SURMODICS INC
Form 10-Q
May 03, 2019

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 March 31, 2019

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number: 0-23837

Surmodics, Inc.

(Exact name of registrant as specified in its charter)

MINNESOTA	41-1356149
(State of incorporation)	(I.R.S. Employer Identification No.)

9924 West 74th Street, Eden Prairie, Minnesota 55344

(Address of principal executive offices) (Zip Code)

Registrant’s telephone number, including area code:

(952) 500-7000

Securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

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 every Interactive Data File required to be submitted 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 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 or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging Growth Company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Title of each class	Trading Symbol	Name of each exchange on which registered
Common Stock, $0.05 par value	SRDX	Nasdaq Global Select Market

The number of shares of the registrant's Common Stock, $0.05 par value per share, as of April 30, 2019 was 13,488,496

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PART I. FINANCIAL INFORMATION

Item 1. Unaudited Condensed Financial Statements

Surmodics, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(in thousands, except share and per share data)	March 31, 2019 (Unaudited)	September 30, 2018
ASSETS		
Current Assets:		
Cash and cash equivalents	$22,470	$23,318
Restricted cash	—	350
Available-for-sale securities	24,023	41,352
Accounts receivable, net of allowance for doubtful accounts of $181 and $147 as of March 31, 2019 and September 30, 2018, respectively	9,312	8,877
Contract assets - royalties and license fees	7,065	—
Inventories, net	4,345	4,016
Income tax receivable	1,137	1,152
Prepaids and other	3,165	2,462
Total Current Assets	71,517	81,527
Deferred tax assets	5,301	6,304
Property and equipment, net	29,512	30,143
Intangible assets, net	16,020	17,683
Goodwill	26,549	27,032
Other assets	2,081	1,446
Total Assets	$150,980	$164,135
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$3,746	$2,546
Accrued liabilities:		
Compensation	2,107	5,635
Accrued other	5,097	6,265
Deferred revenue	6,385	9,646
Contingent consideration	3,009	11,041
Total Current Liabilities	20,344	35,133
Contingent consideration, less current portion	—	3,425
Deferred revenue, less current portion	10,470	11,247
Other long-term liabilities	4,853	5,720
Total Liabilities	35,667	55,525
Commitments and Contingencies (Note 15)		
Stockholders' Equity:		
Series A Preferred stock- $.05 par value, 450,000 shares authorized; no shares issued and outstanding	—	—

Common stock- $.05 par value, 45,000,000 shares authorized; 13,488,738 and 13,397,647 shares issued and outstanding as of March 31, 2019 and September 30, 2018, respectively	674	670
Additional paid-in capital	7,510	7,607
Accumulated other comprehensive income	1,444	2,718
Retained earnings	105,685	97,615
Total Stockholders' Equity	115,313	108,610
Total Liabilities and Stockholders' Equity	$150,980	$164,135

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

Surmodics, Inc. and Subsidiaries

Condensed Consolidated Statements of Operations

(In thousands, except per share data)	Three Months Ended March 31, 2019 (Unaudited)	2018	Six Months Ended March 31, 2019 (Unaudited)	2018
Revenue:				
Product sales	$9,887	$8,686	$19,638	$16,774
Royalties and license fees	9,932	8,428	20,028	15,504
Research, development and other	2,857	1,944	5,251	3,793
Total revenue	22,676	19,058	44,917	36,071
Operating costs and expenses:				
Product costs	3,093	2,913	6,616	5,804
Research and development	13,555	10,774	25,041	18,605
Selling, general and administrative	4,876	6,440	10,825	11,628
Acquired intangible asset amortization	604	636	1,210	1,254
Contingent consideration gain	(317)	(2,230)	(352)	(1,112)
Total operating costs and expenses	21,811	18,533	43,340	36,179
Operating income (loss)	865	525	1,577	(108)
Other income (loss):				
Investment income, net	265	142	581	263
Interest expense	(37)	—	(74)	—
Foreign exchange gain (loss)	5	(353)	141	(539)
Gain on strategic investment and other	2	—	9	177
Other income (loss), net	235	(211)	657	(99)
Income (loss) before income taxes	1,100	314	2,234	(207)
Income tax benefit	162	1,220	338	185
Net income (loss)	$1,262	$1,534	$2,572	$(22)
Basic net income (loss) per share	$0.09	$0.12	$0.19	$(0.00)
Diluted net income (loss) per share	$0.09	$0.11	$0.19	$(0.00)
Weighted average number of shares outstanding:				
Basic	13,390	13,102	13,379	13,078
Diluted	13,785	13,465	13,816	13,078

