SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-KSB

Annual Report Pursuant to Section 13 or 15(d) of
The Securities Exchange Act of 1934

For the fiscal year ended September 30, 1998
Commission file number 0-23837

SURMODICS, INC.
(Name of Small Business Issuer in its Charter)

Minnesota	41-1356149
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification Number)

9924 West 74th Street
Eden Prairie, Minnesota 55344
(Address of Principal Executive Offices; Zip Code)

Issuer's telephone number Including Area Code: (612) 829-2700

Securities registered Under Section 12(b) of the Act: None

Securities registered Under Section 12(g) of the Act: Common Stock

Check whether the Issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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.
X Yes ____ No

Check if no disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [X]

The issuer's revenues for the fiscal year ended September 30, 1998 were $9,778,661.

The aggregate market value of the Issuer's Common Stock held by non-affiliates (persons other than officers, directors or holders of more than 5% of the outstanding stock) as of December 14, 1998, was approximately $65.6 million (based on the closing sale price of the Issuer's Common Stock on such date).

Shares of Common Stock outstanding on December 14, 1998: 7,242,325

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Annual Report to Shareholders for the fiscal year ended September 30, 1998 are incorporated into Part II of this Form 10-KSB. Portions of the Registrant's Proxy Statement for its 1999 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-KSB.

Transitional Small Business Disclosure Format (check one): Yes No X

PART I

ITEM 1. DESCRIPTION OF BUSINESS

General

SurModics, Inc. ("SurModics" or the "Company") is a leading provider of surface modification solutions to the medical device industry. The Company's primary focus is the commercialization of its patented PhotoLink process through third-party licensing arrangements. PhotoLink is a versatile, easily applied, light-activated coating technology that modifies medical device surfaces by creating covalent bonds between those surfaces and a variety of chemical agents. Through the PhotoLink process, these chemical agents can impart many performance enhancing characteristics, such as lubricity, hemocompatibility, infection resistance and drug delivery, onto the surface of a medical device without materially changing the dimensions or physical properties of the device. The Company believes that medical device manufacturers who utilize the Company's technology are able to significantly improve the performance of their products and, in many cases, differentiate their products in a highly competitive marketplace.

The Company focuses on providing high value-added surface modification solutions to a variety of medical device markets and product categories. Examples of products in the market or under development that incorporate the PhotoLink technology include interventional cardiology catheters, vascular stents, interventional neurology catheters, guide wires and shunts, cardiac rhythm management devices, and urological and gynecological devices. The surface properties created by the PhotoLink technology have greatly reduced treatment times in catheter-based vascular procedures and have shown the potential to enhance the long-term performance of implantable devices by improving infection resistance and promoting host cell attachment, growth and subsequent tissue integration. The Company believes further opportunities exist to commercialize

its PhotoLink technology for other market applications, such as biomolecule immobilization for use in the emerging field of DNA-based diagnostics.

The Company has commercialized its PhotoLink technology through licensing arrangements with medical device manufacturers which apply the PhotoLink coatings to their own products. The Company believes this approach allows it to focus its resources on further development of its technology and expansion of its licensing activities, while leveraging the established manufacturing, sales and marketing capabilities of its licensees. Revenues from these arrangements include initial license fees, minimum royalties and earned royalties based on a percentage of licensees' product sales. In addition to licensing its PhotoLink technology, the Company also licenses certain diagnostic technology to Abbott Laboratories for use with rapid point-of-care diagnostic tests, such as pregnancy and strep tests. The Company also manufactures and sells the chemical reagents used in the PhotoLink process, and offers a line of stabilization products used to extend the shelf-life of immunoassay diagnostic tests.

The Company was organized as a Minnesota corporation in June 1979 and changed its name from BSI Corporation to SurModics, Inc. in June 1997.

Markets and Need for Surface Modification

Recent trends in healthcare toward improved patient outcomes and reduced total costs have resulted in intense competition for the development of medical devices that demonstrate superior product performance, reduced procedure times, improved outcomes and overall cost effectiveness. Medical device manufacturers have attempted to address these competitive pressures by developing innovative medical devices manufactured from a wide variety of synthetic materials, including many new, expensive and exotic materials. In an effort to further differentiate their products through improved product performance, a growing number of medical device manufacturers are turning to the emerging field of surface modification technology. Surface modification technology enables device manufacturers to provide medical devices with desired surface characteristics including improved lubricity, hemocompatability and infection resistance, as well as the ability to deliver drugs and promote cell growth and tissue integration.

Although it is an emerging field, surface modification technology has been used to improve medical devices in many different industry segments. The table below identifies several of these market segments and the surface properties the Company believes are desired by each segment.

Market Segment Served	Desired Surface Property and Examples of Applications
Interventional cardiology and vascular access	Lubricity: catheters, guide wires Hemocompatability: vascular stents, catheters, guide wires Therapeutic drug delivery and release: vascular stents, catheters Infection resistance: catheters, implantable ports
Cardiac rhythm management	Lubricity: pacemaker and defibrillator leads, electrophysiology devices Hemocompatability: electrophysiology devices
Cardiothoracic surgery	Infection resistance: heart valves Hemocompatability: minimally invasive bypass devices, vascular grafts, ventricular assist devices Cell growth and tissue integration: heart valves, vascular grafts
Interventional neurology and neurosurgery	Lubricity: catheters, guide wires Infection resistance: catheters, shunts
Urology and gynecology	Lubricity: urinary catheters, incontinence devices, ureteral stents, fertility devices Infection resistance: urinary catheters, incontinence devices, ureteral stents, fertility devices, penile implants
Orthopedics	Cell growth and tissue integration: bone regeneration

In addition to the above-identified market segments, the Company believes that one of the next areas of growth for surface modification technology will be the diagnostic test market. Diagnostic tests utilizing biomolecules, such as DNA, can be used to screen for new drugs, to sequence unknown portions of the human genome, or to search for signs of viruses. The Company believes manufacturers of these diagnostic tests may benefit from surface modification technology to provide biomolecule immobilization and wettability properties.

The PhotoLink Solution

PhotoLink is a versatile, easily applied, light-activated coating technology that modifies medical device surfaces by creating covalent bonds between those surfaces and a variety of chemical agents. The PhotoLink solution to surface modification involves the utilization of proprietary, light sensitive (photochemical) reagents. These reagents can consist of advanced polymers or active biomolecules having desired surface characteristics and an attached light-reactive chemical compound (photogroup). When the reagent is exposed to a direct light source, typically ultraviolet, a photochemical reaction creates a covalent bond between the photogroup and the surface of the medical device, thereby imparting the desired property to the surface. A covalent bond is a very strong chemical bond which results from the sharing of electrons between carbon molecules of the substrate and the applied coating.

SurModics' proprietary PhotoLink reagents work on most polymer-based (e.g., plastic) substrates, biological substrates (latex rubber, cellulose, tissue and natural fibers), and metal and glass substrates. Metal and glass substrates generally require pretreating with polymers to make a carbon-molecule available for bonding prior to the application of the PhotoLink reagents. The reagents are easily applied to a clean material surface by dipping, spraying, roll coating, ink jetting or brushing. SurModics continues to develop proprietary photochemical reagents providing new product features while expanding the number and type of substrates on which the reagents can be applied.

The Company believes that its proprietary PhotoLink process provides its licensees with a number of benefits.

- Flexibility. PhotoLink coatings can be applied to many different kinds of surfaces and can immobilize a variety of chemical, pharmaceutical and biological agents, which allows licensees to be innovative in the design of their products without significantly changing the dimensions or physical properties of the devise.

- Variety of Surface Properties. The PhotoLink process can be tailored to provide SurModics' licensees with the ability to improve the performance of their devices by choosing the specific coating properties desired for particular applications. The PhotoLink technology also provides the medical device manufacturer with the ability to combine multiple surface-enhancing characteristics on the same device.

- Ease of Use. The PhotoLink coating process is a relatively simple process that does not require expensive special equipment or the use of hazardous materials and does not subject the coated products to harsh chemical, pressure or temperature conditions. Further, PhotoLink coatings are compatible with all the generally accepted sterilization processes, so the surface attributes are not lost when the medical device is sterilized prior to usage.

Surface Properties

SurModics' PhotoLink process has been used by manufacturers of pacemaker leads, drug infusion catheters, laser and balloon angioplasty catheters, urinary drainage catheters, vascular closure devices, wound drains, guide wires, angiography catheters, ureteral stents and hydrocephalic shunts, among other devices. The PhotoLink process can be used to provide medical device manufacturers with the following surface properties to improve product performance:

- Lubricity. Low friction or lubricious coatings reduce the force and time required for insertion, navigation and removal of devices in vascular, neurological and urogenital applications. Lubricity also reduces tissue irritation and damage caused by products such as catheters, guide wires and endoscopy devices. Based on Company and licensee testing, when compared to uncoated surfaces, the PhotoLink process has reduced the friction on surfaces by as much as 85% to 95%, depending on the substrate being coated.

- Hemocompatibility. Hemocompatible coatings help reduce adverse reactions that may be created when a device is inserted into the body and comes in contact with blood. Heparin has been used for decades as an injectable drug to reduce blood clotting in patients. SurModics can immobilize heparin on the surface of blood-contacting medical devices thereby inhibiting blood clotting on the device surface, minimizing patient risk and enhancing the performance of the device. PhotoLink heparin coatings have been shown in Company and licensee testing to reduce blood clotting by greater than 90% compared to uncoated surfaces.

- Infection Resistance. Antimicrobial coatings are advantageous for most implantable medical devices where risk of infection is a concern. PhotoLink technology can apply passive coatings which significantly reduce bacterial adhesion to the device or active coatings incorporating antimicrobial agents which kill bacteria around the device. Testing by the Company has demonstrated that a PhotoLink coating can reduce the adherence of microorganisms to biomaterial surfaces by 97% to over 99% depending on the base material of the device. In addition, when compared to uncoated products, the PhotoLink process has been shown to increase the uptake of antimicrobial agents applied to the device just prior to implantation and prolong the release of these agents.

