000. These RSUs are fully vested. The stock-based compensation table above includes RSU expenses recognized related to these awards, which totaled \$0.1 million and less than \$0.1 million for the three months ended December 31, 2013 and 2012, respectively.

11. Restructuring Charges

During the three months ended December 31, 2013 and 2012, the Company did not incur any restructuring charges.

In September 2013 (fiscal 2013), the Company announced a realignment of its business to enhance focus on key growth initiatives. As a result of the organizational change, the Company eliminated approximately 6% of its workforce. These employee terminations occurred across various functions, and the reorganization plan was completed by the end of fiscal 2013. The Company recorded total pre-tax restructuring charges of \$0.5 million in the fourth quarter of fiscal 2013, which consisted of severance pay and benefits expenses.

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The following table summarizes the restructuring accrual activity:

| <i>(Dollars in thousands)</i> | Employee Severance and Benefits | Facility- Related Costs | Total |
|-------------------------------|--|--|--------------|
| Balance at September 30, 2013 | \$ 399 | \$ 17 | \$ 416 |
| Cash payments | (173) | (15) | (188) |
| Balance at December 31, 2013 | \$ 226 | \$ 2 | \$ 228 |

The remaining restructuring accrual balance relates to the fiscal 2013 restructuring and is expected to be paid within the next 12 months. As such, the total balance is recorded as a current liability within other current liabilities on the consolidated balance sheet as of December 31, 2013.

12. Revolving Credit Facility

On November 4, 2013, the Company entered into a three-year \$20.0 million secured revolving credit facility. The Company's obligations under the credit facility are secured by substantially all of its and its subsidiaries' assets, other than intellectual property and real estate. Borrowings under the credit facility, if any, will bear interest at a benchmark rate plus a margin ranging from 1.375% to 2.00% based on the Company's leverage ratio. A facility fee is payable on unused commitments at a rate of 0.20% per annum. In connection with the credit facility, the Company is required to maintain financial covenants related to a maximum leverage ratio and a minimum EBITDA amount and nonfinancial covenants. As of December 31, 2013, the Company has no debt outstanding and was in compliance with all financial and nonfinancial covenants.

13. Income Per Share Data

Basic income per common share is calculated based on the weighted average number of common shares outstanding during the period. Diluted income per common share is computed by dividing income by the weighted average number of common and common equivalent shares outstanding during the period. The Company's only potentially dilutive common shares are those that result from dilutive common stock options, non-vested stock relating to restricted stock awards, restricted stock units and performance shares.

The following table sets forth the denominator for the computation of basic and diluted income per share (in thousands):

| | Three months ended December 31, | |
|--|--|-------------|
| | 2013 | 2012 |
| Basic weighted average shares outstanding | 13,756 | 14,655 |
| Dilutive effect of outstanding stock options, non-vested restricted stock and performance shares | 253 | 208 |
| Diluted weighted average shares outstanding | 14,009 | 14,863 |

The calculation of weighted average diluted shares outstanding excludes outstanding stock options associated with the right to purchase 0.4 million and 0.7 million shares of common stock for the three months ended December 31, 2013 and 2012, respectively, as their inclusion would have had an antidilutive effect on diluted income per share.

During the first quarter of fiscal 2014, the Company repurchased 380,011 shares of common stock for a total of \$8.9 million under the July 2013 authorization, including \$0.5 million associated with open repurchases at December 31, 2013. During the first quarter of fiscal 2013, there were no purchases of common stock of the Company. As of December 31, 2013, the Company has \$2.6 million available for future repurchases under the current authorization. In January 2014, the \$2.6 million remaining under the repurchase program was used to repurchase additional shares of common stock, and the repurchase authorization is now completed.

14. Income Taxes

The Company recorded income tax provisions associated with income from continuing operations of \$1.5 million and \$1.9 million for the three months ended December 31, 2013 and 2012, respectively, representing effective tax rates of 28.8% and 30.6%, respectively. The difference between the U.S. federal statutory tax rate of 35% and the Company's effective tax rate for the three months ended December 31, 2013 and 2012 reflects the impact of state income taxes, permanent tax items and discrete tax benefits. The three months ended December 31, 2013 and 2012 also reflects the impact of a gain related to a Vessix contingent consideration payment and gain on sale of our ownership interest in Vessix stock, neither of which resulted in recognition of tax expense as a result of the reversal of a capital loss valuation allowance.

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The total amount of unrecognized tax benefits including interest and penalties that, if recognized, would affect the effective tax rate as of December 31, 2013 and September 30, 2013, respectively, are \$0.9 million and \$1.0 million for each period. Currently, the Company does not expect the liability for unrecognized tax benefits to change significantly in the next 12 months with the above balances classified on the condensed consolidated balance sheets in other long-term liabilities. Interest and penalties related to unrecognized tax benefits are recorded in income tax expense.