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

Surmodics, Inc. and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income (Loss)

	Three Months Ended March 31,		Six Months Ended March 31,	
(In thousands)	2019	2018	2019	2018
	(Unaudited)		(Unaudited)	
Net income (loss)	$1,262	$1,534	$2,572	$(22)
Other comprehensive (loss) income:				
Unrealized holding gains (losses) on available-for-sale securities, net of tax	39	(28)	44	(41)
Foreign currency translation adjustments	(779)	1,207	(1,318)	1,837
Other comprehensive (loss) income	(740)	1,179	(1,274)	1,796
Comprehensive income	$522	$2,713	$1,298	$1,774

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

Surmodics, Inc. and Subsidiaries

Condensed Consolidated Statements of Stockholders' Equity

Three Months Ended March 31, 2019 and 2018

(In thousands)	Common Stock Shares	Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Total Stockholders' Equity
Balance at December 31, 2018	13,483	$ 674	$ 6,340	$ 2,184	$104,423	$ 113,621
Net income	—	—	—	—	1,262	1,262
Other comprehensive loss, net of tax	—	—	—	(740)	—	(740)
Issuance of common stock	6	—	209	—	—	209
Common stock options exercised, net	1	—	19	—	—	19
Purchase of common stock to pay employee taxes	(1)	—	(17)	—	—	(17)
Stock-based compensation	—	—	959	—	—	959
Balance at March 31, 2019	13,489	$ 674	$ 7,510	$ 1,444	$105,685	$ 115,313
Balance at December 31, 2017	13,196	$ 660	$ 5,337	$ 4,034	$100,516	$ 110,547
Net income	—	—	—	—	1,534	1,534
Other comprehensive income, net of tax	—	—	—	1,179	—	1,179
Issuance of common stock	3	—	166	—	—	166
Common stock options exercised, net	159	8	54	—	—	62
Purchase of common stock to pay employee taxes	(111)	(6)	(1,225)	—	—	(1,231)
Stock-based compensation	—	—	1,099	—	—	1,099
Balance at March 31, 2018	13,247	$ 662	$ 5,431	$ 5,213	$102,050	$ 113,356

Six Months Ended March 31, 2019 and 2018

(In thousands)	Common Stock Shares	Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Total Stockholders' Equity
Balance at September 30, 2018	13,398	$ 670	$ 7,607	$ 2,718	$97,615	$ 108,610
Net impact from adoption of ASC Topic 606 (Note 2)	—	—	—	—	5,498	5,498
Net income	—	—	—	—	2,572	2,572
Other comprehensive loss, net of tax	—	—	—	(1,274)	—	(1,274)
Issuance of common stock	134	6	203	—	—	209
Common stock options exercised, net	2	0	55	—	—	55
Purchase of common stock to pay employee taxes	(45)	(2)	(2,545)	—	—	(2,547)
Stock-based compensation	—	—	2,190	—	—	2,190
Balance at March 31, 2019	13,489	$ 674	$ 7,510	$ 1,444	$105,685	$ 115,313
Balance at September 30, 2017	13,095	$ 655	$ 5,413	$ 3,417	$102,072	$ 111,557
Net loss	—	—	—	—	(22)	(22)
Other comprehensive income, net of tax	—	—	—	1,796	—	1,796

Issuance of common stock	127	6	160	—	—	166
Common stock options exercised, net	171	8	209	—	—	217
Purchase of common stock to pay employee taxes	(146)	(7)	(2,354)	—	—	(2,361)
Stock-based compensation	—	—	2,003	—	—	2,003
Balance at March 31, 2018	13,247	$ 662	$ 5,431	$ 5,213	$102,050	$ 113,356