- Drug Delivery. PhotoLink technology can be used to create reservoirs to entrap drugs on the surface of medical devices. These drugs can then be released from the surface on a controlled basis by tailoring the polymers, by adjusting the extent of crosslinking, or by using a barrier coating to control diffusion. For example, SurModics has developed a PhotoLink coating that would allow a coronary stent manufacturer to incorporate a drug onto the stent directed at reducing the incidence of restenosis (the re-narrowing of the artery).

- Wettability. PhotoLink hydrophilic coatings have been shown in tests by the Company and its licensees to accelerate liquid flow rates on normally hydrophobic (water repelling) materials by 75%. Rapid point-of-care diagnostic tests, such as home monitoring or physician monitoring of glucose levels in diabetics, are currently done by pricking a patient's finger and carefully placing a drop of blood onto a polymer strip which is then inserted into a blood glucose reader. The Company believes that the time it takes for the blood to flow up the strip to provide the patient with a readout can be dramatically reduced and the consistency can be greatly improved with PhotoLink technology.

- Cell Growth, Tissue Integration and Other Tissue Engineering. Studies have shown that attachment of extracellular matrix proteins and peptides onto surfaces of implantable medical devices improves host cell attachment, growth and subsequent tissue integration. PhotoLink technology has been used to coat biomedical devices with photoreactive collagens and other proteins upon which cells normally grow within the body. Company studies have shown that biomedical devices (such as vascular grafts and ocular implants) coated with such proteins, have improved attachment, growth of cells and acceptance by surrounding tissues. In addition, the Company is also using its PhotoLink technology to produce three-dimensional scaffolds to promote bone regeneration.

- Biomolecule Immobilization. During a DNA gene analysis, typically hundreds of different probes need to be placed in a pattern on a surface, called a DNA array. These arrays can be used by the pharmaceutical industry to screen for new drugs, by genome mappers to sequence unknown portions of the human genome, or by diagnostic companies to search a patient sample for disease causing bacteria or viruses. However, DNA does not readily adhere to most surfaces that are important for DNA assays. The Company has demonstrated a versatile method for the immobilization of DNA on various surfaces.

Current Licensing Arrangements

The Company has commercialized its PhotoLink technology through licensing arrangements with medical device manufacturers who apply the PhotoLink coatings to their own products in their own facility. The Company believes this

approach allows it to focus its resources on further developing its technology and expanding its licensing activities, while leveraging the established manufacturing, sales and marketing capabilities of its licensees for the marketing of the specific medical device utilizing the PhotoLink technology. The Company's licensing agreements are designed to allow manufacturers to incorporate the PhotoLink process into their own manufacturing processes without the need to send product outside their facility.

The licensing process begins with the medical device manufacturer specifying the surface characteristics it desires. Because each surface is unique, the Company routinely conducts a feasibility study at no charge to the customer to qualify each new potential product application. Once the feasibility has been proven, the customer typically funds further development by SurModics to optimize the coating formulation to meet the customer's technical needs. A license agreement is then executed granting the licensee the rights to use the technology. SurModics' technical personnel are then available to provide services in the transfer of the PhotoLink technology into the licensee's manufacturing process. Such services can include further coating optimization, process control and trouble shooting which are billable to the licensee. The Company also manufactures and sells the chemical reagents used by all licensees in the PhotoLink process, thus creating another source of revenue.

The term of a license agreement is generally for a period of 15 years or the life of SurModics' patents, whichever is longer, although an agreement may be terminated for any reason upon prior written notice, typically required at least 90 days before termination. The worldwide license can be either exclusive or nonexclusive for a particular medical device, but over 75% of the Company's licensed applications are nonexclusive. SurModics requires the payment of a non-refundable license fee which has historically ranged from $25,000 to $750,000 and quarterly "earned" royalties of 2% to 6% on the sales of products incorporating SurModics' technology. The amount of license fees and the royalty rate are based on whether the arrangement is exclusive or nonexclusive, the perceived value of the PhotoLink application to the device and the size of the potential market. Certain nonrefundable license and research and development fees are recoverable by the licensees as offsets against a percentage of future earned royalties. Most of SurModics' agreements also incorporate a minimum royalty to be paid by the licensee while the medical devices are developed, tested and commercialized. In most cases, payment of these minimum royalties will not commence until several months after the execution of an agreement for a particular application.

Other Products

Stabilization Products

Although the primary focus of the Company is the development and marketing of its PhotoLink technology, the Company also develops and markets stabilization products for use by manufacturers of immunoassay diagnostic tests. SurModics' StabilCoat and StabilZyme Stabilizers are designed to maintain the activity of biological components of the immunoassays, resulting in a longer shelf-life. These products offer SurModics' customers the benefit of product differentiation and improvement while providing the ultimate end users the benefit of a faster test with fewer steps and fewer errors. In fiscal 1998, SurModics generated $2.0 million of revenue from its stabilization products.

Diagnostic Formats

The Company also licenses a format for in vitro diagnostic tests developed during the early years of the Company. This format has found broad application in the expanding area of rapid point-of-care diagnostic testing, such as pregnancy and strep tests, and generated $2.6 million of royalty revenue for the Company in fiscal 1998 pursuant to a license agreement with Abbott Laboratories. Although this revenue is expected to grow in the future with the increased sales of licensed products, limited additional SurModics-funded research and development is being undertaken in this area.

Industrial Applications

While it is not the Company's primary focus, the Company occasionally pursues industrial applications for its PhotoLink technology. The Company only pursues those applications that are perceived to be high value applications in a market that is not considered to be price sensitive. To date, revenue associated with industrial applications has been immaterial and is not expected to be significant in the foreseeable future.

Research and Development

SurModics' research and development department supports the sales and marketing staff in performing feasibility studies, providing technical assistance to potential licensees, optimizing the coating methodologies for specific licensee applications, assisting in training licensees and integrating the Company's technology and know-how into licensee manufacturing processes. In addition, the research and development department works to enhance and expand the PhotoLink technology through the development of new reagents and new applications.

As medical devices become more sophisticated and complex, the Company believes the need for optimized surface properties will grow. The Company intends to continue its development efforts to expand its PhotoLink technology to provide additional optimized surface properties to meet these needs. The Company's technical strategy is to target selected coating characteristics for further development, in order to facilitate and shorten the license cycle. The Company has begun to perform research into applications for future products both on its own and in conjunction with some of its licensees. Some of the research and development projects currently being worked on include coatings designed to improve the characteristics of long-term implants, site-specific drug release, orthopedic repair materials and devices, long-term blood compatibility and DNA immobilization methods. In addition to expanding the number of medical applications that may use PhotoLink technology, the Company intends to broaden the spectrum of surfaces on which reagents can be applied, improve the coating process for metals and glass, develop a process for coating the interior diameter of medical devices, expand the portfolio of PhotoLink reagents, and develop additional proprietary products in which PhotoLink reagents serve as the end product.

The technical staff of the Company consists of 59 employees, including ten with Ph.D. degrees, seven with Masters degrees and 36 with Bachelor degrees, with expertise in chemistry, biomedical engineering, biology, microbiology, cell biology and biochemistry. The technical staff is organized into five areas of specialization: hydrophilicity, microbiology, hemocompatibility, biochemistry and tissue engineering. In addition, a chemistry group supports the synthesis of new reagents needed by the other five groups.

In fiscal 1997 and 1998, the Company's research and development expenses were $3.6 million and $4.5 million, respectively. The Company's research and development efforts are often funded by commercial licensees and government agencies. Such research and development revenues were $2.0 million in both years.

Since its founding, the Company has actively participated in the federal government's Small Business Innovative Research ("SBIR") program to fund development efforts. Since 1979, 140 research contracts resulting in revenues of over $24.0 million have been awarded to SurModics, primarily under the SBIR program. Grant proposals are generally directed toward the commercial strategies of the Company. The Company retains commercial rights to discoveries and technologies resulting from the research and development efforts funded by these grants. Where possible, licensees' products or substrates are used when performing research under the grant; thus the results are often directly applicable to SurModics' licensees. Grant funding has also allowed SurModics to maintain a larger and more technologically diverse employee base than would otherwise be possible.

Patents and Proprietary Rights

The Company has taken steps intended to protect certain PhotoLink related inventions through a series of patents covering a variety of coating reagents and formulations, as well as particular medical device applications, based on or employing the Company's proprietary photoreactive chemistry. The patents related to the PhotoLink technology include 16 issued U.S. patents, ten pending U.S. patent applications, ten issued foreign patents, and 40 pending foreign patent applications. The Company generally files international patent applications in parallel with its U.S. applications. The Company generally files national or regional applications in Australia, Canada, Europe, Japan, and Mexico. In addition to the patents related to the PhotoLink technology, SurModics has five issued U.S. patents, two pending U.S. patent applications, 13 issued foreign patents and ten pending foreign patent applications related to its diagnostic technology. There can be no assurance that any of the pending patent applications will be allowed.

The Company also relies heavily upon trade secrets and unpatented proprietary technology. The Company seeks to maintain the confidentiality of such information by requiring employees, consultants and other parties to sign confidentiality agreements and by limiting access by parties outside the Company to such information. There can be no assurance, however, that these measures will prevent the unauthorized disclosure or use of this information or that others will not be able to independently develop such information. Additionally,

there can be no assurance that any agreements regarding confidentiality and non-disclosure will not be breached, or, in the event of any breach, that adequate remedies would be available to the Company.

Marketing and Sales

The Company markets its PhotoLink technology throughout the world using a direct sales force consisting of four licensing managers who focus on specific markets such as cardiology devices, diagnostic products and urology products. This specialization fosters an in-depth knowledge of the issues faced by SurModics' licensees within these markets such as technology changes, biomaterial changes and the regulatory environment.