The Company files income tax returns, including returns for its subsidiaries, in the U.S. federal jurisdiction and in various state jurisdictions. Uncertain tax positions are related to tax years that remain subject to examination. The Internal Revenue Service has commenced an examination of the Company's U.S. income tax return for fiscal 2012 in the first quarter of fiscal 2014. U.S. income tax returns for years prior to fiscal 2010 are no longer subject to examination by federal tax authorities. For tax returns for state and local jurisdictions, the Company is no longer subject to examination for tax years generally before fiscal 2003.

15. Amounts Reclassified Out of Accumulated Other Comprehensive Income

Amounts reclassified out of accumulated other comprehensive income (AOCI) were less than \$0.1 million on a pre-tax basis for each of the three months ended December 31, 2013 and 2012. The amounts reclassified out of AOCI are associated with unrealized gains on available-for-sale securities that were realized on the sale of the securities and are presented in other income, net in the condensed consolidated statements of income.

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, who is the Company's Chief Executive Officer, in deciding how to allocate resources and in assessing performance. For financial accounting and reporting purposes, the Company reports its results for the two reportable segments as follows: (1) the Medical Device unit, which is comprised of surface modification coating technologies to improve access, deliverability, and predictable deployment of medical devices, as well as drug delivery coating technologies to provide site-specific drug delivery from the surface of a medical device, with end markets that include coronary, peripheral, and neuro-vascular, and urology, among others, and (2) the In Vitro Diagnostics unit, which consists of component products and technologies for diagnostic test kits and biomedical research applications, with products that include protein stabilization reagents, substrates, antigens and surface coatings.

The tables below present segment revenue, operating income and depreciation and amortization, as follows:

| <i>(Dollars in thousands)</i> | Three months ended | |
|-------------------------------|---------------------------|-------------|
| | 2013 | 2012 |
| Revenue: | | |
| Medical Device | \$ 10,549 | \$ 10,531 |
| In Vitro Diagnostics | 3,334 | 3,320 |
| Total revenue | \$ 13,883 | \$ 13,851 |
| Operating income: | | |
| Medical Device | \$ 5,328 | \$ 5,840 |

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| | | |
|---------------------------------------|----------|----------|
| In Vitro Diagnostics | 671 | 751 |
| Total segment operating income | 5,999 | 6,591 |
| Corporate | (1,670) | (1,714) |
| Total operating income | \$ 4,329 | \$ 4,877 |
| Depreciation and amortization: | | |
| Medical Device | \$ 294 | \$ 317 |
| In Vitro Diagnostics | 214 | 215 |
| Corporate | 189 | 190 |
| Total depreciation and amortization | \$ 697 | \$ 722 |

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The Corporate category includes expenses for administrative corporate functions, such as executive, corporate accounting, legal, human resources and Board of Directors related, that have not been fully allocated to the Medical Device and In Vitro Diagnostics segments. Corporate also includes expenses, such as litigation, which are not specific to a segment and thus not allocated to the operating segments.

Asset information by segment is not presented because the Company does not provide its chief operating decision maker assets by segment, as the data is not readily available.

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 revenue. 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.

Southern Research Institute (SRI) Litigation. On July 31, 2009, the Company's SurModics Pharmaceuticals subsidiary was named as a defendant in litigation pending in the circuit court of Jefferson County, Alabama, between SRI and two of SRI's former employees (the Plaintiffs). In the litigation, the Plaintiffs allege that they contributed to or invented certain intellectual property while they were employed at SRI, and pursuant to SRI's policies then in effect, they are entitled to, among other things, a portion of the purchase price consideration paid by the Company to SRI as part of the Company's acquisition of SurModics Pharmaceuticals pursuant to a stock purchase agreement made effective on July 31, 2007 (the Stock Purchase Agreement). The Plaintiffs have also alleged that they are entitled to a portion of the intellectual property income derived from license agreements with certain customers of SurModics Pharmaceuticals that make use of patents to which the Plaintiffs invented or contributed. A trial is expected to take place in the May to July 2014 timeframe. Based on the facts known to date, the Company recorded a \$100,000 expense in discontinued operations for the year ended September 30, 2013. The Company has not recorded additional accruals as the probability of the outcome is currently not determinable and any potential loss is not estimable. The Company believes that it has meritorious defenses to the Plaintiff's claims and will vigorously defend and prosecute this matter. Following the Pharma Sale, the Company remains responsible for this litigation and has agreed to indemnify Evonik against certain losses, including those that may be incurred in connection with this litigation.

Pursuant to the Stock Purchase Agreement, the Company has certain rights of indemnification against losses (including without limitation, damages, expenses and costs) incurred as a result of the litigation. The Company had recorded cumulative unreimbursed legal expenses totaling \$1.3 million as of June 30, 2013, related to this litigation, within selling, general and administrative expenses from continuing operations in the condensed consolidated statements of income. In June 2011, the Company sued SRI in United States District Court for the District of Minnesota seeking a judicial declaration regarding the scope of the Company's indemnification rights under the Stock Purchase Agreement. On April 17, 2013, the District Court entered a judgment in the Company's favor requiring SRI to indemnify the Company for prior and future legal expenditures related to this matter. On July 30, 2013, the Company and SRI entered into a settlement and release agreement resolving the litigation relating to indemnification rights. The settlement and release agreement does not relate to claims for indemnification under the Stock Purchase

Agreement for any substantive liability, judgment, or settlement in or related to the ongoing litigation in Alabama discussed above. The Company received payment of \$1.0 million associated with the historical cumulative unreimbursed legal expenses and recognized the receipt as an expense offset in the fourth quarter ended September 30, 2013. This settlement included \$0.6 million of legal expenses incurred prior to fiscal 2013. Additionally, under the settlement and release agreement, the Company will be reimbursed for 75% of the legal fees, costs and expenses that the Company may incur in the future in connection with the Alabama litigation that are not considered excessive.