Surmodics, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(in thousands)	Six Months Ended March 31, 2019 (Unaudited)	2018
Operating Activities:		
Net income (loss)	$2,572	$(22)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Depreciation and amortization	3,575	3,106
Stock-based compensation	2,190	2,003
Payment of contingent consideration obligations in excess of acquisition-date value	(2,041)	—
Contingent consideration gain	(352)	(1,112)
Unrealized foreign exchange gain	—	518
Deferred taxes (1)	(213)	701
Gain on strategic investment	(7)	(177)
Provision for bad debts	119	25
Other	(10)	92
Change in operating assets and liabilities:		
Accounts receivable and contract asset (1)	(756)	(15)
Inventories	(355)	(500)
Prepaids and other	(1,430)	(1,366)
Accounts payable	1,273	(418)
Accrued liabilities	(4,071)	810
Income taxes (1)	(291)	(776)
Deferred revenue (1)	(4,141)	24,562
Net cash (used in) provided by operating activities	(3,938)	27,431
Investing Activities:		
Purchases of property and equipment	(3,118)	(4,020)
Purchases of available-for-sale securities	(20,085)	(43,517)
Maturities of available-for-sale securities	37,458	33,000
Cash proceeds from sales of property and equipment	10	4
Cash received from sale of strategic investment	7	177
Net cash provided by (used in) investing activities	14,272	(14,356)
Financing Activities:		
Issuance of common stock	264	377
Payments for taxes related to net share settlement of equity awards	(2,678)	(1,132)
Payment of contingent consideration obligations	(9,064)	(925)
Net cash used in financing activities	(11,478)	(1,680)
Effect of exchange rate changes on cash, restricted cash and cash equivalents	(54)	133
Net change in cash, restricted cash and cash equivalents	(1,198)	11,528
Cash, Restricted Cash and Cash Equivalents:		
Beginning of period	23,668	16,534
End of period	$22,470	$28,062
Supplemental Information:		
Cash paid for income taxes	$150	$782

Noncash transactions from investing and financing activities:		
Acquisition of property and equipment, net of refundable credits in other current assets and liabilities	$65	$329
Accrued taxes related to net share settlement of equity awards	—	1,222

(1) Amounts presented are net of impact from adoption of ASC Topic 606.

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

Surmodics, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

Period Ended March 31, 2019

(Unaudited)

1. Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S.") ("GAAP") and, in the opinion of management, reflect all adjustments, consisting of normal recurring adjustments, needed to fairly present the financial results of Surmodics, Inc. and subsidiaries ("Surmodics" or the "Company") for the periods presented. These financial statements include amounts that are based on management's best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of net income (loss) in the period in which the change in estimate is identified. The results of operations for the three and six months ended March 31, 2019 are not necessarily indicative of the results that may be expected for the entire 2019 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 consolidated 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, 2018, and footnotes thereto included in the Company's Form 10-K as filed with the SEC on November 30, 2018.

New Accounting Pronouncements

Recently Adopted

In May 2014, the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") issued Update No. 2014-09, Revenue from Contracts with Customers ("ASC Topic 606"). The core principal of ASC Topic 606 is to recognize revenue in a manner that depicts the transfer of goods or services to customers in amounts that reflect the consideration an entity expects to be entitled to in exchange for those goods or services. The guidance also requires expanded disclosures relating to the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, as well as significant judgements and changes in judgements, which are described in Note 2 to the condensed consolidated financial statements. The Company adopted ASC Topic 606 in the first quarter of fiscal year 2019 using the modified retrospective method and applied the new revenue standard to all new customer contracts initiated on or after the effective date and contracts which had remaining performance obligations as of the effective date.

The adoption of ASC Topic 606 resulted in an acceleration of minimum license fees and sales-based royalty revenue earned under the Company's hydrophilic coating technology license agreements by approximately one quarter. Prior to the adoption of ASC Topic 606, sales-based royalties were recognized in the period the Company's customers reported the underlying sales, which is generally one quarter after the sales occurred. Additionally, minimum royalties were recognized in the period they were contractually owed to the Company. Upon adoption of ASC Topic 606, sales-based royalties are recognized in the period the underlying customer sale occurs, while the minimum royalties are recognized at each renewal of the license contract, which generally occurs on the last day of the quarter for minimum royalties contractually due in the following quarter. The adoption of ASC Topic 606 resulted in cumulative-effect

adjustments to opening retained earnings, contract assets, deferred tax assets and income tax receivable.

The impact of the adoption of ASC Topic 606 on the opening consolidated balance sheet as of October 1, 2018, as compared with the consolidated balance sheet previously reported as of September 30, 2018, was as follows:

(Dollars in thousands)	September 30, 2018, As Reported	Adjustments for Adoption of Topic 606	October 1, 2018 Opening Balance
Assets			
Contract assets - royalties and license fees	$ —	$ 6,904	$6,904
Deferred income taxes	6,304	(1,215)	5,089
Income tax receivable	1,152	(390)	762
Liabilities and Stockholders' Equity			
Deferred revenue, current portion	9,646	(18)	9,628
Deferred revenue, less current portion	11,247	(181)	11,066
Retained earnings	97,615	5,498	103,113

The impact of adoption of ASC Topic 606 to the Company’s condensed consolidated statements of operations for three and six months ended March 31, 2019 was an increase of royalty and license fee revenue of $0.3 million and $0.1 million, respectively, as well as reduced income tax benefit of less than $0.1 million for each period.

Not Yet Adopted

In February 2016, the FASB issued Accounting Standards Update ASU 2016-02, Leases (ASC Topic 842). The new guidance primarily affects lessee accounting, while accounting by lessors will not be significantly impacted by the update. The update maintains two classifications of leases: finance leases, which replace capital leases, and operating leases. Lessees will need to recognize a right-of-use asset and a lease liability on the statement of financial position for those leases previously classified as operating leases under the old guidance. The liability will be equal to the present value of remaining contractual lease payments. The asset will be based on the liability, subject to adjustment, such as for direct costs. The accounting standard will be effective for the Company beginning the first quarter of fiscal year 2020 (October 1, 2019) and will be applied using a modified retrospective approach. The Company is currently evaluating the impact that the adoption of this standard will have on the Company’s results of operations, cash flows and financial position. The Company believes the impact will be material due to the right-of-use assets and lease liabilities that will be recorded on the Company’s consolidated balance sheets upon adoption of the standard.

In June 2016, the FASB issued ASU No 2016-13, Financial Instruments – Credit Losses (ASC Topic 326), Measurement of Credit Losses on Financial Statements. This ASU requires a financial asset (or a group of financial assets) measured at an amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset. The accounting standard will be effective for the Company beginning in the first quarter of fiscal 2021 (October 1, 2020). Early adoption is permitted and the guidance will be applied using a modified retrospective approach. The Company is currently evaluating the impact that the adoption of this standard will have on the Company’s results of operations, cash flows and financial position.

No other new accounting pronouncement issued or effective has had, or is expected to have, a material impact on the Company’s condensed consolidated financial statements.

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2. Revenue

Effective October 1, 2018, the Company adopted ASC Topic 606 using the modified retrospective adoption method. Revenue is recognized when control of the promised goods or services is transferred to our customers, in an amount that reflects the consideration we expect to be entitled to receive in exchange for those goods or services.

The following tables presents our revenues disaggregated by product classification and by operating segment, excluding sales taxes collected and remitted to governmental authorities (in thousands, unaudited).

	Three Months Ended March 31,		Six Months Ended March 31,	
(In thousands)	2019	2018	2019	2018
Medical Device	(Unaudited)		(Unaudited)	
Product sales	$4,558	$3,687	$9,336	$7,537
Royalties	8,313	7,891	15,998	14,933
Research, development and other	2,811	1,937	5,195	3,785
License fees	1,619	537	4,030	571
Total Revenue - Medical Device	17,301	14,052	34,559	26,826
IVD				
Product sales	5,329	4,999	10,302	9,237
Other	46	7	56	8
Total Revenue - IVD	5,375	5,006	10,358	9,245
Total Revenue	$22,676	$19,058	$44,917	$36,071

Performance Obligations

The Company derives its revenue from three primary sources: (1) product revenues from the sale of reagent chemicals to licensees, the sale of stabilization products, antigens, substrates and surface coatings to the diagnostic and biomedical research markets as well as the sale of medical devices and related products (such as balloons and catheters) to original equipment manufacturer (OEM) suppliers and distributors; (2) royalties and license fees from licensing our proprietary surface modification and device drug delivery technologies to customers; and (3) research and commercial development fees generated on customer projects.

The Company recognizes revenue when control is transferred to the customer. The transfer of control varies by revenue classification and is described below.

Product sales – Revenue from product sales is recognized at the point in time control of the products is transferred, generally upon shipment based upon the standard contract terms. Shipping and handling activities are considered to be fulfillment activities rather than promised services and are not, therefore, considered to be separate performance obligations. The Company’s sales terms provide no right of return outside of a standard warranty policy and returns are generally not significant. Payment terms for product sales are generally set at 30-45 days after the consideration becomes due and payable.

Royalties – Royalty revenue consists of sales-based and recurring minimum royalties earned under licenses of our surface modification technologies. Performance obligations under these licenses, which consist of the right to use the Company’s proprietary technology, are satisfied at a point in time corresponding with delivery of the underlying technology rights to the customer, which is generally upon transfer of the licensed technology to the customer.

Sales-based royalty revenue represents variable consideration under the license agreements and is recognized in the period a customer sells products incorporating the Company’s licensed technologies. The Company estimates sales-based royalty revenue earned but unpaid at each reporting period using the expected value method based on historical sales information, adjusted for known changes such as product launches and patent expirations. The Company's license arrangements also often provide for recurring fees (minimum royalties) which the Company recognizes at the later of the satisfaction of the underlying performance obligation or upon renewal of the contract, which is generally done on a quarterly basis. Sales-based and minimum royalties are generally due within 45 days of the end of each quarter.

License fees – For distinct license performance obligations, upfront license fees are recognized when the Company satisfies the underlying performance obligation. This generally occurs upon transfer of the right to use the Company’s licensed technology to the customer, with the exception of the license of the Company’s SurVeil® drug-coated balloon (the “SurVeil DCB”) disclosed below and in Note 3 to the condensed consolidated financial statements. Certain license arrangements include contingent milestone payments,

which are due following achievement by our customers of specified sales or regulatory milestones. Contingent milestone payment terms vary by contract. The Company has generally fulfilled its performance obligation prior to achievement of these milestones. However, because of the uncertainty of the milestone achievement, and/or the dependence on sales of our customers, variable consideration for contingent milestones is fully constrained and excluded from the contract price until the milestone is achieved by our customer, to the extent collectability is reasonably certain.

Pursuant to the terms of the collaborative arrangement contract with Abbott Vascular, Inc. (“Abbott”) disclosed in Note 3 (the “Abbott Agreement”), the Company received an upfront payment of $25 million in fiscal 2018. To the extent the Company achieves certain agreed-upon clinical and regulatory milestones, the Company may receive up to $67 million of additional milestone payments. The performance obligation identified in this arrangement includes delivery of our licensed technology and completion of research and development activities, primarily clinical trial activities (together, “R&D and Clinical Activities”). These promises are not distinct performance obligations because the product necessary for completion of the R&D and Clinical Activities is currently only able to be manufactured by the Company due to the exclusive proprietary know-how and certain regulatory requirements associated with the manufacture of the product. The customer (Abbott) simultaneously receives and consumes the benefits of the R&D and Clinical Activities as study data are generated to support regulatory approval submissions. Control is effectively transferred over time as we complete the TRANSCEND clinical study of our SurVeil DCB. Revenue related to this contract is recognized using the cost-to-cost method which measures progress based on costs incurred to date relative to the expected total cost of the services, as the Company believes this represents a faithful depiction of the satisfaction of its performance obligation. Use of the cost-to-cost method requires significant estimates including the total cost of the TRANSCEND study, which is expected to be completed over the next six years. Revenue is recorded based on the cost-to-cost completion estimate relative to the transaction price, which is equal to the total upfront fee plus the expected value of the clinical and regulatory milestones. As of March 31, 2019, consideration from the clinical and regulatory milestones has been fully constrained and excluded from the contract price, due to the high level of uncertainty as to the achievement of the underlying regulatory approval(s) and/or clinical milestones. Significant judgment is used to estimate total revenue and cost at completion for this contract.

Research and development – The Company performs third-party research and development activities, which are typically charged to customers on a time-and-materials basis. Generally, revenue for research and development is recorded over time as the services are provided to the customer in the amount to which the Company has the right to invoice. These services are generally charged to the customer as they are provided. Payment terms for R&D services are generally set at 30-45 days after the consideration becomes due and payable.

If a contract contains more than one distinct performance obligation, the transaction price is allocated to each performance obligation based on relative standalone selling price.

Contract Assets, Deferred Revenue and Remaining Performance Obligations

Contract assets are generally short in duration given the nature of products produced and services provided by the Company. Contract assets consist of sales-based and minimum royalty revenue earned for which unconditional right to payment does not exist as of the balance sheet date. These assets are comprised of estimated sales-based royalties earned, but not yet reported by the Company’s customers, minimum royalties on non-cancellable contracts, and contingent milestones earned but not yet billable based on the terms of the contract. The increase in contract assets from October 1, 2018 to March 31, 2019 resulted primarily from changes in estimated sales-based royalties earned but not collected at each balance sheet date.

The Company records a contract liability, or deferred revenue, when there is an obligation to provide a product or service to the customer and payment is received or due in advance of performance, or when payment is received for a period outside the contract term. The Company’s deferred revenue at March 31, 2019 and September 30, 2018 is primarily related to the upfront payment received pursuant to the Abbott Agreement (Note 3).

Remaining performance obligations include deferred revenue and amounts the Company expects to receive for goods and services that have not yet been delivered or provided under existing, noncancellable contracts. For contracts that have an original duration of one year or less, the Company has elected the practical expedient applicable to such contracts and does not disclose the transaction price for remaining performance obligations at the end of each reporting period and when the Company expects to recognize this revenue. As of March 31, 2019, the estimated revenue expected to be recognized in future periods related to performance obligations that are unsatisfied for executed contracts with an original duration of one year or more was approximately $16.7 million. This revenue is entirely related to the R&D and Clinical Services performance obligation in the Abbott Agreement from the upfront payment received in fiscal 2018 and does not include revenue from potential contingent milestone payments that may be received throughout the course of the agreement. The Company expects to recognize the remaining revenue from this

performance obligation over the next six years as the services, which are primarily comprised of the TRANSCEND clinical study, are completed.

3. Collaborative Arrangement

Under the Abbott Agreement, Abbott will have exclusive worldwide commercialization rights for the SurVeil DCB to treat the superficial femoral artery, which is currently being evaluated in a U.S. pivotal clinical trial. Separately, Abbott also received options to negotiate agreements for Surmodics' below-the-knee and arteriovenous (AV) fistula DCB products, which are currently in pre-clinical development and a first-in human clinical study, respectively. Surmodics is responsible for conducting all necessary clinical trials and other activities required to achieve U.S. and European Union regulatory clearances for the SurVeil DCB, including completion of the ongoing TRANSCEND clinical trial. Abbott and Surmodics will participate on a joint development committee charged with providing guidance on the Company’s clinical and regulatory activities with regard to the SurVeil product.

To account for the Abbott Agreement, the Company applied the guidance in ASC 808 as the parties are active participants and are exposed to significant risks and rewards dependent on commercial success of the collaborative activity. The Company has determined that the upfront and milestone payments represent consideration paid in a vendor-customer relationship and has thus applied the guidance in ASC Topic 606 to these payments and the related performance obligations, as further discussed in Note 2. The Company is the principal in the arrangement and the related development costs and the revenue and R&D costs will be reported gross in license fee revenue and research and development costs on the condensed consolidated statements of operations.

The Company has received a $25 million upfront fee and may receive up to $67 million of additional payments upon achievement of various clinical and regulatory milestones. For the three and six months ended March 31, 2019, the Company recognized revenue totaling $1.6 million and $4.0 million, respectively from the Abbott arrangement, all of which was previously included in deferred revenue. For both the three and six months ended March 31, 2018, the Company recognized revenue totaling $0.5 million from the Abbott arrangement. As of March 31, 2019 and September 30, 2018, deferred revenue from the upfront payment received of $16.7 million and $20.6 million, respectively is recorded in the condensed consolidated balance sheets. Upon the commercialization of the SurVeil DCB, Surmodics will be responsible for the manufacture and supply of clinical and commercial quantities of the product. Revenue from these product sales, including a per-unit transfer price and a share of net profits resulting from third-party sales by Abbott, will be recognized if and when these products are shipped and control is transferred to the customer.

4. Fair Value Measurements

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

Fair Value Hierarchy

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

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

The Company did not have any Level 1 assets as of March 31, 2019 and September 30, 2018.

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

The Company’s Level 2 assets as of March 31, 2019 and September 30, 2018 consisted of money market funds, commercial paper instruments and corporate bonds.

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

The Level 3 liability as of March 31, 2019 consisted of contingent consideration obligations related to the fiscal 2016 acquisition of NorMedix, Inc. ("NorMedix"). Level 3 liabilities as of September 30, 2018 consisted of contingent consideration obligations related to the fiscal 2016 acquisitions of Creagh Medical Ltd. ("Creagh Medical") and NorMedix. Consideration owed to the sellers of Creagh Medical from revenue and value-creating milestones achieved through September 30, 2018 was paid during the six months ended March 31, 2019. Consideration owed to the sellers of NorMedix upon achievement of revenue and value-creating milestones through September 30, 2019, if any, is due to be paid in first quarter of fiscal 2020. Contingent consideration included in current liabilities of $3.0 million and $11.0 million as of March 31, 2019 and September 30, 2018, respectively, represents the Company's estimated fair value of amounts expected to be paid within one year of each respective balance sheet date. During the first quarter of fiscal 2019, the Company paid contingent consideration obligations related to the Creagh Medical acquisition totaling $11.0 million, including $9.1 million classified as cash flows used in financing activities on the condensed consolidated statement of cash flows. The financing portion of the contingent consideration payment is equal to the acquisition-date value of the contingent consideration obligation, in accordance with ASC 230 Statements of Cash Flows.

In valuing Level 3 assets and liabilities, the Company is required to maximize the use of quoted market prices and minimize the use of unobservable inputs.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

In instances where the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset or liability.

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of March 31, 2019:

(Dollars in thousands)	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value as of March 31, 2019
Assets				
Cash equivalents	$ —	$ 17,950	$ —	$17,950
Available-for-sale securities	—	24,023	—	24,023
Total assets	$ —	$ 41,973	$ —	$41,973
Liabilities				
Contingent consideration	$ —	$ —	$ (3,009)	$(3,009)

Total liabilities	$ —	$ —	$ (3,009)	$(3,009)

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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, 2018:

(Dollars in thousands)	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value as of September 30, 2018
Assets				
Cash equivalents	$ —	$ 13,999	$ —	$ 13,999
Available-for-sale securities	—	41,352	—	$ 41,352
Total assets	$ —	$ 55,351	$ —	$ 55,351
Liabilities				
Contingent consideration	$ —	$ —	$ (14,466)	$ (14,466)
Total liabilities	$ —	$ —	$ (14,466)	$ (14,466)

The following table summarizes the changes in the contingent consideration liabilities measured at fair value using Level 3 inputs for the three and six months ended March 31, 2019 and 2018:

	Three Months Ended March 31,		Six Months Ended March 31,	
(Dollars in thousands)	2019	2018	2019	2018
Beginning balance	$3,326	$16,162	$14,466	$14,864
Additions	—	—	—	—
Fair value adjustments	(362)	(2,317)	(511)	(1,298)
Settlements	—	(925)	(10,979)	(925)
Interest accretion	45	87	159	186
Foreign currency translation loss (gain)	—	338	(126)	518
Ending balance	$3,009	$13,345	$3,009	$13,345

There were no transfers of assets or liabilities between amounts measured using Level 1, Level 2, or Level 3 fair value measurements during fiscal 2019 to date, or fiscal 2018.

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 securities — Fair market values for these assets are based on quoted vendor prices and broker pricing in active markets underlying the securities where all significant inputs are observable. 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.