Because the sales cycle can take several months from feasibility demonstration to the execution of a license agreement, the Company focuses its sales efforts on potential licensees with established market positions rather than those with only development stage products which may never come to market. Generally, the PhotoLink technology is licensed to medical device manufacturers for use on specific products. This strategy enables the Company to license the PhotoLink technology to multiple licensees in the same market. SurModics also targets selling new applications to existing licensees. The Company believes the sales cycle is much faster in these situations because the licensee is already familiar with the technology and the general terms of the license have already been negotiated.

As part of its marketing strategy, the Company publishes technical literature on each surface capability of the PhotoLink technology (i.e., lubricity, hemocompatibility, etc.). In addition, the Company participates at major trade shows and technical meetings, advertises in trade journals and through its website, and conducts direct mailings to appropriate target markets.

The Company also offers ongoing customer service and technical support throughout a licensee's relationship with SurModics. This service and support includes a coating feasibility study at no charge to the licensee as well as services in connection with the transfer of the technology to the licensee, which can include billable services such as further coating optimization, process control and trouble shooting. SurModics also generally assists the licensee at no charge with FDA submissions for coated product approval.

Competition

Competition in the medical device industry has resulted in an increase in competition in the surface modification market. The Company's PhotoLink technology competes with technologies developed by Carmeda (a division of Norsk Hydro, Inc.), Specialty Coatings Systems, Spire Corporation and STS Biopolymers Inc., among others. In addition, many medical device manufacturers have developed or are engaged in efforts to develop surface modification technologies for use on their own products. Most competitors marketing surface modification to the outside marketplace are divisions of organizations with businesses in addition to surface modification. Overall, the Company believes the worldwide market is very fragmented with no competitor marketing to third parties having more than a 10% market share. Many of the Company's existing and potential

competitors (including medical device manufacturers pursuing coating solutions through their own research and development efforts) have substantially greater financial, technical and marketing resources than the Company.

SurModics attempts to differentiate itself from its competition by providing what it believes is a high value-added solution to surface modification. The Company believes that the primary factors customers consider in choosing a particular surface modification technology are performance, ease of manufacturing, ability to produce multiple properties from a single process, compliance with manufacturing regulations, customer service and pricing. The Company believes that its PhotoLink process competes favorably with respect to these factors, enabling it to charge a premium price. The Company believes that the cost and time required to obtain the necessary regulatory approvals significantly reduces the likelihood of a manufacturer changing the coating process it uses once a device has been approved for marketing.

Because a significant portion of the Company's revenue is dependent on the receipt of royalties based on sales of medical devices incorporating PhotoLink coatings, the Company is also affected by competition within the markets for such devices. The Company believes that the intense competition within the medical device markets creates opportunities for the Company's coating technology as medical device manufacturers seek to differentiate their products through new enhancements or to remain competitive with enhancements offered by other manufacturers. Because the Company seeks to license its technology on a non-exclusive basis, the Company may further benefit from competition within the medical device markets by offering its PhotoLink technology to multiple competing manufacturers of a device. However, competition in the medical device markets could also have an adverse effect on the Company. While the Company seeks to license its products to established manufacturers, in certain cases the Company's licensees may compete directly with larger, dominant manufacturers with extensive product lines and greater sales, marketing and distribution capabilities. The Company also is unable to control other factors that may impact commercialization of PhotoLink-coated devices, such as the marketing and sales efforts of its licensees or competitive pricing pressures within the particular device market. There can be no assurance that products coated with the PhotoLink technology will be successfully commercialized by the Company's licensees or that such licensees will otherwise be able to effectively compete.

The primary competition for SurModics' stabilization products is its customers' internally developed formulations. The consolidation of the diagnostic industry increases the availability of internally developed stabilizers to the market. There are several direct competitors that have recently emerged, of which Pierce Medical Products, Inc. and Medix, Inc. are the two largest. The Company believes that quick market penetration is the best strategy for addressing these threats. As in the coating market, the Company also believes that once its stabilization products are accepted in an FDA-approved diagnostic test, the likelihood of change is reduced because of the cost and time required to qualify a new component. SurModics' marketing strategy for its stabilization products is to develop a strong market presence by offering superior product performance and technical service.

Manufacturing

In accordance with its licensing strategy, the Company does not perform the actual coating of its licensees' medical devices, nor does it manufacture any of these devices. The Company has, however, adopted a strategy of developing and manufacturing the reagents itself, allowing it to maintain the quality of the reagents and their proprietary nature, while providing an additional source of revenue. PhotoLink reagents are specialty photoreactive chemicals that are prepared using a proprietary formula in small batch processes (as contrasted with commodity chemicals prepared by large continuous methods). Generally, all PhotoLink reagents share a similar production process: a water soluble polymer is synthesized in a glass reactor; reactive photochemical groups are attached to the polymer; the solution is purified and freeze-dried, thus removing the water and creating a solid; and the PhotoLink reagents are packaged in standard quantities in light- and moisture-proof packaging. The reagents are sold dry, requiring the licensee, in most cases, to simply add water or a water and isopropyl alcohol mix before application. The Company has developed proprietary testing and quality assurance standards for manufacturing the reagents and does not disclose the reagent formulas or manufacturing methods. Although licensees may purchase the requisite chemical reagents from any source, all have elected to purchase them from the Company.

The Company also manufactures its stabilization products. These products are a group of sterile-filtered liquids that generally share a three-step production process. A standard recipe of chemicals is mixed in high purity water, these liquids are sterile-filtered into specific container sizes under aseptic conditions, and the resultant finished goods are packaged and labeled.

The Company maintains multiple sources of supply for the key raw materials used to manufacture reagents and stabilization products. The Company does, however, purchase some raw materials from single sources, but it believes that additional sources of supply are readily available.

Although not required to follow Good Manufacturing Practice quality procedures, SurModics does follow such procedures in part to respond to requests of licensees to establish compliance with their criteria. The Company has not yet sought ISO 9001 certification but may do so in the future.

Government Regulation

Although PhotoLink technology itself is not directly regulated by the FDA, the medical devices incorporating this technology are subject to FDA regulation. The burden of demonstrating safety and efficacy of such medical devices, the ultimate criteria applied by the FDA, rests with the Company's licensees (the medical device manufacturers). Medical products incorporating the PhotoLink technology may generally be marketed only after 510(k) or PMA applications have been submitted and approved by the FDA, which process can take anywhere from six months for a 510(k) application, to two or three years for a PMA application. These applications are prepared by the manufacturer and contain results of extensive laboratory toxicity, mutagenicity and clinical evaluations on animals and humans conducted by the manufacturer.

The Company maintains confidential Device Master Files at the FDA regarding the nature, chemical structure and biocompatibility of the PhotoLink reagents. Although the Company's licensees do not have access to these files, the licensees may, with the permission of the Company, reference these files in any medical device submission to the FDA. This process allows the FDA to understand in confidence the details of the PhotoLink technology without the Company having to share this highly confidential information with its licensees.

Recent U.S. legislation allows device manufacturers, prior to obtaining FDA approval to market a medical device in the U.S., to manufacture such medical device in the U.S. and export it for sale in international markets, which could allow SurModics to realize earned royalties sooner. However, sales of medical devices outside the U.S. are subject to international requirements that vary from country to country. The time required to obtain approval for sale internationally may be longer or shorter than that required by the FDA.

Employees

As of December 1, 1998, SurModics had 93 full-time and 5 part-time employees of whom 58 were engaged in development or manufacturing positions, with the remainder in marketing, quality or administrative positions. Of SurModics' employees, 9 hold Ph.D. degrees and 14 hold Masters degrees. The Company is not a party to any collective bargaining agreements and believes that its employee relations are good.

Management believes that the future success of the Company will depend in part on its ability to attract and retain qualified technical, management and marketing personnel. Such experienced personnel are in high demand, and the Company must compete for their services with other firms which may be able to offer more favorable benefits.

ITEM 2. DESCRIPTION OF PROPERTY

SurModics leases approximately 35,000 square feet of office/warehouse space in Eden Prairie, Minnesota under a lease that expires at the end of calendar year 1999. SurModics has an option to extend this lease through the end of 2001. The lease commitment for fiscal 1998 is approximately $210,000. Of the total leased space, approximately 15,000 square feet is office space, 13,000 square feet is laboratory space and 7,000 square feet is manufacturing space. Approximately 6,000 square feet of the manufacturing space is a HEPA-filtered, highly controlled environment, but not certified as a "clean room" under FDA standards. The Company believes that projected capacity of the manufacturing area is adequate to service the needs of its licensees for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

The Company is not a party to nor is any of its property subject to any material pending legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter of fiscal 1998.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

(a) Use of Proceeds for the period ending September 30, 1998.

(1)	Effective Date:	March 3, 1998
	SEC File Number:	333-43217
(2)	Offering Date:	March 3, 1998
(4)(i)	The offering has terminated; all securities registered were sold.	
(4)(ii)	Managing Underwriter:	John G. Kinnard and Company, Incorporated
(4)(iii)	Title of Securities:	Common Stock
(4)(iv)	Amount Registered:	2,300,000
	Aggregate Offering Price:	$17,250,000
	Amount Sold:	2,300,000
	Aggregate Offering Price Sold:	$17,250,000
(4)(v)	Underwriting Discounts and Commissions	$ 1,293,750
	Other Expenses, $435,148; Total Expenses	$ 1,728,898
All the above items represented direct or indirect payments to others.		
(4)(vi)	Net Offering Proceeds	$15,521,102
(4)(vii)	Use of Net Offering Proceeds:	
	Research and development	$ 151,077
	Sales and marketing	$ 238,204
	Equipment upgrades	$ 391,992
	Patent protection	$ 0
	Working capital and general corporate purposes	$ 268,131
	Money market funds	$14,471,698
All the above items represented direct or indirect payments to others.		

(b) The information required by Item 5 relating to the Company's Common Stock and other shareholder matters is incorporated herein by reference to the section entitled "Stock Listing and Price History" which appears in the Company's 1998 Annual Report to Shareholders.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

The Section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the 1998 Annual Report to Shareholders is incorporated herein by reference.

ITEM 7. FINANCIAL STATEMENTS

The balance sheets as of September 30, 1998 and 1997 and the statements of operations, stockholders' equity and cash flows for each of the three years in the period ended September 30, 1998 together with the Report of Independent Public Accountants contained on pages 13 through 22 of the Company's Annual Report to Shareholders for the year ended September 30, 1998 are incorporated herein by reference.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT

The names, ages and positions of the Company's executive officers are as follows:

Name	Age	Position
Dale R. Olseth	68	Chairman and Chief Executive Officer
James C. Powell	49	President and Chief Operating Officer
Stephen C. Hathaway	43	Vice President and Chief Financial Officer
Patrick E. Guire, Ph.D.	62	Senior Vice President of Research and Chief Scientific Officer
Andrew B. Summerville	53	Vice President of Sales and Marketing
Walter H. Diers, Jr.	47	Vice President of Corporate Development
Marie J. Versen	37	Vice President of Quality Management and Regulatory Compliance

Dale R. Olseth joined the Company in 1986 as its President, Chief Executive Officer and a director of the Company and has served as Chairman of the Board since 1988. Mr. Olseth also serves on the Board of Directors of The Toro Company and Graco, Inc. He served as Chairman or President and Chief Executive Officer of Medtronic, Inc. from 1976 to 1986. From 1971 to 1976, Mr. Olseth served as President and Chief Executive Officer of Tonka Corporation. Mr. Olseth received a B.B.A. degree from the University of Minnesota in 1952 and an M.B.A. degree from Dartmouth College in 1956.

James C. Powell joined the Company in 1987. He became Vice President of Technical Operations in 1992 and was elected President and Chief Operating Officer in 1998. He was employed at Precision-Cosmet Company, Inc., a manufacturer of contact and intraocular lenses, from 1978 until he joined SurModics. Mr. Powell received a B.S. degree in wood sciences from Texas A&M University in 1972 and an M.S. degree in polymer science in 1975 from the University of Washington.

Stephen C. Hathaway joined the Company as its Vice President and Chief Financial Officer in September 1996. Prior to joining SurModics, he served as Director of Finance for Ceridian Employer Services, Ceridian Corporation from 1995 to 1996. Prior to that, Mr. Hathaway was Vice President - Finance & Operations for Wilson Learning Corporation from 1988 to 1995. He also spent ten years with Arthur Andersen LLP. Mr. Hathaway received a B.S. degree in accounting in 1977 from Miami University and became a Certified Public Accountant in 1980.

Patrick E. Guire, Ph.D. is a co-founder of the Company and has served as Senior Vice President of Research and Chief Scientific Officer and a director since 1980. Dr. Guire is responsible for the research affairs of the Company. Prior to founding SurModics, Dr. Guire was employed by Kallestad Laboratories, Inc. as a senior scientist from 1978 to 1979 and was a researcher at the Midwest Research Institute, Inc. in Kansas City, Missouri from 1972 to 1978. He received a B.S. degree in Chemistry from the University of Arkansas, Fayetteville in 1958 and a Ph.D. in biochemistry from the University of Illinois in 1963.

Andrew B. Summerville joined the Company in 1994, and in 1995 became its Vice President of Marketing. He held various sales and marketing positions with Graco, Inc. from 1986 until joining SurModics. Prior to that, Mr. Summerville held similar positions with 3M Company. Mr. Summerville received a B.A. degree in applied science and a B.S. degree in material science from Lehigh University in 1968 and an M.B.A. degree from Dartmouth College in 1970.

Walter H. Diers, Jr. joined the Company in 1988 and currently serves as Vice President of Corporate Development. He served as a consultant to several small, high technology companies from 1984 until he joined SurModics. Prior to that, he was the Controller of the Laserdyne division of Data Card Corporation. Mr. Diers received a B.S. degree in economics and a B.S. degree in business in 1977 and an M.B.A. degree in finance in 1979 from the University of Minnesota.

Marie J. Versen joined the Company in 1987, and in 1996 became its Vice President of Quality Management and Regulatory Compliance. She was previously employed at Precision-Cosmet Company, Inc. from 1983 to 1986. Ms. Versen received a B.S. degree in chemical engineering from the University of Minnesota in 1983.

The executive officers of the Company are elected by and serve at the discretion of the Board of Directors.

The information required by Item 9 relating to directors and compliance with Section 16(a) is incorporated herein by reference to the sections entitled "Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance" which appear in the Company's definitive proxy statement for its 1999 Annual Meeting of Shareholders.

ITEM 10. EXECUTIVE COMPENSATION

The information required by Item 10 is incorporated herein by reference to the section entitled "Executive Compensation" which appears in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by Item 11 is incorporated herein by reference to the section entitled "Shareholdings of Principal Shareholders and Management" which appears in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by Item 12 is incorporated herein by reference to the section entitled "Certain Transactions" in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits. See "Exhibit Index" on the page following signatures.

(b) Reports on Form 8-K. No reports on Form 8-K were filed during the fourth quarter ended September 30, 1998.

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Registrant has caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

SURMODICS, INC.
("Registrant")

Dated: December 22, 1998

By: /s/ Dale R. Olseth
Dale R. Olseth
Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed by the following persons on behalf of the Registrant, in the capacities, and on the dates, indicated.

(Power of Attorney)

Each person whose signature appears below constitutes and appoints DALE R. OLSETH and STEPHEN C. HATHAWAY as his true and lawful attorneys-in-fact and agents, each acting alone, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any or all amendments to this Annual Report on Form 10-KSB and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, each acting alone, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all said attorneys-in-fact and agents, each acting alone, or his substitute or substitutes, may lawfully do or cause to be done by virtue thereof.

Signature	Title	Date
/s/ Dale R. Olseth Dale R. Olseth	Chairman, Chief Executive Officer and Director (Chief Executive Officer)	December 22, 1998
/s/ Stephen C. Hathaway Stephen C. Hathaway	Vice President and Chief Financial Officer (Chief Financial and Accounting Officer)	December 22, 1998
/s/ Donald S. Fredrickson Donald S. Fredrickson, M.D.	Director	December 22, 1998
/s/ James J. Grierson James J. Grierson	Director	December 23, 1998
/s/ Patrick E. Guire Patrick E. Guire	Director	December 22, 1998
/s/ Kenneth H. Keller Kenneth H. Keller	Director	December 23, 1998
/s/ David A. Koch David A. Koch	Director	December 22, 1998
/s/ Kendrick B. Melrose Kendrick B. Melrose	Director	December 22, 1998

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

EXHIBIT INDEX TO FORM 10-KSB

For the Fiscal Year Ended September 30, 1998

SURMODICS, INC.

Exhibit	
3.1	Restated Articles of Incorporation, as amended--incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-QSB for the quarter ended March 31, 1998, SEC. File No. 0-23837
3.2	Restated Bylaws--incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.1	Lease Agreement, dated November 18, 1991, relating to manufacturing and office space located at 9924 West 74th Street, Eden Prairie, Minnesota--incorporated by reference to Exhibit 10.1 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.2*	Company's Incentive 1987 Stock Option Plan, including specimen of Incentive Stock Option Agreement--incorporated by reference to Exhibit 10.2 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.3*	Company's Incentive 1997 Stock Option Plan, including specimen of Incentive Stock Option Agreement--incorporated by reference to Exhibit 10.3 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.4*	Form of Restricted Stock Agreement--incorporated by reference to Exhibit 10.4 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.5*	Form of Non-qualified Stock Option Agreement--incorporated by reference to Exhibit 10.5 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.6	Form of License Agreement--incorporated by reference to Exhibit 10.6 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.7	License Agreement with Abbott Laboratories dated November 20, 1990, as amended--incorporated by reference to Exhibit 10.7 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217

10.8 Form of Promissory Note from Walter H. Diers Jr. and James C. Powell--incorporated by reference to Exhibit 10.8 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217

13 Portions of Annual Report to Shareholders for the fiscal year ended September 30, 1998 incorporated by reference in this Form 10-KSB

23 Consent of Arthur Andersen LLP

24 Power of Attorney (included on signature page of this Form 10-KSB).

27 Financial Data Schedule

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*Management contract or compensatory plan or arrangement

SURMODICS, INC

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

SurModics is a leading provider of surface modification solutions to medical device manufacturers. The Company's revenues are derived from four primary sources: fees from licensing its patented technology to customers; royalties received from licensees; the sale of photoreactive chemical compounds to licensees and stabilization products to the diagnostics industry; and research and development fees generated on projects for commercial customers and government grants. In March 1998, the Company completed an initial public offering ("IPO") of 2.3 million shares of Common Stock which generated proceeds of approximately $15.5 million, net of related offering costs.

Fiscal 1998 showed further evidence that SurModics' unique economic model, based on the licensing of PhotoLink technology to the medical device industry, can significantly impact the Company's financial performance. Revenues increased 29.0% to $9.8 million in fiscal 1998 from $7.6 million in fiscal 1997. The financial results were led by growth in royalty revenues, which increased 64.2% over the prior year to a record $4.8 million. The Company is continuing to see significant increases in the usage of PhotoLink. PhotoLink royalties increased 52.3% to $2.2 million, and sales of reagents, those chemicals used by clients in the PhotoLink coating process, increased 60.7% to almost $800,000 in fiscal 1998. Diagnostic royalties also showed an increase of 76.0% to almost $2.6 million. These revenue gains led to net income of $1.6 million, or $.24 per diluted share, compared to $0.2 million, or $.04 per diluted share, in fiscal 1997.