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. The Company has not recorded any accrual for this contingency as of December 31, 2013 as the milestones have not been achieved and the probability of achievement is low.

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InnoCore Technologies BV. In March 2006, the Company entered into a license agreement whereby SurModics obtained an exclusive license to a drug delivery coating for licensed products within the vascular field which included peripheral, coronary and neurovascular biodurable stent product. The license requires an annual minimum payment of 200,000 euros (equivalent to \$275,000 using a euro to U.S. \$ exchange rate of 1.3766 as of December 31, 2013) until the last patent expires which is currently estimated to be September 2027. The total minimum future payments associated with this license are approximately \$3.9 million. The license is currently utilized with one of SurModics drug delivery customers.

PR Pharmaceuticals, Inc. In November 2008, SurModics Pharmaceuticals acquired certain contracts and assets of PR Pharma to enhance its portfolio of drug delivery technologies for the pharmaceutical and biotechnology industries. The Company agreed to indemnify Evonik, for a period of five years, for up to \$2.5 million of contingent consideration obligations to the sellers of PR Pharma related to a future patent issuance milestone when it sold substantially all of the SurModics Pharmaceuticals assets to Evonik on November 17, 2011. The Company has not recorded any accrual for this contingency as of December 31, 2013 as the milestone has not been achieved and the probability of achievement is low.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis provides information that we believe is useful in understanding our operating results, cash flows and financial condition. The discussion should be read in conjunction with both the unaudited condensed consolidated financial statements and related notes included in this Form 10-Q, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2013. This discussion contains various Forward-Looking Statements within the meaning of the Private Securities Litigation Reform Act of 1995. We refer readers to the statement entitled Forward-Looking Statements located near the end of Part I of this report.

Overview

SurModics is a leading provider of surface modification and *in vitro* diagnostic technologies to the healthcare industry. In fiscal 2013, our business performance continued to be driven by growth from our Medical Device hydrophilic coatings royalty revenue, and from our In Vitro Diagnostics segment from existing products, new product launches as well as the addition of new diagnostic test kit manufacturer customers.

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. For financial accounting and reporting purposes, we report our results for the two reportable segments as follows: (1) the Medical Device unit, which is comprised of surface modification coating technologies to improve access, deliverability, and predictable deployment of medical devices, as well as drug delivery coating technologies to provide site-specific drug delivery from the surface of a medical device, with end markets that include coronary, peripheral, and neurovascular, and urology, among others, and (2) the In Vitro Diagnostics unit, which consists of component products and technologies for diagnostic immunoassay and molecular tests and biomedical research applications, with products that include protein stabilization reagents, substrates, antigens and surface coatings. We made this determination based on how we manage our operations and the information provided to our chief operating decision maker who is our Chief Executive Officer.

We derive our revenue from three primary sources: (1) royalties and license fees from licensing our proprietary surface modification and device drug delivery technologies and *in vitro* diagnostic formats to customers; the vast majority (typically in excess of 90%) of revenue in the royalties and license fees category is in the form of royalties; (2) the sale of reagent chemicals to licensees and the sale of stabilization products, antigens, substrates and surface coatings to the diagnostic and biomedical research markets; and (3) research and commercial development fees generated on customer projects. 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; and the value of reagent chemicals and other products sold to customers.

Overview of Research and Development Activities

We manage our customer-sponsored research and development (R&D) programs based largely on the requirements of our customers. In this regard, our customers typically establish the various measures and metrics that are used to monitor a program's progress, including key deliverables, milestones, timelines, and an overall program budget. The customer is ultimately responsible for deciding whether to continue or terminate a program, and does so based on research results (relative to the above measures and metrics) and other factors, including their own strategic and/or business priorities. Customer R&D programs are mainly in our Medical Device segment.

Our internal R&D activities are engaged in the exploration, discovery and application of technologies that solve meaningful problems in the diagnosis and treatment of disease. Our key R&D activities include efforts that support and expand our core offerings. These efforts include activities that support the development of our coating technologies that enhance drug-coated balloons. In the second quarter of fiscal 2013, we completed development activities and launched our next generation hydrophilic coating platform which is commercially available under the tradename Serene™ (formerly referred to as Gen 5). We also launched in July 2013, a new *in vitro* diagnostic product, StabliZyme® Protein-Free Stabilizer, which focuses on stabilizing biomolecule activity in assay tests. Additional planned activities include initiation of surface modification experiments that improve medical device performance and developing chemistries to support molecular diagnostic applications.