Contingent consideration obligations — The values of the contingent consideration liabilities were determined based on discounted cash flow analyses that included revenue estimates, probability of strategic milestone achievement and a discount rate, which are considered significant unobservable inputs. For the NorMedix revenue-based milestones, the Company discounted forecasted revenue by 20.5%, which represents the Company's weighted average cost of capital for this transaction, adjusted for the short-term nature of the cash flows. The present value of forecasted revenue was used as an input into an option pricing approach, which also considered the Company's risk of non-payment of the NorMedix revenue-based milestones. Non-revenue milestones for the NorMedix acquisition that have not already been achieved were projected to have a 5%-100% probability of achievement and expected payments were discounted using the Company's estimated cost of debt of 6.0%. To the extent that actual results differ from these estimates, the fair value of the contingent consideration liabilities could change significantly during the contingency periods. Accretion expense is recorded as an increase to the contingent consideration liabilities due to the passage of time. Fair

value adjustments represent changes in the value of the obligations related to adjustments to forecasted revenue and probability of strategic milestone completion. The contingent consideration liability related to the Creagh Medical acquisition was denominated in Euros. Foreign currency translation gains and losses are recorded as this obligation is marked to exchange rates at period-end and on the date of settlement.

5. Investments

Investments consisted principally of commercial paper and corporate bond securities and are classified as available-for-sale as of March 31, 2019 and September 30, 2018. These available-for-sale securities are reported at fair value with unrealized gains and losses, net of tax, excluded from the condensed consolidated statements of operations and reported in the condensed consolidated statements of comprehensive income (loss) 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 as they occur. 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 would result in a new cost basis for the investment. Interest earned on debt securities, including amortization of premiums and accretion of discounts, is included in investment income, net within 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. Investment purchases are accounted for on the date the trade is executed, which may not be the same as the date the transaction is cash settled.

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

	March 31, 2019			
(Dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Short-term commercial paper and corporate bonds	$24,030	$ —	$ (7)	$ 24,023
Total	$24,030	$ —	$ (7)	$ 24,023

	September 30, 2018			
(Dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Short-term commercial paper and corporate bonds	$41,403	$ —	$ (51)	$ 41,352
Total	$41,403	$ —	$ (51)	$ 41,352

6. Inventories

Inventories are principally stated at the lower of cost or market using the specific identification method and include direct labor, materials and overhead, with cost of product sales determined on a first-in, first-out basis. Inventories consisted of the following components:

(Dollars in thousands)	March 31, 2019	September 30, 2018
Raw materials	$1,969	$ 1,890
Work-in process	807	780
Finished products	1,569	1,346
Total	$4,345	$ 4,016

7. Other Assets

Other assets consist of the following:

(Dollars in thousands)	March 31, 2019	September 30, 2018
ViaCyte, Inc.	$479	$ 479
Other noncurrent assets	1,602	967
Other assets, net	$2,081	$ 1,446

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. The

balance of the investment of $0.5 million, which is net of previously recorded other-than-temporary impairments of $4.8 million, is accounted for under the cost method and represents less than a 1% ownership interest. The Company does not exert significant influence over ViaCyte's operating or financial activities.

The carrying value of each cost method investment 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 effect on the fair value of the investment.

8. Intangible Assets

Intangible assets consist principally of acquired patents and technology, customer lists and relationships, licenses and trademarks. The Company recorded amortization expense of $0.7 million for both the three month periods ended March 31, 2019 and 2018. The Company recorded amortization expense of $1.3 million and $1.4 million for the six months ended March 31, 2019 and 2018, respectively.

Intangible assets consisted of the following:

	March 31, 2019			
(Dollars in thousands)	Weighted Average Original Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net
Definite-lived intangible assets:				
Customer lists and relationships	8.9	$ 17,687	$ (10,022)	$ 7,665
Developed technology	11.5	9,563	(2,780)	6,783
Non-compete	5.0	230	(173)	57
Patents and other	16.5	2,321	(1,644)	677
Subtotal		29,801	(14,619)	15,182
Unamortized intangible assets:				
In-process research and development		258	—	258
Trademarks and trade names		580	—	580
Total		$ 30,639	$ (14,619)	$ 16,020

	September 30, 2018			
(Dollars in thousands)	Weighted Average Original Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net
Definite-lived intangible assets:				
Customer lists and relationships	8.9	$ 18,086	$ (9,377)	$ 8,709
Developed technology	11.5	9,656	(2,361)	7,295
Non-compete	5.0	230		