RESULTS OF OPERATIONS

YEARS ENDED SEPTEMBER 30, 1998 AND 1997

REVENUES. The Company's revenues were $9.8 million in fiscal 1998, an increase of 29.0% over fiscal 1997. The revenue components were as follows:

(DOLLARS IN THOUSANDS)	FISCAL 1998	FISCAL 1997	INCREASE (DECREASE)	% INCREASE (DECREASE)
Royalties:				
Diagnostic	$2,578	$1,465	$1,113	76.0%
PhotoLink	2,205	1,448	757	52.3%
Total royalties	4,783	2,913	1,870	64.2%
License fees	222	540	(318)	(58.9%)
Product sales:				
Reagents	794	494	300	60.7%
Stabilization	2,004	1,665	339	20.4%
Total product sales	2,798	2,159	639	29.6%
Research and development:				
Commercial	891	742	149	20.1%
Government	1,085	1,228	(143)	(11.6%)
Total research and development	1,976	1,970	6	0.3%
Total revenues	$9,779	$7,582	$2,197	29.0%

The fiscal 1998 revenue increase was primarily due to an increase in royalties received from licensed clients. The 76.0% increase in diagnostic royalties was due primarily to the impact of two events in fiscal 1998: a product acquisition by a licensee and the issuance of a new patent to SurModics, both of which resulted in more of the licensee's sales being subject to royalties. While these two events will continue to impact royalties into the future, the most significant portion of the increase has already occurred; therefore, diagnostic royalties are expected to produce more modest growth in fiscal 1999. The 52.3% growth in PhotoLink royalties was due to increases in the minimum royalty payments from certain clients, the introduction of ten additional licensed products by the Company's clients, and increased earned royalties from greater market penetration of coated products sold by licensees.

The Company's product sales increased 29.6%, to $2.8 million. The 20.4% increase in stabilization sales was the result of greater market penetration due to the Company's sales and marketing efforts. The sales of reagent chemicals, those chemicals used by licensees in the PhotoLink coating process, increased 60.7%, which indicates growing production of PhotoLink-coated devices by SurModics' clients. This increase should result in royalty growth in the future as these coated products are sold by the Company's clients. Commercial research and development revenue increased 20.1% between years due to more customer-funded development projects related to PhotoLink coatings. Half of this revenue was generated on projects for a single customer. Finally, license revenue decreased due to the completion of fewer new license agreements in fiscal 1998. Only three new license agreements were signed during the year. The Company ended fiscal 1998 with a strong pipeline of new potential license agreements and it expects to improve on the number of agreements executed in fiscal 1999.

PRODUCT COSTS. The Company's product costs were $1.2 million for fiscal 1998, a decrease of $238,000, or 16.7%, from fiscal 1997. Overall product margins increased to 57.3% in fiscal 1998 from 33.7% in fiscal 1997. The margin improvements were due to various manufacturing efficiencies achieved during the year as a result of increased production volumes. The most significant factors were: the transfer of stabilization production to a new manufacturing space

which increased efficiency; a change to a less costly raw material formulation for the production of some stabilization products; and the increased market demand for some of the Company's products that allowed the Company to establish separate teams for stabilization and reagent production.

RESEARCH AND DEVELOPMENT EXPENSE. Research and development expense was $4.5 million for fiscal 1998, an increase of $925,000, or 25.7%, over fiscal 1997. Most of this increase was due to the added compensation, benefit, and general business expenses associated with the additional technical personnel hired by the Company during the year. In addition, the Company incurred additional depreciation expense associated with the build-out of additional laboratory space. These cost increases were offset by a reduction in the amount of research performed at external laboratories on government grants.

SALES AND MARKETING EXPENSE. Sales and marketing expense was $1.4 million for fiscal 1998, an increase of $321,000, or 29.2%, over fiscal 1997. This increase was primarily due to the additional compensation, benefit, and travel expenses associated with additional sales and marketing personnel hired during the year and the cost of an external market study performed during the year on potential genomics product applications.

GENERAL AND ADMINISTRATIVE EXPENSE. General and administrative expense was $1.7 million for fiscal 1998, an increase of $279,000, or 19.7%, over fiscal 1997. The increase was primarily due to the cost of a new directors' and officers' liability insurance policy that was entered into at the time of the IPO; new expenses associated with being a public company, such as investor relations costs, Nasdaq fees, and other external reporting expenses; and additional expenses associated with certain consulting projects.

OTHER INCOME (EXPENSE), NET. The Company's net other income was $726,000 for fiscal 1998, an increase of $517,000, or 246.9%, over fiscal 1997. The increase in interest income was due to the earnings generated on the additional investments resulting from the $15.5 million of proceeds received from the IPO in March.

YEARS ENDED SEPTEMBER 30, 1997 AND 1996

Revenues. The Company's revenues were $7.6 million in fiscal 1997, an increase of 22.6% over fiscal 1996. The revenue components were as follows:

(DOLLARS IN THOUSANDS)	FISCAL 1997	FISCAL 1996	INCREASE (DECREASE)	% INCREASE (DECREASE)
Royalties:				
Diagnostic	$1,465	$1,288	$ 177	13.7%
PhotoLink	1,448	1,052	396	37.6%
Total royalties	2,913	2,340	573	24.5%
License fees	540	383	157	41.1%
Product sales:				
Reagents	494	358	136	38.0%
Stabilization	1,665	1,283	382	29.8%
Total product sales	2,159	1,641	518	31.6%
Research and development:				
Commercial	742	526	216	41.0%
Government	1,228	1,293	(65)	(5.0%)
Total research and development	1,970	1,819	151	8.3%
Total revenues	$7,582	$6,183	$1,399	22.6%

The revenue increase in fiscal 1997 was primarily due to increases in all PhotoLink-related revenue sources: PhotoLink royalties increased 37.6%, license fees increased 41.1%, reagent sales increased 38.0% and commercial research and development increased 41.0% between years. The growth in PhotoLink royalties was primarily due to increases in the minimum royalty payments from certain clients and increased earned royalties from greater market penetration of coated products sold by licensees. The increase in reagent chemical sales was due to growing production of PhotoLink-coated devices by SurModics' clients. The increase in commercial development revenue was due to more customer-funded development projects related to PhotoLink coatings. Finally, the increase in license revenue was due to ten new license agreements being signed in fiscal 1997 compared to five in fiscal 1996.

The 29.8% increase in stabilization sales was the result of greater market penetration due to the Company's sales and marketing efforts.

PRODUCT COSTS. The Company's product costs were $1.4 million in fiscal 1997, an increase of $217,000, or 17.9%, over fiscal 1996. Overall product margins increased to 33.7% in fiscal 1997 from 26.0% in fiscal 1996. The margin improvement was primarily due to manufacturing efficiencies achieved in producing reagent chemicals due to the increased demand.

RESEARCH AND DEVELOPMENT EXPENSE. Research and development expense was $3.6 million in fiscal 1997, an increase of $280,000, or 8.5%, over fiscal 1996. Most

of this increase was due to increased patent-related costs, additional research studies at external laboratories and the additional compensation and benefit costs associated with the additional technical personnel hired by the Company during the year.

SALES AND MARKETING EXPENSE. Sales and marketing expense was $1.1 million in fiscal 1997, an increase of $186,000, or 20.5%, over fiscal 1996. This was primarily due to the additional compensation, benefit, and travel expenses associated with additional sales and marketing personnel hired during the year and increased customer activities, which resulted in more travel and promotional spending.

GENERAL AND ADMINISTRATIVE EXPENSE. General and administrative expense was $1.4 million in fiscal 1997, an increase of $263,000, or 22.8%, over fiscal 1996. The increase was primarily due to the expenses associated with a new incentive compensation program.

OTHER INCOME (EXPENSE), NET. The Company's net other income was $198,000 in fiscal 1997, a decrease of $23,000, or 10.2% over fiscal 1996. This decrease was due primarily to a reduced level of interest income from investments.

NET OPERATING LOSS CARRYFORWARDS

As of September 30, 1998, the Company had a net operating loss carryforward of approximately $4.7 million, which expires in varying amounts through 2011. The Company also had $490,000 of capital loss carryforwards at September 30, 1998, which expire in 2001. A valuation allowance for the full amount of the deferred tax asset has been established due to the uncertainty of realization.

YEAR 2000 COMPLIANCE

The Company has evaluated its information technology infrastructure for Year 2000 compliance. The Company does not utilize any mainframe technology, but instead has an internal technical infrastructure comprised of client server networks and desktop microcomputers. The applications which run on these computers are primarily purchased software without any significant customized programming. Over the last two years, the Company has routinely upgraded most of its computer hardware, software and telecommunications systems. As a result of its internal reviews,

the Company does not anticipate any problems related to Year 2000 compliance with its information technology infrastructure.

The Company is in the process of evaluating its non-information technology systems with regard to Year 2000 compliance. This is especially important related to embedded technology such as microcontrollers contained in various lab equipment, and raw material suppliers who support the Company's manufacturing process. Based upon information currently available, the Company does not anticipate any material disruption in its operations as a result of any failure by either non-information technology equipment or one of its suppliers to be in compliance. Compliance should not be an issue with the Company's products, since they are not date-sensitive.

Costs associated with Year 2000 compliance are expensed as incurred. To date, those costs have not been material. Based upon currently available information, the Company does not expect that the costs of addressing potential Year 2000 problems will have a material impact on the Company's financial condition or results of operations. The Company plans to devote the necessary resources to resolve any significant Year 2000 issues by no later than the end of fiscal year 1999.

Although the Company is committed to addressing any issues well in advance of the Year 2000, there are risks if the Company's objectives are not met. The most severe risk is business interruption. Specific examples of situations that could cause business interruption include, among others, (i) computer hardware or application software processing errors or failures; (ii) failure of lab or manufacturing equipment; and (iii) outside suppliers who may not be Year 2000 compliant. Depending on the extent and duration of the business interruption resulting from non-compliant Year 2000 systems, such interruption could have a material adverse effect on the Company's financial condition and results of operations.

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 1998, the Company had working capital of approximately $5.1 million and cash, cash equivalents and investments totaling approximately $21.1 million. The Company has generated positive cash flows from operating activities of approximately $2.1 million in fiscal 1998, $0.5 million in fiscal 1997 and $0.4 million in fiscal 1996. The increase in fiscal 1998 was primarily due to the increased net income generated during the year. The significant increase in investing activities during fiscal 1998 was due to the repositioning of the public offering proceeds within an investment portfolio managed by an external investment manager. The Company's investments principally consist of U.S. government obligations and investment grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are three years or less. In addition, there was an increase in the Company's purchase of property and equipment in fiscal 1998 due to the build-out of some additional manufacturing and laboratory space and the purchase of additional equipment with a portion of the proceeds from the offering. The most significant financing activity over the last three years was the completion of the initial public offering of 2.3 million shares of Common Stock in March 1998. In total, the IPO generated net proceeds to the Company of approximately $15.5 million after deducting all offering expenses.

As of September 30, 1998, the Company had no debt, nor did it have any credit agreements. The Company believes that its existing capital resources will be adequate to fund the Company's operations into the foreseeable future.

FORWARD-LOOKING STATEMENTS

Certain statements contained in this Annual Report and other written and oral statements made from time to time by the Company do not relate strictly to historical or current facts. As such, they are considered "forward-looking statements" which provide current expectations or forecasts of future events. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Reform Act of 1995. Such statements can be identified by the use of terminology such as "anticipate," "believe," "estimate," "expect," "intend," "may," "could," "possible," "plan," "project," "will," "forecast" and similar words or expressions. The Company's forward-looking statements generally relate to its growth strategy, financial results, product development programs, sales efforts, and Year 2000 compliance. One must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions. Consequently, no forward-looking statement can be guaranteed and actual results may vary materially. The Company undertakes no obligation to update any forward-looking statement.

Although it is not possible to create a comprehensive list of all factors that may cause actual results to differ from the Company's forward-looking statements, such factors include, among others, (i) the trend of consolidation in the medical device industry, resulting in more significant, complex and long-term contracts than in the past and potentially greater pricing pressures; (ii) the Company's ability to attract new licensees and to enter into agreements for additional product applications with existing licensees, and the willingness of potential customers to sign license agreements under the terms offered by the Company; (iii) the success of existing licensees in selling products incorporating SurModics' technology and the timing of new product introductions by licensees; (iv) the difficulties and uncertainties associated with the lengthy and costly new product development and foreign and domestic regulatory approval processes, such as delays, difficulties or failures in achieving acceptable clinical results or obtaining foreign or FDA marketing clearances, which may result in lost market opportunities or postpone or preclude product commercialization by licensees; (v) efficacy or safety concerns with respect to products marketed by SurModics and its licensees, whether scientifically justified or not, that may lead to product recalls, withdrawals or declining sales; (vi) the development of new products or technologies by competitors, technological obsolescence and other changes in competitive factors; (vii) the Company's ability to successfully respond to Year 2000 issues, which depends, in part, on the availability of personnel, the Company's ability to identify and resolve issues, both foreseen and unforeseen, and the readiness of third parties to resolve their issues; and (viii) economic factors over which the Company has no control, including changes in inflation and consumer confidence. Investors

are advised to consult any further disclosures by the Company on this subject in its filings with the Securities and Exchange Commission.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To SurModics, Inc.:

We have audited the accompanying balance sheets of SurModics, Inc. (a Minnesota corporation) as of September 30, 1998 and 1997, and the related statements of operations, stockholders' equity and cash flows for each of the three years in the period ended September 30, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SurModics, Inc. as of September 30, 1998 and 1997, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 1998, in conformity with generally accepted accounting principles.

/s/ ARTHUR ANDERSEN LLP

Minneapolis, Minnesota,
November 4, 1998

REPORT OF MANAGEMENT

The management of SurModics, Inc. is responsible for the integrity of the financial statements and other financial information contained in this annual report. The financial statements and related information were prepared in accordance with generally accepted accounting principles and include some amounts that are based on management's best estimates and judgments.

To meet its responsibility, management depends on its accounting systems and related internal accounting controls. These systems are designed to provide reasonable assurance, at an appropriate cost, that financial records are reliable for use in preparing financial statements and that assets are safeguarded. Qualified personnel throughout the organization maintain and monitor these internal accounting controls on an ongoing basis.

The Company's financial statements have been audited by Arthur Andersen LLP, independent public accountants, whose report thereon was based on audits conducted in accordance with generally accepted auditing standards. As part of their audits, the independent public accountants consider the Company's system of internal accounting controls for the purpose of determining the nature, scope and timing of audit tests to be performed.

The Audit Committee of the Board of Directors, composed entirely of directors who are not employees of the Company, has met with the Company's independent public accountants, as well as management, to review accounting, auditing, internal control, financial reporting and other matters.

/s/ Dale R. Olseth
Chairman and Chief Executive Officer

/s/ Stephen C. Hathaway
Vice President and Chief Financial Officer

SURMODICS, INC
BALANCE SHEETS

AS OF SEPTEMBER 30	1998	1997
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 1,343,561	$ 491,624
Short-term investments	3,526,493	1,455,976
Accounts receivable, net of allowance of $35,000 and $29,000	1,056,710	922,466
Inventories, net	379,946	264,008
Prepaids and other	255,456	74,124
Total current assets	6,562,166	3,208,198
PROPERTY AND EQUIPMENT		
Laboratory fixtures and equipment	2,313,236	2,027,940
Office furniture and equipment	1,002,210	834,222
Leasehold improvements	1,323,387	1,049,802
Less-Accumulated depreciation and amortization	(3,399,285)	(2,846,954)
Property and equipment, net	1,239,548	1,065,010
LONG-TERM INVESTMENTS	16,248,914	1,874,118
OTHER ASSETS, NET	254,361	302,930
	$ 24,304,989	$ 6,450,256
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 304,706	$ 280,467
Accrued liabilities --		
Compensation	615,264	400,861
Other	334,904	91,807
Deferred revenues	227,725	308,143
Total current liabilities	1,482,599	1,081,278
DEFERRED REVENUES AND OTHER, LESS CURRENT PORTION	124,231	266,973
Total liabilities	1,606,830	1,348,251
COMMITMENTS AND CONTINGENCIES (NOTE 6)		
STOCKHOLDERS' EQUITY		
Series AConvertible Preferred Stock-$.05 par value; none and 376,828 shares issued and outstanding	--	18,841
Common Stock-$.05 par value, 15,000,000 shares authorized; 7,214,085 and 3,400,868 shares issued and outstanding	360,704	170,044
Additional paid-in capital	28,934,732	13,491,665
Unearned compensation	(170,335)	(259,000)
Stock purchase notes receivable	(182,273)	(160,000)
Unrealized gain on investments	278,244	--
Accumulated deficit	(6,522,913)	(8,159,545)
Total stockholders' equity	22,698,159	5,102,005
	$ 24,304,989	$ 6,450,256

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE BALANCE SHEETS.

SURMODICS, INC.
STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED SEPTEMBER 30	1998	1997	1996
REVENUES			
Royalties	$ 4,782,626	$ 2,913,119	$ 2,340,187
License fees	222,500	540,000	382,500
Product sales	2,797,647	2,158,572	1,641,226
Research and development	1,975,888	1,970,174	1,818,739
Total revenues	9,778,661	7,581,865	6,182,652
OPERATING COSTS AND EXPENSES			
Product	1,193,178	1,431,675	1,214,526
Research and development	4,521,689	3,597,061	3,316,767
Sales and marketing	1,419,028	1,098,316	911,622
General and administrative	1,696,741	1,417,524	1,154,412
Total operating costs and expenses	8,830,636	7,544,576	6,597,327
INCOME (LOSS) FROM OPERATIONS	948,025	37,289	(414,675)
OTHER INCOME (EXPENSE)			
Investment income and other, net	698,193	209,204	275,849
Gain (loss) on sale of investments	27,634	--	(54,901)
Other income, net	725,827	209,204	220,948
NET INCOME (LOSS) BEFORE INCOME TAXES	1,673,852	246,493	(193,727)
PROVISION FOR INCOME TAXES	37,220	10,820	--
NET INCOME (LOSS)	$ 1,636,632	$ 235,673	$ (193,727)
NET INCOME (LOSS) PER SHARE			
Basic	$ .26	$ .05	$ (.04)
Diluted	$ .24	$ .04	$ (.04)
WEIGHTED AVERAGE SHARES OUTSTANDING			
Basic	6,224,362	4,853,558	4,775,598
Dilutive effect of outstanding stock options	574,271	531,780	--
Diluted	6,798,633	5,385,338	4,775,598

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.

SURMODICS, INC
STATEMENTS OF STOCKHOLDERS' EQUITY

FOR THE YEARS ENDED SEPTEMBER 30, 1998, 1997 AND 1996

	CONVERTIBLE PREFERRED STOCK		COMMON STOCK	
	SHARES	AMOUNT	SHARES	AMOUNT
BALANCE, SEPTEMBER 30, 1995	376,828	$ 18,841	3,218,420	$ 160,920
Common stock options exercised	--	--	71,628	3,584
Conversion of nonvoting common stock to common stock	--	--	26,232	1,312
Restricted stock canceled	--	--	(4,800)	(240)
Amortization of unearned compensation	--	--	--	--
Unrealized loss on investments	--	--	--	--
Realized loss on investments	--	--	--	--
Net loss	--	--	--	--
BALANCE, SEPTEMBER 30, 1996	376,828	18,841	3,311,480	165,576
Common stock options exercised	--	--	45,388	2,268
Restricted stock granted	--	--	44,000	2,200
Amortization of unearned compensation	--	--	--	--
Net income	--	--	--	--
BALANCE, SEPTEMBER 30, 1997	376,828	18,841	3,400,868	170,044
Common stock options exercised	--	--	25,905	1,296
Conversion of preferred stock to common stock	(376,828)	(18,841)	1,507,312	75,364
Issuance of common stock	--	--	2,300,000	115,000
Restricted stock canceled	--	--	(20,000)	(1,000)
Restricted stock extension	--	--	--	--
Net loan activity	--	--	--	--
Amortization of unearned compensation	--	--	--	--
Unrealized gain on investments	--	--	--	--
Net income	--	--	--	--
BALANCE, SEPTEMBER 30, 1998	--	$ --	7,214,085	$ 360,704

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.

NONVOTING COMMON STOCK							
SHARES	AMOUNT	ADDITIONAL PAID-IN CAPITAL	UNEARNED COMPENSATION	STOCK PURCHASE NOTES RECEIVABLE	UNREALIZED INVESTMENT GAIN (LOSS)	ACCUMULATED DEFICIT	TOTAL STOCKHOLDERS' EQUITY
26,232	$ 1,312	$ 12,898,473	$ (221,120)	$ --	$ --	$ (8,201,491)	$ 4,656,935
--	--	214,448	--	--	--	--	218,032
(26,232)	(1,312)	--	--	--	--	--	--
--	--	(18,960)	3,840	--	--	--	(15,360)
--	--	--	74,560	--	--	--	74,560
--	--	--	--	--	(54,901)	--	(54,901)
--	--	--	--	--	54,901	--	54,901
--	--	--	--	--	--	(193,727)	(193,727)
--	--	13,093,961	(142,720)	--	--	(8,395,218)	4,740,440
--	--	179,904	--	(160,000)	--	--	22,172
--	--	217,800	(220,000)	--	--	--	--
--	--	--	103,720	--	--	--	103,720
--	--	--	--	--	--	235,673	235,673
--	--	13,491,665	(259,000)	(160,000)	--	(8,159,545)	5,102,005
--	--	111,988	--	--	--	--	113,284
--	--	(56,523)	--	--	--	--	--
--	--	15,406,102	--	--	--	--	15,521,102
--	--	(34,500)	35,500	--	--	--	--
--	--	16,000	(16,000)	--	--	--	--
--	--	--	--	(22,273)	--	--	(22,273)
--	--	--	69,165	--	--	--	69,165
--	--	--	--	--	278,244	--	278,244
--	--	--	--	--	--	1,636,632	1,636,632
--	$ --	$ 28,934,732	$ (170,335)	$ (182,273)	$ 278,244	$ (6,522,913)	$ 22,698,159

SURMODICS, INC
STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED SEPTEMBER 30	1998	1997	1996
OPERATING ACTIVITIES			
Net income (loss)	$ 1,636,632	$ 235,67	$ (193,727)
Adjustments to reconcile net income (loss) to net cash provided by operating activities-			
Depreciation and amortization	617,536	460,039	427,274
Realized (gain)loss on investments	(27,634)	--	54,901
Amortization of unearned compensation, net	69,165	103,720	59,200
Change in deferred rent	(17,742)	(11,104)	2,174
Change in assets and liabilities:			
Accounts receivable	(134,244)	(294,647)	(67,849)
Inventories	(115,938)	(3,240)	(3,945)
Accounts payable and accrued liabilities	481,739	446,729	(9,962)
Deferred revenue	(205,418)	(393,416)	138,268
Prepaids and other	(181,332)	(12,701)	(33,303)
Net cash provided by operating activities	2,122,764	531,053	373,031
INVESTING ACTIVITIES			
Purchase of property and equipment, net	(775,402)	(298,388)	(201,580)
Purchases of available-for-sale investments	(33,595,043)	(3,923,184)	(1,497,290)
Sales/maturities of available-for-sale investments	17,455,608	2,425,000	2,659,520
Issuance of stock purchase notes receivable, net of repayments	(22,273)	--	--
Other	31,897	(277,935)	--
Net cash provided by (used in) investing activities	(16,905,213)	(2,074,507)	960,650
FINANCING ACTIVITIES			
Issuance of common stock, net of offering costs	15,634,386	22,172	218,032
Repayment of long-term debt and capital lease obligations	--	--	(16,917)
Net cash provided by financing activities	15,634,386	22,172	201,115
Net increase (decrease) in cash and cash equivalents	851,937	(1,521,282)	1,534,796
CASH AND CASH EQUIVALENTS			
Beginning of year	491,624	2,012,906	478,110
End of year	$ 1,343,561	$ 491,624	$ 2,012,906
SUPPLEMENTAL CASH FLOW INFORMATION			
Interest paid	$ --	$ 1,700	$ 2,254
Non-cash investing and financing activity-			
Issuance of stock purchase notes receivable from exercised stock options	$ --	$ 160,000	$ --

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.

SURMODICS, INC
NOTES TO FINANCIAL STATEMENTS

1. DESCRIPTION

SurModics, Inc. (the Company) develops, manufactures and markets innovative surface modifications primarily for medical devices and diagnostic products. The Company also produces and markets a line of proprietary biomolecule stabilization products. Its revenues are derived from the following: fees from licensing its patented technology to customers; royalties received from licensees; the sale of photoreactive chemical compounds to licensees and stabilization products to the diagnostic industry; and research and development fees generated on projects for commercial customers and government grants. The Company markets its products through a direct sales force primarily in the United States and some international markets.

In March 1998, the Company completed an initial public offering of 2.3 million shares of Common Stock, including 300,000 shares purchased by the underwriters pursuant to the exercise of an overallotment option. In total, the offering generated net proceeds to the Company of approximately $15.5 million after deducting all offering expenses.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

CASH AND CASH EQUIVALENTS
Cash and cash equivalents consist principally of money market instruments with original maturities of three months or less and are stated at cost which approximates fair value.

INVESTMENTS
Investments consist principally of U.S. government obligations and corporate debt securities and are classified as available-for-sale as of September 30, 1998 and 1997. Available-for-sale investments are reported at fair value with unrealized gains and losses excluded from operations and reported as a separate component of stockholders' equity, except for other-than-temporary impairments, which are reported as a charge to current operations and result in a new cost basis for the investment.

The amortized cost, unrealized holding gains and losses, and fair value of investments as of September 30, 1998, and the amortized cost of the investments, which approximated fair value as of September 30, 1997, were as follows:

	SEPTEMBER 30, 1998				SEPTEMBER 30, 1997
	AMORTIZED COST	UNREALIZED GAINS	UNREALIZED LOSSES	FAIR VALUE	AMORTIZED COST
U.S. government obligations	$12,178,480	$243,326	$ --	$12,421,806	$ --
Corporate bonds	5,638,397	5,755	(724)	5,643,428	3,330,094
Mortgage-backed securities	1,286,413	28,784	(3,071)	1,312,126	--
Municipal bonds	200,000	4,174	--	204,174	--
Other debt securities	193,873	--	--	193,873	--
Total	$19,497,163	$282,039	$ (3,795)	$19,775,407	$ 3,330,094

The amortized cost and fair value of investments by contracted maturity date at September 30, 1998, was as follows:

	AMORTIZED COST	FAIR VALUE
Debt securities due within:		
One year	$ 3,526,493	$ 3,526,493
One to five years	14,943,048	15,209,626
Five years or more	1,027,622	1,039,288
Total	$19,497,163	$19,775,407

INVENTORIES
Inventories are 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 as of September 30:

	1998	1997
Raw materials	$107,522	$ 67,099
Finished products	272,424	196,909
Total	$379,946	$264,008

PROPERTY AND EQUIPMENT
Property and equipment are stated at cost and are depreciated using the straight-line method over three to five years, the estimated useful lives of the assets. Amortization of leasehold improvements is recorded on a straight-line basis over the estimated useful lives of the assets or the lease term, whichever is shorter.

OTHER ASSETS
Other assets consist principally of patents, which are amortized over 7 to 12 years. Accumulated amortization was $40,000 and $23,000 as of September 30, 1998 and 1997, respectively.

REVENUE RECOGNITION

Royalty revenue is recognized as third-party licensees report sales of the licensed product or as minimum royalties become due. Initial nonrefundable license fees are recognized as revenue upon execution of the license agreement. Certain nonrefundable license and research and development fees are recoverable by the licensees as offsets against a percentage of future earned royalties.

Revenues on product sales are recognized as products are shipped and for research and development as performance progresses under the applicable contract.

Cash received prior to performance is recorded as deferred revenues in the accompanying balance sheets. Deferred revenues also included advance payments from a third-party licensee to the Company, which were applied as a reduction of amounts otherwise due for earned royalties up to $75,000 per quarter and were fully absorbed during fiscal 1998.

MAJOR CUSTOMERS

Revenues from customers which exceed 10% of total revenues were as follows for the year ended September 30:

	1998	1997	1996
U.S. government agencies	11%	16%	21%
Company A	26%	21%	24%

INCOME TAXES

The Company utilizes the liability method to account for income taxes, and deferred taxes are based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws.

USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Ultimate results could differ from those estimates.

RECLASSIFICATION

Certain 1996 and 1997 amounts in the accompanying financial statements have been reclassified to conform to the 1998 presentation. These reclassifications had no effect on previously reported net income (loss) or stockholders' equity.

NEW ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board has issued Statement of Financial Accounting Standards (SFAS) No. 130, "Reporting Comprehensive Income," which establishes standards for reporting and displaying comprehensive income and its components in financial statements. The Company will adopt the provisions of SFAS No. 130 in fiscal 1999.

SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information," establishes standards for reporting information about operating segments in annual and interim financial statements. Operating segments are determined consistent with the way management organizes and evaluates financial information internally for making decisions and assessing performance. The Company will adopt the provisions of SFAS No. 131 in fiscal 1999.

3. STOCKHOLDERS' EQUITY

AUTHORIZED SHARES

The authorized capital stock of the Company consists of 20,000,000 shares of capital stock, $.05 per share par value, of which 15,000,000 shares are Common Stock and 5,000,000 shares are undesignated.

Each share of the Series A Convertible Preferred Stock was automatically converted into four shares of voting Common Stock upon the closing of the initial public offering. The authorized shares of Series A Convertible Preferred Stock were eliminated and this class of stock was canceled.

STOCK SPLIT

On December 22, 1997, the Company's board of directors approved a 4-for-1 stock split of all the Company's outstanding Common Stock. All share and per share data have been restated for all periods presented to reflect the Common Stock split.

RESTRICTED STOCK AWARDS

The Company has entered into restricted stock agreements with certain key employees, covering the issuance of Common Stock (the Restricted Stock). The Restricted Stock will be released to the key employees if they are employed by the Company at the end of a five-year waiting period. Unearned compensation has been recognized for the estimated fair value of the applicable common shares, reflected as a reduction of stockholders' equity, and is being charged to operations over the five-year waiting period.

Transactions in restricted stock were as follows:

Outstanding at September 30, 1995	87,200
Canceled	(4,800)
Outstanding at September 30, 1996	82,400
Granted	44,000
Outstanding at September 30, 1997	126,400
Granted	4,000
Canceled	(24,000)
Exercised	(42,400)
Outstanding at September 30, 1998	64,000

STOCK PURCHASE NOTES RECEIVABLE

The Company established a loan program during fiscal 1997 to assist employees in purchasing shares of the Company's stock. The loans are collateralized by the employees' purchased shares

and require annual interest payments at a rate equal to prime at the date of issuance (8.5%) with principal and any unpaid interest due at the earlier of five years after the date of issuance or three months after termination of employment. Employees may borrow up to 100% of the option price for the shares purchased or up to 100% of their previous investment in the Company's stock. No further loans are being granted under this program.

4. STOCK-BASED COMPENSATION PLAN

Upon adoption of the Company's 1997 Incentive Stock Option Plan (the Plan), 600,000 shares of Common Stock were reserved for issuance to employees and officers. The Plan requires that the option price per share cannot be less than 100% of the fair market value of the Common Stock (as determined by the board of directors) on the date of the grant of the option or 110% with respect to optionees who own more than 10% of the total combined voting power of all classes of stock. Options expire in five to seven years or upon termination of employment and are exercisable at a rate of 20% per year from the date of grant or 20% per year commencing one year after the date of grant. In addition, options representing a total of 272,900 shares remain outstanding from the Company's 1987 Incentive Stock Option Plan which was replaced by the 1997 Plan.

Under the Company's Nonqualified Stock Option Plan, 972,240 shares of Common Stock were reserved for issuance to outside directors, employees and officers. The options have been granted at fair market value as determined by the board of directors on the date of grant. Options expire in five to ten years and are exercisable at a rate of 20% per year from the date of grant or 20% per year commencing two years after the date of grant.

As of September 30, 1998, there were 575,500 additional shares available for grant under the stock plans. Information regarding stock options under all plans is summarized as follows:

	1998		1997		1996	
OPTIONS	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding, beginning of period....	1,204,800	$ 4.60	1,163,600	$ 4.52	1,396,280	$ 4.35
Granted.....	137,300	6.98	157,400	5.00	5,400	5.00
Exercised.....	(26,220)	4.47	(45,388)	4.01	(71,628)	3.04
Canceled.....	(46,240)	4.78	(70,812)	4.51	(166,452)	3.78
Outstanding, end of period.....	1,269,640	$ 4.86	1,204,800	$ 4.60	1,163,600	$ 4.52
Exercisable, end of period.....	757,860	$ 4.49	589,320	$ 4.42	436,760	$ 4.26
Weighted average fair value of options granted.....	$ 4.91		$ 3.30		$ 3.23	

The options outstanding at September 30, 1998 have exercise prices ranging between $4.00 and $7.75, with a weighted average exercise price of $4.86 and a weighted average remaining contractual life of 3.44 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1998 and 1997, respectively: risk-free interest rates of 5.00% and 6.24%; expected lives of 6.4 and 5.6 years; and expected volatility of 73% for both years.

The Company accounts for the options under APB Opinion No. 25, under which no compensation cost has been recognized. Had compensation cost for the options been determined consistent with SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income (loss) would have been the following pro forma amounts for the years ended September 30:

	1998	1997	1996
Net income (loss):			
As reported.....	$1,636,632	$235,673	$(193,727)
Pro forma.....	$1,506,492	$155,541	$(194,890)
Net income (loss) per share:			
As reported diluted.....	$ .24	$ .04	$ (.04)
Pro forma diluted.....	$ .22	$ .03	$ (.04)

Because the SFAS No. 123 method of accounting has not been applied to options granted prior to October 1, 1995, the resulting pro forma information may not be representative of that to be expected in future periods.

SURMODICS, INC
NOTES TO FINANCIAL STATEMENTS

5. INCOME TAXES

Deferred income taxes consisted of the following as of September 30:

	1998	1997
Deferred tax assets.....	$ 2,615,000	$ 3,242,000
Less- Valuation allowance.....	(2,615,000)	(3,242,000)
Net deferred tax assets.....	$ --	$ --

These deferred tax assets result from differences in the recognition of transactions for income tax and financial reporting purposes. The principal temporary differences relate to certain financial reserves not deductible for tax purposes until paid, a capital loss carryforward and net operating loss carryforwards.

The Company's net operating loss carryforwards of approximately $4.7 million at September 30, 1998 expire in varying amounts through 2011. The Company also had $490,000 of capital loss carryforwards at September 30, 1998, which expire in 2001. A valuation allowance for the full amount of the deferred tax asset has been established due to the uncertainty of realization.

During fiscal year 1998 and 1997, the Company utilized approximately $1.7 million and $64,000 of net operating loss carryforwards to offset the current year income tax liability.

6. COMMITMENTS AND CONTINGENCIES

OPERATING LEASES

The Company leases its office and laboratory space under an operating lease that expires in 1999. The lease provides for base monthly payments, which increase annually, and additional amounts to cover the Company's share of common area expenses and property taxes. The Company is responsible for maintenance, insurance and other normal operating costs. Rental expense for the base monthly payments and additional costs was approximately $296,000, $290,000 and $290,000 for the years ended September 30, 1998, 1997 and 1996, respectively.

Future commitments under the operating lease are as follows as of September 30, 1998:

1999.....	$216,000
2000.....	54,000
	$270,000

GOVERNMENT CONTRACTS

Under provisions contained in the government research contracts, representatives of the government agencies have the right to access and review the Company's underlying records of contract costs. The government retains the right to reject expenses considered unallowable under the terms of the contract. The Defense Contract Audit Agency has reviewed the contracts through 1989. In the opinion of management, future amounts due, if any, with respect to open contract years will not have a material impact on the financial position or results of operations of the Company.

7. DEFINED CONTRIBUTION PLAN

The Company has a 401(k) retirement and savings plan for the benefit of qualified employees. Under the plan, qualified employees may elect to defer up to 20% of their compensation, subject to a maximum limit determined by the Internal Revenue Service. The Company, at the discretion of the board of directors, may elect to make an additional contribution. Additional contributions totaling $117,000, $86,000 and $78,000 have been charged to operations for the years ended September 30, 1998, 1997 and 1996, respectively.

8. QUARTERLY FINANCIAL DATA
(UNAUDITED, IN THOUSANDS EXCEPT PER SHARE DATA)

	FISCAL 1998			
	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER
Revenues.....	$1,909	$2,579	$2,672	$2,619
Income from operations.....	101	288	330	229
Net income.....	151	376	566	544
Net income per share:				
Basic.....	.03	.07	.08	.08
Diluted.....	.03	.06	.07	.07

	FISCAL 1998			
	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER
Revenues.....	$1,655	$1,866	$1,954	$2,107
Income (loss) from operations.....	(13)	17	19	14
Net income.....	26	68	73	69

Net income per share:				
Basic.....	.01	.01	.01	.01
Diluted.....	.00	.01	.01	.01

STOCK LISTING AND PRICE HISTORY

On March 4, 1998, the Company completed its initial public offering of Common Stock at a price of $7.50 per share. The stock is trading on the Nasdaq National Market under the symbol "SRDX." The following table sets forth the range of high and low closing sale prices for the Company's Common Stock, as reported by Nasdaq:

FISCAL QUARTER ENDED	HIGH	LOW
December 31, 1997.....	N/A	N/A
March 31, 1998.....	$ 9 3/4	$ 7 3/4
June 30, 1998.....	$ 11 3/4	$ 8 1/4
September 30, 1998.....	$ 14 1/8	$ 7 3/16

According to the records of the Company's transfer agent, as of November 25, 1998, the Company had 258 holders of record of the Company's Common Stock (excluding beneficial owners of shares registered in nominee or street name).

The Company has never paid any cash dividends on its Common Stock and does not anticipate doing so in the foreseeable future. SurModics, Inc.

EXHIBIT 23

CONSENT OF INDEPENDENT PUBLIC ACCOUNTANTS

As independent public accountants, we hereby consent to the incorporation of our report incorporated by reference in this Form 10-KSB, into the Company's previously filed Registration Statements File Nos. 33-64171 and 33-64173.

/s/ ARTHUR ANDERSEN LLP

Minneapolis, Minnesota,
December 22, 1998

This schedule contains summary financial information extracted from the financial statements for the year ended September 30, 1998 and is qualified in its entirety by reference to such financial statements.

1,000
U.S. Dollars

YEAR
SEP-30-1998
OCT-01-1997
SEP-30-1998
1
1,344
3,526
1,092
35
380
6,562
4,639
3,399
24,305
1,483
0
0
0
0
361
22,337
24,305
2,798
9,779
1,193
8,831
0
0
0
1,674
37
1,637
0
0
0
1,637
0.26
0.24