For our internal R&D programs in our segments, we prioritize these programs based on a number of factors, including a program's strategic fit, commercial impact, potential competitive advantage, technical feasibility, and the amount of investment required. The measures and metrics used to monitor a program's progress vary based on the program, and typically include many of the same factors discussed above with respect to our customer R&D programs. We typically make decisions to continue or terminate a program based on research results (relative to the above measures and metrics) and other factors, including our own strategic and/or business priorities, and the amount of additional investment required.

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With respect to cost components, R&D expenses consist of labor, materials and overhead costs (for example, utilities, depreciation, and indirect labor) for both customer R&D and internal R&D programs. We manage our R&D organization in a flexible manner, balancing workloads/resources between customer R&D and internal R&D programs primarily based on the level of customer program activity. Therefore, costs incurred for customer R&D and internal R&D can shift as customer activity increases or decreases.

Critical Accounting Policies

Critical accounting policies are those policies that require the application of management's most challenging subjective or complex judgment, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Critical accounting policies involve judgments and uncertainties that are sufficiently likely to result in materially different results under different assumptions and conditions. For a detailed description of our critical accounting policies, see the notes to the consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2013.

Results of Operations – Three Months Ended December 31

Revenue. Revenue during the first quarter of fiscal 2014 was \$13.9 million, essentially unchanged from the first quarter of fiscal 2013. The fiscal 2013 period included a one-time royalty catch up payment of \$0.6 million. The change in revenue, as detailed in the table below, is further explained in the narrative below.

| <i>(Dollars in thousands)</i> | Three Months Ended | | Increase | Change |
|-------------------------------|---------------------------|---------------------|-------------------|---------------|
| | December 31, | December 31, | (Decrease) | |
| | 2013 | 2012 | | |
| Revenue: | | | | |
| Medical Device | \$ 10,549 | \$ 10,531 | \$ 18 | 0.2% |
| In Vitro Diagnostics | 3,334 | 3,320 | 14 | 0.4% |
| Total revenue | \$ 13,883 | \$ 13,851 | \$ 32 | 0.2% |

Medical Device. Revenue in Medical Device was \$10.5 million in the first quarter of fiscal 2014, essentially unchanged compared with the first quarter of fiscal 2013. The change in total revenue was attributable to \$0.2 million of higher license fees and R&D revenue, primarily offset by \$0.2 million of lower royalty revenue. Fiscal 2013 revenue included \$0.6 million from a one-time royalty revenue catch-up payment.

In Vitro Diagnostics. Revenue in In Vitro Diagnostics was \$3.3 million in the first quarter of fiscal 2014, essentially unchanged compared with the first quarter of fiscal 2013. In Vitro Diagnostics fiscal 2014 results included increases in sales of microarray slides of \$0.2 million and BioFX branded products of \$0.2 million which were offset by a \$0.2 million decrease in antigen sales as well as a \$0.1 million decrease in stabilization product sales.

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

| Three months ended | Three months |
|---------------------------|---------------------|
| December 31, 2013 | ended |

| <i>(Dollars in thousands)</i> | Amount | % of Total Revenue | December 31, 2012 | |
|-------------------------------------|----------|-----------------------|-------------------|-----------------------|
| | | | Amount | % of Total Revenue |
| Product costs | \$ 2,004 | 14% | \$ 1,959 | 14% |
| Research and development | 3,699 | 27 | 3,362 | 24 |
| Selling, general and administrative | 3,851 | 28 | 3,653 | 26 |

Product costs. Product costs were \$2.0 million in each of the three months ended December 31, 2013 and 2012, respectively, or 14% of total revenue in each period. Product gross margins were 63% in fiscal 2014 and 2013, respectively.

Research and development (R&D) expenses. R&D expenses were \$3.7 million and \$3.4 million for the first quarter of fiscal 2014 and 2013, or 27% and 24% of total revenue in each respective period. The fiscal 2014 increase from fiscal 2013 of \$0.3 million, or 10%, was primarily a result of \$0.6 million higher spending for our drug-coated balloon development project offset partially by \$0.1 million each of lower patent related legal expenses and compensation costs. We expect R&D expenses to increase in fiscal 2014 as compared with fiscal 2013 as we continue to fund drug-coated balloon development activities.

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Selling, general and administrative expenses. Selling, general and administrative expenses were \$3.9 million and \$3.7 million for the three months ended December 31, 2013 and 2012, respectively, or 28% and 26% of total revenue for each respective period. The increase in fiscal 2014 from fiscal 2013 of \$0.2 million, or 5%, was primarily attributable to \$0.6 million of higher compensation and benefit costs, principally from a \$0.4 million increase in stock compensation expenses, offset partially by \$0.1 million of lower professional services, \$0.2 million of lower consulting expenses and \$0.1 million of lower legal expenses. Legal expenses are anticipated to increase by approximately \$1.0 million in fiscal 2014 compared with fiscal 2013 because of the \$1.0 million SRI legal settlement we received in fiscal 2013.

Other income. Major classifications of other income are as follows:

| <i>(Dollars in thousands)</i> | Three months ended | |
|--------------------------------------|---------------------------|-------------|
| | December 31, | |
| | 2013 | 2012 |
| Investment income | \$ 86 | \$ 72 |
| Gain on sale of strategic investment | 681 | 1,174 |
| Other investment capital gains | | 2 |
| Total other income | \$ 767 | \$ 1,248 |

Other income was \$0.8 million in the first quarter of fiscal 2014, compared with \$1.2 million for the first quarter of fiscal 2013. The first quarter of fiscal 2014 includes a gain of \$0.7 million from a milestone contingent consideration payment from the sale of our ownership interest in Vessix. The first quarter of fiscal 2013 includes the gain of \$1.2 million from the sale of our ownership interest in Vessix. Income from investments in fiscal 2014 increased slightly compared with the prior-year period primarily from improvement in interest rate yields on securities in our investment portfolio.

Income tax provision. The reconciliation of the statutory U.S. federal tax rate of 35.0% and our effective tax rate for the three months ended December 31, 2013 and 2012 is as follows:

| | Three months ended | |
|--|---------------------------|-------------|
| | December 31, | |
| | 2013 | 2012 |
| Statutory U.S. federal income tax rate | 35.0% | 35.0% |
| State income taxes, net of federal benefit | 0.8 | 1.3 |
| Gain on strategic investment | (1.3) | (2.1) |
| Discrete item state tax reserve release | (4.4) | (2.8) |
| Other | (1.3) | (0.8) |
| Effective tax rate | 28.8% | 30.6% |

The income tax provision was \$1.5 million and \$1.9 million for the three months ended December 31, 2013 and 2012, respectively, representing effective tax rates of 28.8% and 30.6%, respectively. The difference between the U.S. federal statutory tax rate of 35.0% and our effective tax rate for the three months ended December 31, 2013 and 2012

reflects the impact of state income taxes, permanent tax items and discrete tax benefits. Discrete items largely consist of state income tax reserve reversals related to the expiration of statutory filing requirements in each period. The three months ended December 31, 2013 and 2012 also reflects the impact of a gain related to a Vessix milestone contingent consideration payment and gain on sale of our ownership interest in Vessix stock, respectively, for which there is tax expense recognized which has been offset by the reversal of a capital loss valuation allowance. We may receive an additional \$3.5 million of future contingent payments through fiscal 2017 based on sales of Vessix products. These proceeds, if any, will generate capital gains which will result in reduction of the existing capital loss carryforward valuation allowance.

Table of Contents**Segment Operating Results**

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

| <i>(Dollars in thousands)</i> | Three Months Ended | | |
|--------------------------------|---------------------------|-------------|--------------------------|
| | December 31, | | |
| | 2013 | 2012 | Increase/Decrease |
| Operating income: | | | |
| Medical Device | \$ 5,328 | \$ 5,840 | (9)% |
| In Vitro Diagnostics | 671 | 751 | (11)% |
| Total segment operating income | 5,999 | 6,591 | (9)% |
| Corporate | (1,670) | (1,714) | (3)% |
| Total operating income | \$ 4,329 | \$ 4,877 | (11)% |

Medical Device. Operating income was \$5.3 million in the first quarter of fiscal 2014, compared with \$5.8 million in the first quarter of fiscal 2013. The first quarter of fiscal 2013 included a one-time royalty catch up payment of \$0.6 million. The decrease in operating income resulted from \$0.4 million of higher direct operating expenses in the first quarter of fiscal 2014 as we invested \$0.6 million in the drug-coated balloon development project, offset partially by \$0.2 million lower compensation expenses resulting from our September 2013 restructuring. Allocated corporate costs increased approximately \$0.1 million in the first quarter of fiscal 2014 when compared with the first quarter of fiscal 2013. The operating income as a percentage of revenue was 51% and 55% in the first quarter of fiscal 2014 and 2013, respectively.

In Vitro Diagnostics. Operating income was \$0.7 million in the first quarter of fiscal 2014, compared with \$0.8 million in the first quarter of fiscal 2013. The product sales and product gross margins of 60% in the first quarter of fiscal 2014 were relatively unchanged compared with the first quarter of fiscal 2013. In Vitro Diagnostics direct expenses increased \$0.1 million in the fiscal 2014 compared with fiscal 2013 driven by higher compensation expenses. Allocated corporate expenses increased by less than \$0.1 million in the first quarter of fiscal 2014 compared with the first quarter of fiscal 2013. The operating income as a percentage of revenue was 20% and 23% in the first quarter of fiscal 2014 and 2013, respectively, as the first quarter of each fiscal year is typically our lowest operating margin levels based on lower sales volumes driven by customer order patterns.

Corporate. The Corporate category includes expenses for administrative corporate functions, such as executive, corporate accounting, legal, human resources and Board of Directors related, that have not been fully allocated to the Medical Device and In Vitro Diagnostics segments. Corporate also includes expenses, such as litigation, which are not specific to a segment. Operating loss was \$1.7 million in both the first quarter of fiscal 2014 and 2013. Higher compensation expenses of \$0.5 million, primarily stock-based compensation, were offset by a decrease of \$0.5 million associated with consulting, professional services and legal expenses.

Liquidity and Capital Resources

As of December 31, 2013, we had working capital of \$27.7 million, a decrease of \$2.1 million from September 30, 2013. Our cash, cash equivalents and available-for-sale securities totaled \$53.1 million at December 31, 2013, a decrease of \$5.0 million from \$58.1 million at September 30, 2013, principally from share repurchases of \$9.4 million

in the first quarter of 2014.

Our investments consist principally of U.S. government and government agency obligations, mortgage-backed securities, municipal bonds, asset-backed securities and corporate bonds with varying maturity dates, the majority of which are five years or less. Our investment policy excludes ownership of collateralized mortgage obligations, mortgage-backed derivatives and other derivative securities without prior written approval of the Board of Directors. Our investment policy also requires that no more than 5% of investments be held in any one credit or issue, excluding U.S. government and government agency obligations. The primary investment objective of the portfolio is to provide for the safety of principal and appropriate liquidity while generating an above benchmark (Merrill Lynch 1-3 Year Government-Corporate Index) total rate of return on a pre-tax basis. Management plans to continue to direct its investment advisors to manage our security investments primarily for the safety of principal for the foreseeable future as we continue to assess other investment opportunities and uses of its cash and securities investments, including those described below.

On November 4, 2013, we entered into a three-year \$20.0 million secured revolving credit facility. Borrowings under the credit facility, if any, will bear interest at a benchmark rate plus an applicable margin based on the Company's leverage ratio. No borrowings have been made on the credit facility and the Company is in compliance with the financial covenants related to a maximum leverage ratio and a minimum EBITDA amount and nonfinancial covenants.

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We generated cash flows from operating activities from continuing operations of approximately \$4.9 million and \$5.4 million in the first quarter ended December 31, 2013 and 2012, respectively. The following table depicts our cash flows provided by operating activities from continuing operations:

| <i>(Dollars in thousands)</i> | Three Months Ended December 31, | |
|---|--|-----------------|
| | 2013 | 2012 |
| Net income | \$ 3,630 | \$ 4,248 |
| Depreciation and amortization | 697 | 722 |
| Stock-based compensation | 813 | 392 |
| Deferred tax | 395 | 27 |
| Net other operating activities | (1,371) | (1,172) |
| Net change in other operating assets and liabilities | 86 | 1,190 |
| Net cash provided by operating activities from continuing operations | \$ 4,250 | \$ 5,407 |

Operating Activities. We generated cash flows from operating activities from continuing operations of \$4.3 million and \$5.4 million for the first quarter ended December 31, 2013 and 2012, respectively. The first quarter of fiscal 2014 decrease compared with the first quarter of fiscal 2013 reflected lower cash generated from operations of \$0.1 million, a reduction in accounts receivable of \$0.4 million and a reduction in accounts payable, accrued liabilities and accrued income taxes of \$0.8 million, offset partially from an increase in inventory of \$0.2 million.

Investing Activities. We invested \$0.1 million in property and equipment in the first quarter of fiscal 2014, compared with \$0.9 million in the prior-year period. The property and equipment investment in the first quarter of fiscal 2014 is significantly lower than our investment in the first quarter of fiscal 2013 as we increased spending on building improvements in the first quarter of fiscal 2013. We anticipate spending \$2.1 million to \$2.4 million for the remainder of fiscal 2014 which will result in a full year increase when compared with fiscal 2013 investment. We received cash of \$0.7 million (contingent milestone payment) and \$1.3 million (sale of shares) in the first quarter of fiscal 2014 and 2013, respectively, associated with the sale of our ownership interest in Vessix Vascular. In the first quarter of fiscal 2014, we invested cash associated with our discontinued operations of less than \$0.1 million compared with cash generated from our discontinued operations of \$0.1 million in the first quarter of fiscal 2013.

Financing Activities. We (used) provided cash flows from financing activities from continuing operations of \$(9.8) million in the first quarter of fiscal 2014, compared with \$0.1 million in the first quarter of fiscal 2013. In July 2013, our Board of Directors authorized the repurchase of up to \$20.0 million of our outstanding common stock through open-market purchases, private transactions, block trades, accelerated share repurchase transactions, tender offers, or by any combination of such methods. During the first quarter of fiscal 2014, we repurchased 380,011 shares of common stock worth \$8.9 million at an average price of \$23.48 per share under this authorization. The repurchase authorization does not have a fixed expiration date and \$2.6 million remained available for future repurchases as of December 31, 2013. In January 2014 the remaining \$2.6 million was used to repurchase additional shares of common stock. We also used cash of \$1.1 million in the first quarter of fiscal 2014 to purchase common stock to pay employee taxes resulting principally from issuance of common shares associated with our fiscal year 2011-2013 performance share program.

We believe that our existing cash, cash equivalents and available-for-sale securities, which totaled \$53.1 million as of December 31, 2013, together with cash flow from operations and our credit facility, will provide liquidity sufficient to meet the below stated needs and fund our operations for the remainder of fiscal 2014. There can be no assurance, however, that SurModics' business will continue to generate cash flows at current levels, and disruptions in financial markets may negatively impact our ability to access capital in a timely manner and on attractive terms. Our anticipated liquidity needs for the remainder of fiscal 2014 may include, but are not limited to, the following: general capital expenditures in the range of \$2.1 million to \$2.4 million; \$2.6 million related to our share repurchase program discussed previously; and obligations remaining after the Pharma Sale, including indemnification obligations of \$2.5 million to Evonik related to contingent consideration payments from the acquisition of assets from PR Pharmaceuticals in November 2008.

Discontinued Operations. Our Pharmaceuticals discontinued operation used operating cash of less than \$0.1 million in the first quarter of fiscal 2014 and generated operating cash of \$0.1 million in the first quarter of fiscal 2013. Cash generated in financing activities of less than \$0.1 million in the first quarter of fiscal 2014 and cash used of \$0.1 million in the first quarter of fiscal 2013 related to transfers of cash to the continuing operations of SurModics and consisted of cash used for accounts payable balances and cash generated from payments related to retained accounts receivable balances in the first quarter of fiscal 2014 and 2013, respectively.

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Customer Concentrations. Our licensed technologies provide royalty revenue, which represents the largest revenue stream to the Company. We have licenses with a diverse base of customers and certain customers have multiple products using our technology. Medtronic, Inc. (Medtronic) was our largest customer comprising 19% of total revenue for fiscal 2013 and remains at this level in the first quarter of fiscal 2014. Medtronic has several separately licensed products that generate royalty revenue for SurModics, none of which represented more than 6% of SurModics' total revenue. No other individual customer using licensed technology constitutes more than 10% of SurModics' total revenue.

Off-Balance Sheet Arrangements

As of December 31, 2013, we did not have any off-balance sheet arrangements with any unconsolidated entities.

Forward-Looking Statements

This Quarterly Report on Form 10-Q, including Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 2, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include expectations concerning our growth strategy, including our ability to sign new license agreements and broaden our hydrophilic coatings royalty revenue, product development programs, various milestone achievements, research and development expenses, increased legal expenses within selling, general and administrative expenses, future cash flow and sources of funding, short-term liquidity requirements, future property and equipment investment levels, the impact of potential lawsuits or claims, and the impact of Medtronic, as well as other significant customers, including new diagnostic kit customers. Without limiting the foregoing, words or phrases such as anticipate, believe, could, estimate, expect, forecast, intend, may, possible, project, will and similar terminology, generally identify forward-looking statements. Forward-looking statements may also represent challenging goals for us. These statements, which represent the Company's expectations or beliefs concerning various future events, are based on current expectations that involve a number of risks and uncertainties that could cause actual results to differ materially from those of such forward-looking statements. We caution that undue reliance should not be placed on such forward-looking statements, which speak only as of the date made. Some of the factors which could cause results to differ from those expressed in any forward-looking statement are set forth under Risk Factors in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2013. We disclaim any intent or obligation to update publicly these forward-looking statements, whether because of new information, future events or otherwise.

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

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

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

a decrease in our available cash or the value of our investment holdings could impact short-term liquidity requirements and expected capital and other expenditures;

the difficulties and uncertainties associated with the lengthy and costly new product development and foreign and domestic regulatory approval processes, such as delays, difficulties or failures in achieving acceptable clinical results or obtaining foreign or U.S. Food and Drug Administration marketing clearances or approvals, which may result in lost market opportunities or postpone or preclude product commercialization by licensees;

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

our ability to perform successfully certain product development activities, the related R&D expense impact and governmental and regulatory compliance activities which we have not previously undertaken in any significant manner; and

other factors described in **Risk Factors** and other sections of SurModics Annual Report on Form 10-K for the fiscal year ended September 30, 2013, which you are encouraged to read carefully.

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

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our investment policy requires investments with high credit quality issuers and limits the amount of credit exposure to any one issuer. Our investments consist principally of U.S. government and government agency obligations, mortgage-backed securities, municipal bonds, asset-backed securities and corporate bonds with varying maturity dates, the majority of which are five years or less. Because of the credit criteria of our investment policies, the primary market risk associated with these investments is interest rate risk. We do not use derivative financial instruments to manage interest rate risk or to speculate on future changes in interest rates. A one percentage point increase in interest rates would result in an approximate \$0.8 million decrease in the fair value of our available-for-sale securities as of December 31, 2013, but would have no material impact on the results of operations or cash flows.

Management believes that a reasonable change in raw material prices would not have a material impact on future earnings or cash flows because our inventory exposure is not material.

Although we conduct business in foreign countries, our international operations consist primarily of sales of reagent and stabilization chemicals. Additionally, all sales transactions are denominated in U.S. dollars. We generate royalty revenue from the sale of customer products in foreign jurisdictions. Royalties generated in foreign jurisdictions by customers are converted and paid in U.S. dollars per contractual terms. Given the diverse nature of our customers products and international operations, changes in foreign currencies are not expected to materially impact our operating results. A limited number of our purchasing transactions are denominated in foreign currencies and they are converted to U.S. dollars. These purchasing transactions are not material to our operating results. Accordingly, we do not expect to be subject to material foreign currency risk with respect to future costs or cash flows from our foreign sales. To date, we have not entered into any foreign currency forward exchange contracts or other derivative financial instruments to hedge the effects of adverse fluctuations in foreign currency exchange.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, referred to collectively herein as the Certifying Officers, are responsible for establishing and maintaining our disclosure controls and procedures. The Certifying Officers have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the Exchange Act)) as of December 31, 2013. Based on that review and evaluation, which included inquiries made to certain other employees of the Company, the Certifying Officers have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures, as designed and implemented, are effective to ensure that information required to be disclosed by the Company in reports that it files under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the Securities Exchange Commission rules and forms, and to ensure that information required to be disclosed by the Company in the reports the Company files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its Certifying Officers, as appropriate, to allow timely decisions regarding required disclosures.

Changes in Internal Controls Over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) during the three months ended December 31, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II OTHER INFORMATION****Item 1. Legal Proceedings**

There have been no material developments in the legal proceedings previously disclosed in the Company's Form 10-K for the fiscal year ended September 30, 2013.

Item 1A. Risk Factors

In our report on Form 10-K for the fiscal year ended September 30, 2013, filed with the SEC on December 11, 2013, we identify under Part 1, Item 1A. Risk Factors, important factors which could affect our financial performance and could cause our actual results for future periods to differ materially from our anticipated results or other expectations, including those expressed in any forward-looking statements made in this Form 10-Q.

There have been no material changes in our risk factors subsequent to the filing of our Form 10-K for the fiscal year ended September 30, 2013.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**(c) Issuer Purchases of Equity Securities**

The following table presents information with respect to purchases of common stock of the Company made during the three months ended December 31, 2013, by the Company or on behalf of the Company or any affiliated purchaser of the Company, as defined in Rule 10b-18(a)(3) under the Exchange Act.

| Period | Total Number of Shares Purchased (1) | Average Price Paid per Share (1) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs (2) |
|------------------|---|---|---|---|
| 10/1/13 10/31/13 | 112,200 | \$ 23.57 | 112,200 | \$ 8,881,325 |
| 11/1/13 11/30/13 | 153,434 | \$ 22.76 | 111,614 | \$ 6,333,671 |
| 12/1/13 12/31/13 | 177,460 | \$ 23.83 | 156,197 | \$ 2,603,780 |
| Total | 443,094 | \$ 23.39 | 380,011 | \$ 2,603,780 |

- (1) The purchases in this column included shares repurchased as part of our publicly announced program and in addition include 63,803 shares that were repurchased by the Company to satisfy tax withholding obligations in connection with so-called stock swap exercises related to the exercise of employee stock options or vesting of performance share awards.

- (2) On July 29, 2013, our Board of Directors authorized the repurchase of up to \$20.0 million of our outstanding common stock. Through December 31, 2013, we have repurchased 380,011 shares at an average price of \$23.48 under the July 2013 authorization and as of December 31, 2013, there remains \$2.6 million available to repurchase shares in the future. The repurchase authorization does not have a fixed expiration date. In January 2014 the remaining \$2.6 million was used to repurchase additional shares of common stock.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

None.

Table of Contents**Item 6. Exhibits**

| Exhibit | Description |
|----------------|--|
| 3.1 | Restated Articles of Incorporation, as amended - incorporated by reference to Exhibit 3.1 of the Company's Quarterly Report on Form 10-QSB for the quarter ended December 31, 1999, SEC File No. 0-23837. |
| 3.2 | Restated Bylaws of SurModics, Inc., as amended November 30, 2009 - incorporated by reference to Exhibit 3.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 2009, SEC File No. 0-23837. |
| 10.1 | Credit Agreement dated November 4, 2013, by and between SurModics, Inc., and Wells Fargo Bank, National Association - incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on November 5, 2013, SEC File No. 0-23837. |
| 10.2 | Revolving Line of Credit Note dated November 4, 2013 - incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed on November 5, 2013, SEC File No. 0-23837. |
| 31.1* | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2* | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1* | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2* | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101* | Financial statements from the Quarterly Report on Form 10-Q for SurModics, Inc. for the quarterly period ended December 31, 2013, filed on February 4, 2014, formatted in Extensible Business Reporting Language (XBRL): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Income, (iii) Condensed Consolidated Statements of Comprehensive Income, (iv) Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements. |

* Filed herewith

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

February 4, 2014

SurModics, Inc.

By: /s/ Andrew D. C. LaFrence
Andrew D. C. LaFrence
Vice President of Finance and
Chief Financial Officer

(duly authorized signatory and
principal financial officer)

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
EXHIBIT INDEX TO FORM 10-Q
For the Quarter Ended December 31, 2013
SURMODICS, INC.

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| 101.INS* | XBRL Instance Document |
| 101.SCH* | XBRL Taxonomy Extension Schema Document |
| 101.CAL* | XBRL Taxonomy Calculation Linkbase Document |

101.LAB* XBRL Taxonomy Extension Label Linkbase Document

101.PRE* XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith