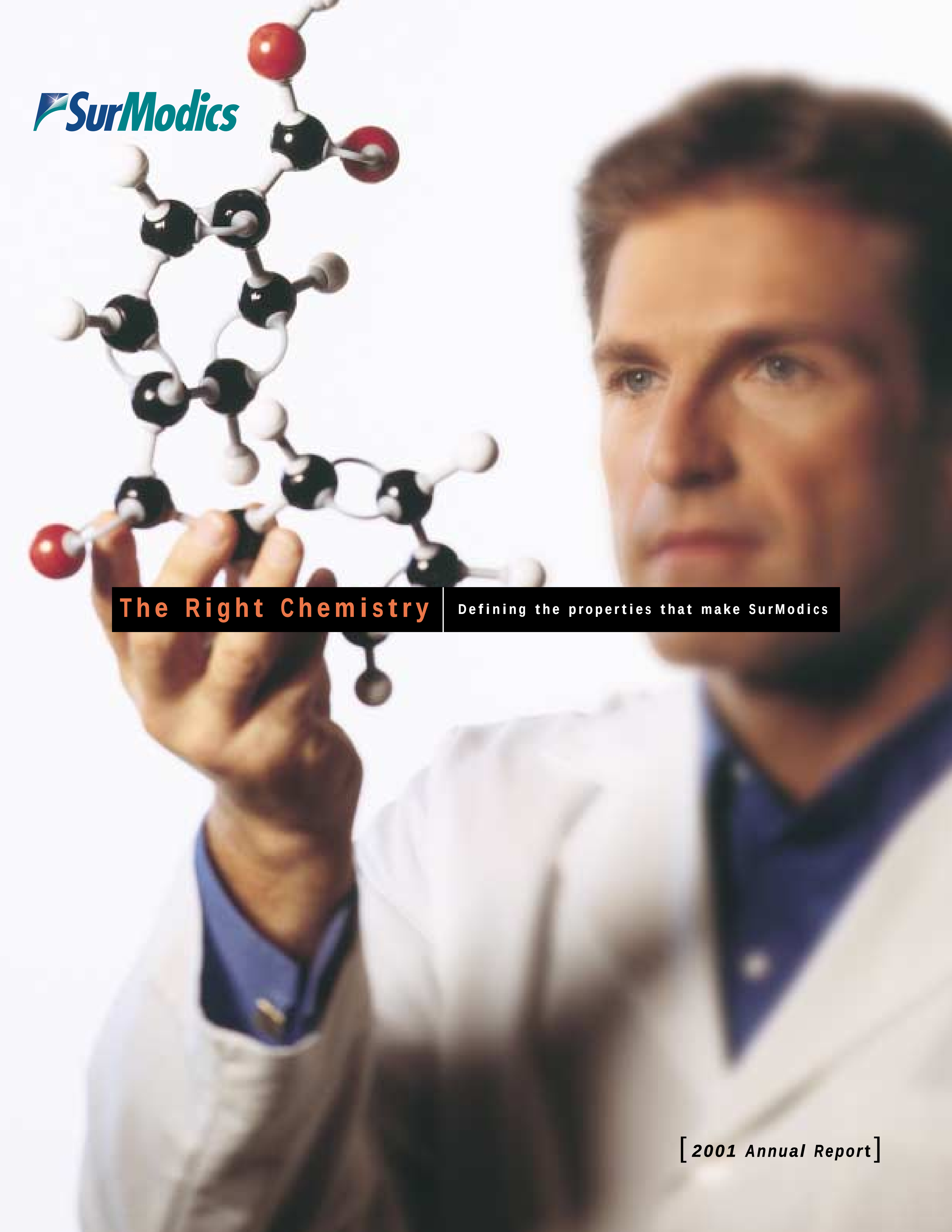
SurModics



The Right Chemistry

Defining the properties that make SurModics

[*2001 Annual Report*]

Corporate Profile

SurModics, Inc. is the leading provider of surface modification solutions to the medical device industry. The Company licenses its patented coating process to medical device manufacturers around the world, primarily focusing on its PhotoLink® technology. PhotoLink is a versatile, easily applied, light-activated coating technology that modifies medical device surfaces, making the devices easier for physicians to use and more compatible with the human body.

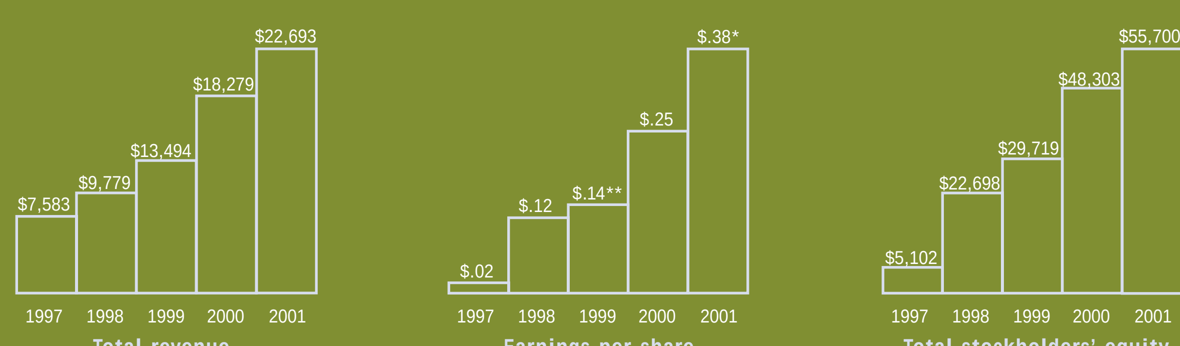
SurModics' strategy is to license its technology to medical device manufacturers who apply the coatings to products in their own facilities. The Company generates revenue from four main sources: license fees, high-margin royalties, sales of reagent chemicals and research and development fees.

By partnering with the world's leading medical device and technology companies, SurModics is also leveraging its core technology into other high-growth, high-value opportunities, including genomics, tissue engineering and drug incorporation coatings.

Financial Highlights

[*Fiscal years ended September 30*]

(Dollars in thousands, except per share data)



* Before the cumulative effect of a change in accounting principle of $1.7 million.
** As adjusted, excluding the reversal of a $2.5 million income tax valuation allowance.

To Our Shareholders

[*Defining the properties that make SurModics*]

In fiscal 2001, SurModics saw its commitment to "the right chemistry" shine more brightly than ever. Market awareness of the value of our patented PhotoLink® technology continued its steady rise, as did the demand for our coatings among medical device manufacturers. SurModics helped generate excitement in the medical community when Johnson & Johnson's Cordis division reported impressive results in the European clinical trials of a drug-coated stent using our technology. In addition, our partnership with Motorola Life Sciences continued to grow, further solidifying our presence in the emerging field of genomics.

Significant strides were made this year toward making SurModics a more well-rounded company. As noted in last year's annual report, we are committed to balancing innovative technological capabilities with an increased focus on sound business fundamentals, coupled with new strategic initiatives. In keeping with this strategy, we continue to add key technical personnel to explore new business opportunities, enhance existing business segments, and further strengthen our core capabilities.

2001 Financial Review

Sustaining a growth trend that now spans more than

Fiscal year 2001 saw steady growth of the core PhotoLink business. SurModics generates revenue through several different means: license fees, development revenue, sales of reagent chemicals and, most importantly, royalties from our clients' sales of coated products. All of these areas showed double-digit growth in fiscal 2001.

a decade, SurModics generated record financial results for the fiscal year ended September 30, 2001. Revenue rose 24% to $22.7 million. The Company's PhotoLink business continued to perform well, with total PhotoLink revenue increasing 31% to $15.9 million. Royalties accounted for nearly half of this total, indicating our clients are successfully marketing coated medical devices. Fiscal 2001 revenue also included a $1.0 million payment from Motorola for meeting a technical benchmark under the terms of the existing partnership agreement.

SurModics' unique business model allowed us to convert this revenue gain into a 40% increase in operating income. Net income before the cumulative effect of a change in accounting principle was $6.8 million, or $.38 per diluted share, up from $4.2 million, or $.25 per diluted share, in fiscal 2000.

Absolute Perfection — A Tribute to the Right Chemistry

For SurModics, one of the most exciting moments of the year came in early September. In a meeting of the European Society of Cardiology, researchers announced stellar results in human clinical trials for a drug-coated coronary stent produced by Johnson & Johnson's Cordis division. The results showed that, of the 120 test subjects implanted with a stent coated with SurModics' technology, *none* of the patients experienced restenosis after six months. Restenosis is the reclosure of an artery due to vessel damage following angioplasty or a stenting procedure.

The perfect results in the clinical stent trials are a tribute to the selection of an effective drug by Johnson & Johnson and to SurModics' commitment to outstanding quality and "the right chemistry." It demonstrates the reliability of our coatings and is an example of the wide range of medical products that can benefit from our surface modification technology.

Showcasing the Versatility of SurModics' Technology

The European trial results also indicate what the future may hold for SurModics as we continue to move our core technology beyond "slippery surface" applications for medical devices and into other areas. The drug-coated stent used in the European trials demonstrates how SurModics' technology can be used for drug elution, the ability to incorporate drugs onto the surface of devices for gradual release into the surrounding tissue.

Financial Highlights

Fiscal years ended September 30
(Dollars in thousands, except per share data)

	2001	2000	1999	1998	1997
Total revenue	**$ 22,693**	$ 18,279	$ 13,494	$ 9,779	$ 7,583
PhotoLink revenue	**$ 15,861**	$ 12,071	$ 7,555	$ 4,112	$ 3,224
PhotoLink royalty revenue	**$ 7,781**	$ 6,763	$ 3.912	$ 2,205	$ 1,448
Income from operations	**$ 7,566**	$ 5,333	$ 2,419	$ 948	$ 37
Net income	**$ 5,109**	$ 4,240	$ 2,286*	$ 1,637	$ 236
Diluted net income per share	**$ .29**	$ .25	$ .14*	$ .12	$ .02
Pro forma amounts assuming the accounting change was applied retroactively:					
Net income	**$ 6,814**	$ 3,669	$ 2,125*	$ 1,633	$ 136
Diluted net income per share	**$ .38**	$ .22	$ .13*	$ .12	$ .01

* As adjusted, excluding the reversal of a $2.5 million income tax valuation allowance.

Drug-eluting coatings present SurModics with an opportunity to be a major contributor to the stent market. Some industry analysts predict this market will expand significantly in the coming years—potentially tripling in size to $6 billion by 2004. Thanks in large part to our relationship with Johnson & Johnson, we are now well-positioned in this market. We also signed a second stent agreement with another medical device company in the fourth quarter of 2001. In our opinion, additional stent agreements are likely as we leverage our current technology, while we also broaden our product platform through ongoing development of additional drug-elution coating capabilities.

PhotoLink Growth Continues

Fiscal year 2001 saw steady growth of the core PhotoLink business. SurModics generates revenue through several different means: license fees, development revenue, sales of reagent chemicals and, most importantly, royalties from our clients' sales of coated products. All of these areas showed double-digit growth in fiscal 2001.

We also had a successful year closing new license agreements by executing 10 licenses, which met the top end of our goal of 8 to 10 new agreements. This is especially impressive since our sales force is now focused on the value, not the quantity, of new agreements. Some of the new agreements involve totally new therapeutic devices, several of which have the potential to generate substantial revenue in the next few years. We now have license agreements with 50 companies for more than 100 product applications.

Maintaining Momentum

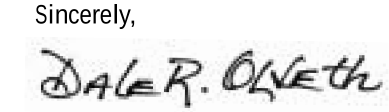
The financial success of SurModics in 2001 added to an impressive financial base for the Company. At year-end, SurModics had $44.4 million in cash and investments and no debt. With solid financial footings, we are now considering actions that will spur additional growth in key market segments. Moving into fiscal 2002 and beyond, we will look to further broaden the Company's revenue base through selective strategic alliances and acquisitions.

SurModics will continue to blend technological innovation with careful financial management. The Company remains committed to its long-term goal of achieving annual revenue growth of 25%, with annual net income growth exceeding that level. We expect this goal will be more difficult to achieve in fiscal 2002, due to a relatively flat first half of the year.

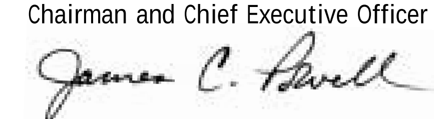
Moving forward, SurModics faces the challenge of maintaining momentum in its innovative development of new products and technologies. We will continue to motivate our employees to achieve aggressive growth targets. Although the Company has experienced significant successes this year, we will not rest on our laurels. We will push forward to build on the momentum of our recent successes.

SurModics is the pioneer in surface modification, but we know there is no monopoly on good ideas. In order to stay competitive, we will rely on the proven chemistry of our talented and dedicated employees. We thank them for their outstanding efforts. And we thank you, our shareholders, for your continuing support. We look forward to sharing the future successes of SurModics with you.

Sincerely,



Dale R. Olseth
Chairman and Chief Executive Officer



James C. Powell
President and Chief Operating Officer

Take a look below the surface | In nature, *symbiosis* describes a mutually beneficial relationship between organisms of different species. The complementary interaction between bees and flowers is just one example of this unique situation. A similar model exists at SurModics, where the actions of one group serve to benefit another. We depend on our valued employees, trusted business partners and superior surface modification technology to keep the Company vibrant and growing. In the following pages, examine the details and consider how our people, partners and products combine to create a powerful engine for technical expertise, innovation and growth.

Relying on the Right People

[*experience, quality and excellence*]

At SurModics, "the right chemistry" extends beyond our technical capabilities. It involves the people we employ and the infrastructure we've created to serve our customers and develop world-class surface modification solutions.

We have resources dedicated to every aspect of surface modification for medical devices. From experts in synthetic chemistry to coating engineers to regulatory specialists, we have the right people positioned to extend our technical capabilities and meet or exceed our customers' expectations. We strive for steady improvements in our existing technologies. We now have 15 Ph.D.s on staff and over half of our 140 employees are devoted to expanding our technological capabilities through scientific research and development.

We have the right people—employees with individualized skills that round out SurModics' overall surface modification expertise. Our specialists in surface characterization, biochemistry, organic synthesis, microbiology, hemocompatibility, regulatory affairs, quality assurance, genomics, tissue engineering, polymer science and lubricity give us an advantage over the one-dimensional experience of our competition.

We also restructured our marketing efforts in 2001, segmenting and defining the medical device marketplace for our sales force. Already, this effort has identified significant new sales opportunities. It has helped our salespeople focus their efforts on the medical products and devices that would significantly benefit from our surface coating expertise.

SurModics' winning combination of marketing and technical expertise often results in extra benefits to potential business partners. For example, customers who approach the Company in need of specific surface modification characteristics often find, thanks to our expertise and years of experience, we can add functionality to their device that they were not even considering.

Late in 2002, we plan to move to a new location that will better accommodate our business growth and provide us with the additional laboratory facilities required to meet broader needs. The new facility will allow us to achieve our growth targets while providing more flexibility for the future.

...we have the right people positioned to extend our technical capabilities and meet or exceed our customers' expectations.

Partnerships with the Right Chemistry

[growth, development and expanding markets]

The success of SurModics' business partnership philosophy was reaffirmed in fiscal year 2001 when one of our partners, Motorola Life Sciences, honored us with its "Supplier of the Year" award.

Throughout our history, we have sustained a commitment to creating and maintaining mutually beneficial business partnerships. Once we sign a licensing agreement with a client, it can take months to years of technical collaboration before a product is commercially available. Because our success is contingent on the success of our clients, an energetic business relationship that grows and matures over time is critically important.

In 2001, our successful work with Johnson & Johnson's Cordis division and Motorola Life Sciences were just two examples of how SurModics has expanded its partnership expertise to include industry "elephants"—very large companies that wield substantial influence and have the potential to generate large revenue. We are increasing our understanding of what it takes to become a better partner with such large corporations.

A stent agreement signed with Johnson & Johnson more than five years ago has blossomed into a successful multi-year partnership. Similarly, our partnership with Motorola has strengthened substantially since fiscal year 2000, when our two companies first entered into an exclusive agreement for SurModics' genomics-related technology.

The importance of strong partnerships is growing throughout the Company. Our marketing team, for example, works closely with customers to identify the dynamic needs of the medical device industry. Marketing then communicates with our scientists to initiate the development of innovative coatings to meet customer needs. Engineers work side-by-side with the scientists to refine the processes so that customers can successfully and easily incorporate our world-class surface coatings into their manufacturing facilities.

...SurModics has expanded its partnership expertise to include industry "elephants"—very large companies that wield substantial influence and have the potential to generate large revenue.

Improving the Products that Improve Lives

[*innovation, development and medical advances*]

For SurModics, 2001 will stand out as the year in which the medical device industry began to fully realize the importance of coatings. With outstanding European clinical trial results for Johnson & Johnson, the value of drug-eluting stents is being proven. To-date, these stents have prevented any occurrence of restenosis, the reclosure of an artery due to vessel damage following angioplasty or a stenting procedure.

The news from Europe was important for SurModics, but was also important for millions of patients worldwide who potentially will benefit from drug-coated stents in coming years. According to the American College of Cardiology, approximately 700,000 Americans undergo coronary interventions involving stent placements each year. Using uncoated stents, over 20% of these patients can be expected to experience in-stent restenosis, a condition that often necessitates additional treatments, including bypass surgery. Drug-eluting stents have the potential to virtually eliminate such problems.

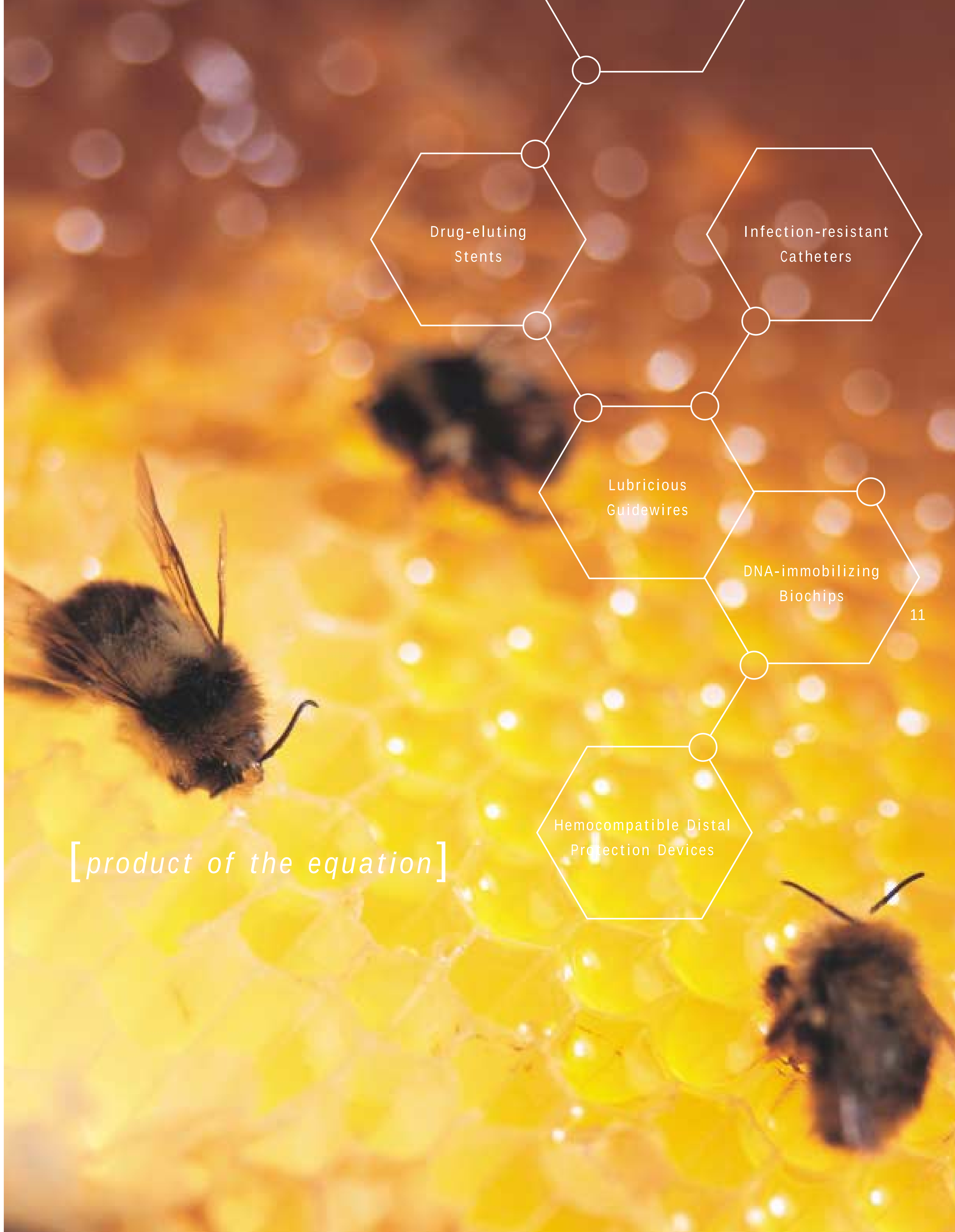
SurModics will continue to develop new applications for drug-eluting coatings on medical devices, an area that holds significant potential for the Company. We will also strive to maintain and expand our leadership role in other areas of the surface modification industry.

As we continue to develop innovative products based around our core PhotoLink technology, we will expand our work in products and applications that offer sizeable market opportunities for the Company, including:

- Genomics applications, originating with the 3D-Link™ Activated Slide, which were exclusively licensed to Motorola Life Sciences.
- Hemocompatible coatings, which allow a medical device to interact more effectively with human blood, reducing the likelihood of clotting and associated problems.
- Tissue engineering applications, which involve the development of coatings and matrices designed to either promote or inhibit the response of specific cell types.

We are committed to developing new surface modification technologies and applications to generate new business relationships and strengthen the valuable partnerships we've forged with our existing clients.

...continue to develop new applications for drug-eluting coatings on medical devices, an area that holds significant potential for the Company.



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, stabilization products to the diagnostics industry and coated glass slides to the genomics market; and research and development fees generated on projects for commercial customers and government grants.

Fiscal 2001 was another record year for SurModics. Total revenue increased 24% to $22.7 million from $18.3 million in fiscal 2000. PhotoLink-related revenue increased 31% to a record $15.9 million from $12.1 million in 2000. All PhotoLink categories showed double-digit growth, but commercial development revenue was especially strong.

Commercial development revenue jumped to $3.6 million from $1.4 million in 2000, a 152% increase. PhotoLink royalties increased 15% to $7.8 million and reagent sales, those chemicals used by licensees in the coating process, increased 10% to $2.6 million. Operating income rose 42% to $7.6 million from $5.3 million in fiscal 2000. Net income was $5.1 million, or $.29 per diluted share, compared to $4.2 million, or $.25 per diluted share, in fiscal 2000. Fiscal 2001 results included a charge of $1.7 million, or $.09 per diluted share, for the cumulative effect of a change in accounting principle related to the adoption of the SEC's Staff Accounting Bulletin No. 101.

Years Ended September 30, 2001 and 2000

Revenue. The Company's revenue was $22.7 million in fiscal 2001, an increase of 24% over fiscal 2000. The revenue components were as follows:

(Dollars in thousands)	Fiscal 2001	Fiscal 2000	Increase (Decrease)	% Increase (Decrease)
PhotoLink revenue				
Royalties	$ 7,781	$ 6,763	$ 1,018	15%
License fees	1,794	1,470	324	22%
Reagent sales	2,638	2,393	245	10%
Commercial development	3,648	1,445	2,203	152%
Total PhotoLink revenue	15,861	12,071	3,790	31%
Diagnostic royalties	3,253	2,917	336	12%
Stabilization & other products	3,047	2,687	360	13%
Government research	532	604	(72)	(12%)
Total revenue	**$ 22,693**	**$ 18,279**	**$ 4,414**	**24%**

The revenue growth in fiscal 2001 was mostly due to a 31% increase in total PhotoLink revenue, especially commercial development and royalty revenue. An increase in customer-funded development activity resulted in a 152% rise in commercial development revenue. The two largest components of this were collaborative work performed with Johnson & Johnson's Cordis division on its drug-coated stent and Motorola Life Sciences on genomics projects. A single customer accounted for approximately 66% of the commercial development revenue in 2001 and 63% in fiscal 2000. PhotoLink royalties increased 15% due to sales growth of previously introduced coated products by licensees, new coated products introduced in 2001, and increased minimum royalties. The top 10 product applications accounted for 84% of the PhotoLink royalties received in fiscal 2001. SurModics' clients now have 57 coated products on the market compared to 47 one year ago.

Reagent sales increased 10% due to additional coated products on the market and increased production of previously introduced devices by PhotoLink clients. A single customer purchased 38% of the reagents sold during fiscal 2001, down from 55% in fiscal 2000. More importantly, reagent sales to all other customers increased 53% between years. During fiscal 2001, SurModics signed 10 new license agreements resulting in a 22% increase in license fee revenue to $1.8 million. Included in both years were $1.0 million in license fees from Motorola Life Sciences. The Company now has license agreements with 50 companies covering over 100 product applications.

In total, non-PhotoLink revenue sources increased 10% in fiscal 2001. Diagnostic royalties increased 12%, most of which was due to proceeds from patent infringement settlements. Sales of stabilization and other products grew 13% between years. A 31% decrease in stabilization chemical sales was more than offset by a 141% increase in sales of 3D-Link Activated Slides; however, slide sales were down in the fourth quarter. Finally, revenue from government grants decreased 12% as the Company continues to de-emphasize its reliance on the government to fund its research projects.

In fiscal 2002, management expects revenue growth in the 20 to 25% range. A significant event impacting this rate of growth will be the timing of Johnson & Johnson's launch of its drug-coated stent. If European regulatory approval is received around April 1, 2002, SurModics will receive royalties in only the fourth quarter of fiscal 2002. If European approval is received sooner, royalties will also be generated in the third quarter. Royalties will also be positively impacted by the 12 new coated products that clients are expected to launch in fiscal 2002. Several of these products have the potential to generate significant annual royalties. With respect to license revenue, the implementation of SAB 101 will require license fees to be deferred and recognized over an average of 15 years.

Revenue will fluctuate from quarter to quarter depending on, among other factors: success by clients in selling coated medical devices; the timing of introductions of coated products by clients; the number and size of development projects that are entered into; the number of new license agreements that are finalized; one significant contract that generates lower royalty rates as the client's sales increase; and the impact of most medical device clients generating lower sales during the summer months, which results in relatively lower royalty revenue to SurModics in the first quarter of each fiscal year.

Product costs. The Company's product costs were $2.4 million for fiscal 2001, an increase of $500,000, or 28%, over fiscal 2000. Overall product margins averaged 57%, a decrease from 63% in fiscal 2000. Reagent margins increased in 2001, while stabilization and slide margins declined. A portion of this decrease was due to a 15% reduction in stabilization product pricing. In addition, the Company completed additional manufacturing capacity in the first quarter, which added to certain of the overhead cost allocations. In fiscal 2002, management expects overall product margins to improve by one or two percentage points.

Research and development expense. Research and development expense was $8.0 million for fiscal 2001, an increase of $1.2 million, or 18%, over fiscal 2000. Most of this increase was due to compensation and benefit expenses associated with the technical personnel hired by the Company during the year. In addition, the Company incurred increased legal fees associated with patents and increased depreciation from the full-year impact of the build-out of additional lab space in the prior year. In fiscal 2002, management expects research and development expenses to increase 18 to 20% over fiscal 2001, as the Company continues to invest in expanding its coating technology.

Sales and marketing expense. Sales and marketing expense was $1.7 million for fiscal 2001, an increase of $125,000, or 8%, over fiscal 2000. Increased compensation and benefit expenses, travel, and consulting fees were partially offset by a decrease in recruiting costs associated with sales and marketing positions filled in the last quarter of fiscal 2000. In fiscal 2002, management expects sales and marketing expenses to increase in a similar range to fiscal 2001.

General and administrative expense. General and administrative expense was $3.0 million for fiscal 2001, an increase of $300,000, or 12%, over fiscal 2000. The increase was primarily due to higher compensation and benefit costs, increased professional fees and higher utility costs. In addition, the Company expanded its operation within the current facility, eliminating tenant rental income that previously offset a portion of operating costs. In fiscal 2002, management expects general and administrative expenses to increase 8 to 10% over fiscal 2001.

Other income, net. The Company's net other income was $3.1 million for fiscal 2001, an increase of $1.6 million, or 116%, over fiscal 2000. Interest earned on the Company's investments amounted to $2.3 million, an increase of 66% from fiscal 2000. The increase was due to the additional $7.8 million of cash provided by operating activities during the year, and the full year impact of the $13.0 million in proceeds from the issuance of Common Stock in the fourth quarter of fiscal 2000. The remaining $701,000 of net other income represented capital gains on investment sales to take advantage of an expiring tax capital loss carryforward. In fiscal 2002, management expects other income to decrease significantly due to a lower interest rate environment and, now that the tax capital loss has been fully utilized, no need to generate capital gain income for tax purposes.

Income tax expense. The Company's income tax provision was $3.8 million in fiscal year 2001 versus $2.5 million in fiscal 2000. The effective tax rate was 36% in fiscal 2001, a slight decrease from 37% in fiscal 2000 due to the utilization of the capital loss carryforward discussed above.

Years Ended September 30, 2000 and 1999

Revenue. The Company's revenue was $18.3 million in fiscal 2000, an increase of 35% over fiscal 1999. The revenue components were as follows:

(Dollars in thousands)	Fiscal 2000	Fiscal 1999	Increase (Decrease)	% Increase (Decrease)
PhotoLink revenue				
Royalties	$ 6,763	$ 3,912	$ 2,851	73%
License fees	1,470	645	825	128%
Reagent sales	2,393	1,876	517	28%
Commercial development	1,445	1,122	323	29%
Total PhotoLink revenue	12,071	7,555	4,516	60%
Diagnostic royalties	2,917	2,758	159	6%
Stabilization & other products	2,687	2,261	426	19%
Government research	604	920	(316)	(34%)
Total revenue	**$ 18,279**	**$ 13,494**	**$ 4,785**	**35%**

The revenue growth in fiscal 2000 was largely due to the 60% increase in total PhotoLink revenue between years. PhotoLink royalties increased 73% due primarily to sales growth of previously introduced coated products by licensees. SurModics' clients had 47 coated products on the market. Reagent sales increased 28% due to increased production of coated devices by PhotoLink clients. A single customer purchased 55% of the reagents sold during fiscal 2000, down from 57% in fiscal 1999. More importantly, reagent sales to all other customers increased 32% between years. During fiscal 2000, SurModics signed 10 new license agreements, compared to 14 new agreements executed in fiscal 1999. Revenue from license fees increased 128% from fiscal 1999 due to the receipt of a $1.0 million license fee from Motorola Life Sciences during the fourth quarter of fiscal 2000. Customer-funded development projects to optimize the PhotoLink coatings for each customer's specific application resulted in a 29% increase in commercial development revenue. Approximately 63% of the commercial development revenue resulted from work on a project for a single customer. This same customer accounted for 34% of the commercial development revenue in fiscal 1999.

Non-PhotoLink revenue sources also grew in fiscal 2000; however, this growth was offset by a reduction in government revenue. Diagnostic royalties increased 6% between years. Most of this growth occurred in the first half of the year, as FDA manufacturing issues at the sole licensee impacted royalties in the second half. Sales of stabilization and other products grew 19%. A 9% decrease in stabilization chemical sales was more than offset by large growth in 3D-Link Activated Slides. Stabilization sales suffered from the loss of a single large customer. Finally, revenue from government grants decreased 34% between years, as the Company has de-emphasized its reliance on grants and has internally funded more of its research projects.

Product costs. The Company's product costs were $1.9 million for fiscal 2000, an increase of $400,000, or 26%, over fiscal 1999. Overall product margins averaged 63% during both years. Efficiencies gained through increased sales volumes were offset by additional scrap and labor costs.

Research and development expense. Research and development expense was $6.8 million for fiscal 2000, an increase of $1.5 million, or 30%, over fiscal 1999. Most of this increase was due to compensation and benefit expenses associated with the additional technical personnel hired by the Company during the year. In addition, the Company incurred increased costs due to the build-out of additional lab space within the current facility early in the year and the associated costs to furnish the new space with equipment and supplies.

Sales and marketing expense. Sales and marketing expense was $1.6 million for fiscal 2000, a decrease of $200,000, or 11%, over fiscal 1999. This decrease was due primarily to compensation and benefit expenses associated with unfilled sales and marketing positions throughout the year. Some of these positions were filled during the fourth quarter.

General and administrative expense. General and administrative expense was $2.7 million for fiscal 2000, an increase of $100,000, or 5%, over fiscal 1999. The increase was primarily due to inflation, resulting in higher compensation and benefit costs, and increased legal and professional fees.

Other income, net. The Company's net other income was $1.4 million for fiscal 2000, an increase of $300,000, or 22%, over fiscal 1999. This income primarily represents interest earned on the Company's investments. The level of investments increased due to the $7.4 million of cash provided by operating activities, $13.2 million from the issuance of Common Stock and higher yields due to an increase in interest rates.

Income tax expense. The Company's income tax provision was $2.5 million for fiscal year 2000 versus a $783,000 income tax benefit in fiscal 1999. The Company's effective tax rate was 37% in fiscal 2000. The income tax benefit in fiscal 1999 resulted from the reversal of an income tax valuation allowance of approximately $2.5 million, reducing the Company's tax provision at statutory rates to a net credit of $783,000.

Liquidity and Capital Resources

As of September 30, 2001, the Company had working capital of $17.7 million and cash, cash equivalents and investments totaling $44.4 million. The Company generated positive cash flows from operating activities of $7.8 million in fiscal 2001, $7.4 million in fiscal 2000, and $4.4 million in fiscal 1999. The increase in cash flows in fiscal 2001 was primarily due to the increased net income generated during the year and tax benefits generated from the exercise of employee stock options.

The significant increase in investing activities over the last year was primarily due to the activity in the Company's available-for-sale investment portfolio as managed by an independent investment manager. Due to the desire to fully utilize an expiring tax capital loss carryforward, investing activities increased as certain investments were sold to generate gains and the proceeds were then reinvested.

SurModics' investment policy requires investments with high credit quality issuers and limits the amount of credit exposure to any one issuer. The Company's investments principally consist of U.S. government and government agency obligations and investment-grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are five years or less. Because of the credit criteria of the Company's investment policies, the primary market risk associated with these investments is interest rate risk. SurModics does not use derivative financial instruments to manage interest rate risk or to speculate on future changes in interest rates. A 10% increase in interest rates would result in an approximate $350,000 decrease in the fair value of the Company's available-for-sale securities as of September 30, 2001, but no material impact on the results of operations or cash flows. Management believes that a reasonable change in raw material prices would not have a material impact on future earnings or cash flows because the Company's inventory exposure is not material. Also, the Company's foreign currency exposure is not significant.

The Company purchased $2.1 million of personal property and equipment in fiscal 2001, and $3.0 million in fiscal 2000. In addition, in June 2001, the Company used $2.5 million to purchase real property for potential future expansion. The property was classified as an other asset at September 30, 2001, as the Company now intends to sell the property and expand into a different location. Subsequent to year-end, the Company purchased a facility on 27 acres of land for approximately $7.1 million and intends to move its operations into this facility towards the end of 2002.

The most significant financing activity over the last three years was the sale of almost 800,000 shares of Common Stock to Motorola, Inc. in a private placement that generated $13.0 million in August 2000. Proceeds from stock option exercises generated an additional $700,000 and $200,000 during fiscal 2001 and 2000, respectively.

As of September 30, 2001, 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 SurModics' operations into the foreseeable future.

New Accounting Pronouncements

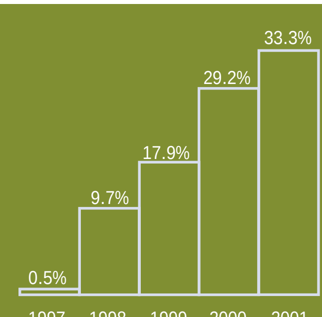
In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." SAB 101 requires that license and other up-front fees be recognized over the term of the agreement unless the fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process. The Company adopted SAB 101 effective October 1, 2000. As a result, the Company reported a charge to fiscal 2001 earnings of $1.7 million, net of taxes, or $.09 per diluted share, for the cumulative effect of a change in accounting principle. Had the accounting change been applied retroactively, net income would have decreased by $600,000 to $3.7 million, or $.22 per diluted share, in the year ended September 30, 2000 and decreased by $200,000 to $4.2 million, or $.26 per diluted share, in the year ended September 30, 1999. The Company now has $2.6 million in additional deferred revenue, net of deferred costs, that will be recognized as revenue in the future.

Forward-Looking Statements

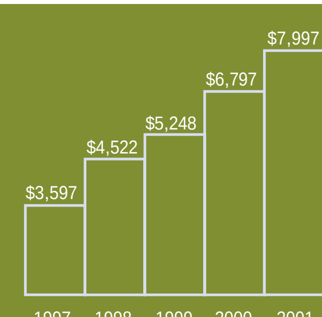
Certain statements contained in this Annual Report and other written and oral statements made from time to time by the Company do not relate strictly to historical or current facts. As such, they are considered "forward-looking statements" that provide current expectations or forecasts of future events. 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 the impact of the Motorola and Johnson & Johnson agreements. 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; and (vii) economic and other 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.

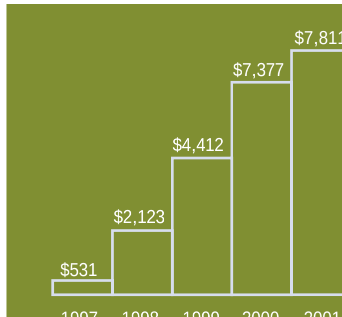
PhotoLink revenue
(in thousands)



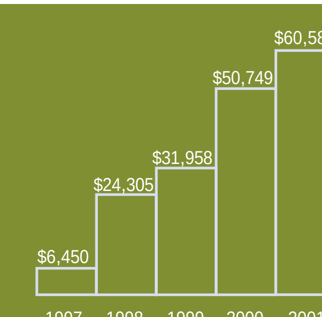
Operating margins



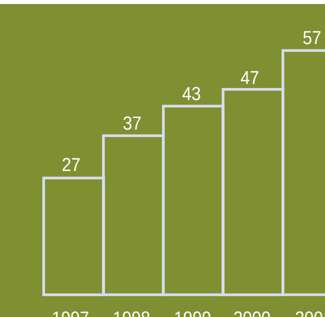
R&D expenditures
(in thousands)



Operating cash flow
(in thousands)



Total assets
(in thousands)



Number of coated products on the market *(as of September 30)*

Balance Sheets

As of September 30

(in thousands, except share data)

	2001	2000
Assets		
Current Assets		
Cash and cash equivalents	$ 9,044	$ 1,510
Short-term investments	5,796	15,847
Accounts receivable, net of allowance for doubtful accounts of $40	3,245	1,406
Inventories	724	500
Deferred tax asset	297	912
Prepaids and other	877	911
Total current assets	19,983	21,086
Property and Equipment, net	7,672	7,166
Long-Term Investments	29,565	22,293
Deferred Tax Asset	646	—
Other Assets, net	2,717	204
	$ 60,583	$ 50,749
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	$ 553	$ 379
Accrued liabilities—		
Compensation	874	1,110
Income taxes	356	—
Other	442	474
Deferred revenue	303	433
Total current liabilities	2,528	2,396
Deferred Revenue, less current portion	2,355	50
Total liabilities	4,883	2,446
Commitments and Contingencies (Note 6)		
Stockholders' Equity		
Series A preferred stock- $.05 par value, 450,000 shares authorized, no shares issued and outstanding	—	—
Common stock- $.05 par value, 45,000,000 shares authorized, 16,760,501 and 16,556,002 shares issued and outstanding	838	828
Additional paid-in capital	47,777	45,740
Unearned compensation	(376)	(289)
Stock purchase notes receivable	—	(7)
Accumulated other comprehensive income (loss)	275	(46)
Retained earnings	7,186	2,077
Total stockholders' equity	55,700	48,303
	$ 60,583	$ 50,749

The accompanying notes are an integral part of these balance sheets.

Statements of Income

For the years ended September 30

(in thousands, except net income per share)

	2001	2000	1999
Revenue			
Royalties	$ 11,034	$ 9,680	$ 6,670
License fees	1,794	1,470	645
Product sales	5,685	5,080	4,137
Research and development	4,180	2,049	2,042
Total revenue	22,693	18,279	13,494
Operating Costs and Expenses			
Product	2,440	1,903	1,511
Research and development	7,997	6,797	5,248
Sales and marketing	1,698	1,573	1,769
General and administrative	2,992	2,673	2,547
Total operating costs and expenses	15,127	12,946	11,075
Income from Operations	7,566	5,333	2,419
Other Income			
Investment income	2,354	1,418	1,069
Gain (loss) on sale of investments	701	(2)	89
Other income, net	3,055	1,416	1,158
Income Before Income Taxes	10,621	6,749	3,577
Income Tax Provision (Benefit)	3,807	2,509	(783)
Income Before Cumulative Effect of a Change in Accounting Principle	6,814	4,240	4,360
Cumulative Effect of a Change in Accounting Principle, Net of Tax	(1,705)	—	—
Net Income	$ 5,109	$ 4,240	$ 4,360
Basic net income per share before cumulative effect of a change in accounting principle	$ .41	$ .27	$ .30
Cumulative effect of a change in accounting principle	(.10)	—	—
Basic Net Income per Share	$ .31	$ .27	$ .30
Diluted net income per share before cumulative effect of a change in accounting principle	$ .38	$ .25	$ .27
Cumulative effect of a change in accounting principle	(.09)	—	—
Diluted Net Income per Share	$ .29	$ .25	$ .27
Weighted Average Shares Outstanding			
Basic	16,692	15,699	14,708
Dilutive effect of outstanding stock options	1,158	1,119	1,376
Diluted	17,850	16,818	16,084
Proforma Amounts Assuming the Accounting Change was Applied Retroactively			
Net income	$ 6,814	$ 3,669	$ 4,199
Basic net income per share	$ .41	$ .23	$ .29
Diluted net income per share	$ .38	$ .22	$ .26

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

Statements of Stockholders' Equity

For the years ended September 30, 2001, 2000 and 1999
(in thousands)

	Common Stock					Accumulated		
	Shares	Amount	Additional Paid-In Capital	Unearned Compensation	Stock Purchase Notes Receivable	Other Comprehensive Income (Loss)	Retained Earnings (Accumulated Deficit)	Total Stockholders' Equity
Balance, September 30, 1998	14,428	$ 721	$ 28,574	$ (170)	$ (182)	$ 278	$ (6,523)	$ 22,698
Components of comprehensive income, net of tax:								
Net income	—	—	—	—	—	—	4,360	4,360
Unrealized holding losses on available-for-sale securities arising during the period	—	—	—	—	—	(465)	—	(465)
Total comprehensive income								3,895
Common stock options exercised, net	966	48	1,286	—	—	—	—	1,334
Tax benefit from exercise of stock options	—	—	1,650	—	—	—	—	1,650
Restricted stock activity	17	1	170	(171)	—	—	—	—
Net loan activity	(7)	—	(56)	—	124	—	—	68
Amortization of unearned compensation	—	—	—	74	—	—	—	74
Balance, September 30, 1999	15,404	770	31,624	(267)	(58)	(187)	(2,163)	29,719
Components of comprehensive income, net of tax:								
Net income	—	—	—	—	—	—	4,240	4,240
Unrealized holding gains on available-for-sale securities arising during the period	—	—	—	—	—	141	—	141
Total comprehensive income								4,381
Issuance of common stock	794	40	12,960	—	—	—	—	13,000
Common stock options exercised, net	360	18	220	—	—	—	—	238
Tax benefit from exercise of stock options	—	—	818	—	—	—	—	818
Restricted stock activity	(2)	—	118	(118)	—	—	—	—
Net loan activity	—	—	—	—	51	—	—	51
Amortization of unearned compensation	—	—	—	96	—	—	—	96
Balance, September 30, 2000	16,556	828	45,740	(289)	(7)	(46)	2,077	48,303
Components of comprehensive income, net of tax:								
Net income	—	—	—	—	—	—	5,109	5,109
Unrealized holding gains on available-for-sale securities arising during the period	—	—	—	—	—	762	—	762
Less reclassification for gains included in net income	—	—	—	—	—	(441)	—	(441)
Total comprehensive income								5,430
Issuance of common stock	22	1	279	—	—	—	—	280
Common stock options exercised, net	177	9	168	—	—	—	—	177
Tax benefit from exercise of stock options	—	—	1,392	—	—	—	—	1,392
Restricted stock activity	6	—	198	(198)	—	—	—	—
Net loan activity	—	—	—	—	7	—	—	7
Amortization of unearned compensation	—	—	—	111	—	—	—	111
Balance, September 30, 2001	16,761	$ 838	$ 47,777	$ (376)	$ —	$ 275	$ 7,186	$ 55,700

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

Statements of Cash Flows

For the years ended September 30
(in thousands)

	2001	2000	1999
Operating Activities			
Net income	**$ 5,109**	$ 4,240	$ 4,360
Adjustments to reconcile net income to net cash provided by operating activities—			
Depreciation and amortization	**1,547**	1,126	709
Loss (gain) on sale of investments	**(701)**	2	(89)
Amortization of unearned compensation, net	**111**	96	74
Tax benefit from exercise of stock options	**1,392**	818	1,650
Deferred tax provision	**(31)**	1,553	(2,465)
Cumulative effect of a change in accounting principle, net of tax	**1,705**	—	—
Change in operating assets and liabilities:			
Accounts receivable	**(1,839)**	27	(377)
Inventories	**(224)**	(41)	(79)
Accounts payable and accrued liabilities	**(94)**	(8)	716
Accrued income taxes	**356**	—	—
Deferred revenue	**470**	215	(53)
Prepaids and other	**10**	(651)	(34)
Net cash provided by operating activities	**7,811**	7,377	4,412
Investing Activities			
Purchases of property and equipment, net	**(2,053)**	(2,994)	(4,721)
Purchases of available-for-sale investments	**(81,907)**	(52,862)	(24,436)
Sales/maturities of available-for-sale investments	**85,708**	34,725	23,972
Repayment of stock purchase notes receivable	**7**	51	68
Purchase of other assets	**(2,489)**	—	3
Net cash used in investing activities	**(734)**	(21,080)	(5,114)
Financing Activities			
Issuance of common stock, net	**457**	13,238	1,334
Net cash provided by financing activities	**457**	13,238	1,334
Net increase (decrease) in cash and cash equivalents	**7,534**	(465)	632
Cash and Cash Equivalents			
Beginning of year	**1,510**	1,975	1,343
End of year	**$ 9,044**	$ 1,510	$ 1,975
Supplemental Information			
Cash paid for taxes	**$ 1,232**	$ 67	$ 95

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

1. Description

SurModics, Inc. (the Company) develops, manufactures and markets innovative surface modification solutions to the medical device industry. The Company's revenue is derived from the following: fees from licensing its patented technology to customers; royalties received from licensees; the sale of photoreactive chemical compounds to licensees, stabilization products to the diagnostic industry and coated glass slides to the genomics market; 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 certain international markets.

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 and government agency obligations and mortgage-backed securities and are classified as available-for-sale as of September 30, 2001 and 2000. 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 were as follows *(in thousands)*:

2001

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government obligations	$ 11,210	$ 82	$ (5)	$ 11,287
Mortgage-backed securities	11,204	266	(5)	11,465
Municipal bonds	6,022	254	—	6,276
Corporate bonds	3,268	17	(220)	3,065
Asset-backed securities	3,221	52	(5)	3,268
Total	**$ 34,925**	**$ 671**	**$ (235)**	**$ 35,361**

2000

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government obligations	$ 14,039	$ 52	$ (74)	$ 14,017
Corporate bonds	9,095	2	(14)	9,083
Mortgage-backed securities	9,003	35	(33)	9,005
Asset-backed securities	3,598	10	(7)	3,601
Municipal bonds	2,451	3	(20)	2,434
Total	$ 38,186	$ 102	$ (148)	$ 38,140

The amortized cost and fair value of investments by contractual maturity at September 30, 2001, were as follows:

	Amortized Cost	Fair Value
Debt securities due within:		
One year	$ 6,010	$ 5,829
One to five years	22,488	22,989
Five years or more	6,427	6,543
Total	$ 34,925	$ 35,361

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 (in thousands):

	2001	2000
Raw materials	**$ 269**	$ 197
Finished products	**455**	303
Total	**$ 724**	$ 500

Property and Equipment

Property and equipment are stated at cost and are depreciated using the straight-line method over 3 to 20 years, the estimated useful lives of the assets. Upon completion, construction-in-progress will begin depreciation over the estimated useful lives of the assets. Property and equipment consisted of the following components as of September 30 (in thousands).

	2001	2000	Useful life (in years)
Laboratory fixtures and equipment	**$ 5,718**	$ 4,651	3 to 5
Office furniture and equipment	**2,401**	1,790	3 to 5
Building and improvements	**6,213**	5,811	5 to 20
Construction-in-progress	**—**	52	
Less-Accumulated depreciation and amortization	**(6,660)**	(5,138)	
Property and equipment, net	**$ 7,672**	$ 7,166	

Other Assets

Other assets consist principally of real property and patents. The real property represents land that was purchased in fiscal 2001 for approximately $2.5 million and is currently held for resale. The cost of the patents is amortized over 7 to 12 years. Accumulated amortization was $113,000 and $87,000 as of September 30, 2001 and 2000, respectively.

Impairment of Long-Lived Assets

The Company periodically evaluates whether events and circumstances have occurred which may affect the estimated useful life or the recoverability of the remaining balance of its long-lived assets. If such events or circumstances were to indicate that the carrying amount of these assets would not be recoverable, the Company would estimate the future cash flows expected to result from the use of the assets and their eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) were less that the carrying amount of the assets, the Company would recognize an impairment loss. No such impairment losses were required to be recorded in the years ended September 30, 2001, 2000, and 1999.

Revenue Recognition

Revenue on product sales is recognized as products are shipped. Revenue for research and development is recorded as performance progresses under the applicable contract. Royalties are recognized as third-party licensees report sales of the licensed product or as minimum royalties become due. Cash received prior to performance is recorded as deferred revenue in the accompanying balance sheets.

Historically, the Company recognized initial license fees as revenue upon receipt, after a license agreement transferring the technology was executed and all significant obligations had been performed. In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." SAB 101 required that license and other up-front fees be recognized over the term of the agreement unless the fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process.

Effective October 1, 2000, the Company adopted SAB 101. The Company now recognizes initial license fees over the term of the related agreement. As a result of adopting SAB 101, the Company recorded a cumulative effect of a change in accounting principle related to license fees recognized in prior years in the amount of $1,705,000, net of tax of $1,000,000, or $.09 per diluted share. Revenue related to performance milestones is recognized based on the achievement of the milestone, as defined in the respective agreements.

Prior period financial statements have not been restated to retroactively apply SAB 101; however, the pro forma amounts included in the statements of income show the net income and net income per share assuming the Company had retroactively applied SAB 101 to all prior periods.

Certain non-refundable license and research and development fees are recoverable by the licensees as offsets against a percentage of future earned royalties.

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 revenue and expenses during the reporting period. Estimates are used for such items as depreciable lives and uncollectible accounts. Ultimate results could differ from those estimates.

New Accounting Pronouncements

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS No. 141") and No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). SFAS 141 supercedes Accounting Principles Board ("APB") Opinion No. 16 and requires that all business combinations initiated after June 30, 2001 be accounted for by the purchase method. SFAS 141 also changes the requirements for recognizing intangible assets as assets apart from goodwill in business combinations accounted for by the purchase method for which the date of acquisition is July 1, 2001, or later. SFAS 142 addresses how intangible assets that are acquired individually or with a group of other assets (but not in a business combination) should be accounted for upon their acquisition. SurModics will adopt SFAS 141 and 142 on October 1, 2002, and management expects no material impact on its financial statements.

3. Stockholders' Equity

Employee Stock Purchase Plan

Under the 1999 Employee Stock Purchase Plan ("Stock Purchase Plan") the Company is authorized to issue up to 200,000 shares of Common Stock. All full-time and part-time employees can choose to have up to 10% of their annual compensation withheld to purchase the Company's Common Stock at purchase prices defined within the provisions of the Stock Purchase Plan. The Company issued 21,764 shares under the Stock Purchase Plan during fiscal 2001, the first full year of the Plan. As of September 30, 2001, there was approximately $209,000 of employee contributions included in accrued liabilities in the accompanying balance sheets.

Restricted Stock Awards

The Company has entered into restricted stock agreements with certain key employees, covering the issuance of Common Stock ("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 income over the five-year term. Transactions in restricted stock were as follows:

Outstanding at September 30, 1998	128,000
Granted	25,000
Canceled	(8,000)
Outstanding at September 30, 1999	145,000
Granted	11,000
Canceled	(12,500)
Exercised	(48,000)
Outstanding at September 30, 2000	95,500
Granted	5,500
Outstanding at September 30, 2001	**101,000**

Stock Purchase Notes Receivable

The Company established a loan program during fiscal 1997 to assist employees in purchasing shares of the Company's Common Stock. The loans were collateralized by the employees' purchased shares and required annual interest payments at a rate equal to prime at the date of issuance. All loans have been repaid in full. This program has been discontinued, with no additional loans granted since fiscal 1997.

4. Stock-based Compensation Plan

Under the Company's 1997 Incentive Stock Option Plan (the Plan), 1.2 million shares of Common Stock were reserved for issuance to employees and officers. The Plan requires that the option price per share must be at least 100% of the fair market value of the Common Stock on the date of the grant or 110% with respect to optionees who own more than 10% of the total combined voting power of all classes of stock. 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 112,800 shares remain outstanding from the Company's 1987 Incentive Stock Option Plan that was replaced by the 1997 Plan.

Under the Company's Nonqualified Stock Option Plan, 1,944,480 shares of Common Stock were reserved for issuance to outside directors, employees and officers. The options are granted at fair market value. Options expire in 5 to 10 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, 2001, there were 596,850 additional shares available for grant under the stock plans. Information regarding stock options under all plans is summarized as follows:

	2001		2000		1999	
Options	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding,						
beginning of year	**1,565,560**	**$ 7.45**	1,748,580	$ 3.76	2,539,280	$ 2.43
Granted	**16,550**	**42.29**	267,800	23.96	367,400	7.87
Exercised	**(191,510)**	**3.26**	(417,720)	2.56	(1,082,060)	2.08
Canceled	**(7,340)**	**15.50**	(33,100)	4.83	(76,040)	2.91
Outstanding,						
end of year	**1,383,260**	**$ 8.41**	1,565,560	$ 7.45	1,748,580	$ 3.76
Exercisable,						
end of year	**851,190**	**$ 4.80**	727,280	$ 3.19	878,820	$ 2.59
Weighted average						
fair value of						
options granted	**$ 31.11**		$ 16.92		$ 5.73	

The options outstanding at September 30, 2001 have exercise prices ranging between $2.50 and $53.00, with a weighted average exercise price of $8.41 and a weighted average remaining contractual life of 3.21 years.

The fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 2001, 2000 and 1999, respectively: risk-free interest rates of 4.51%, 5.95% and 6.01%; expected lives of 7.0, 7.2 and 7.3; and expected volatility of 77%, 72% and 71%.

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 would have been the following pro forma amounts for the years ended September 30 (in thousands, except per share data):

	2001	2000	1999
Net income:			
As reported	**$ 5,109**	$ 4,240	$ 4,360
Pro forma	**$ 3,496**	$ 3,565	$ 4,120
Diluted net income per share:			
As reported	**$ .29**	$ .25	$ .27
Pro forma	**$ .20**	$ .21	$ .26

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.

5. Income Taxes

The Company utilizes the liability method to account for income taxes. 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.

The deferred income tax provision (benefit) reflects the net change during the year in deferred tax assets and liabilities. Income taxes in the accompanying statements of income for the years ended September 30 were as follows (in thousands):

	2001	2000	1999
Current provision:			
Federal	**$ 2,672**	$ 904	$ —
State and foreign	**362**	77	17
Total current provision	**3,034**	981	17
Deferred provision:			
Federal	**832**	1,528	(735)
State	**(59)**	—	(65)
Total deferred provision (benefit)	**773**	1,528	(800)
Total provision (benefit)	**$ 3,807**	$ 2,509	$ (783)

The reconciliation of the difference between amounts calculated at the statutory federal tax rate of 34% and the Company's effective tax rate was as follows (in thousands):

	2001	2000	1999
Amount at statutory federal income tax rate	**$ 3,605**	$ 2,500	$ 1,323
Change due to:			
Reversal of tax valuation allowance	**(161)**	—	(2,466)
State taxes	**201**	—	—
Rate difference for deferred tax assets	**—**	—	180
Other	**162**	9	180
Income tax provision (benefit)	**$ 3,807**	$ 2,509	$ (783)

The components of deferred income taxes consisted of the following as of September 30 and result from differences in the recognition of transactions for income tax and financial reporting purposes (in thousands):

	2001	2000
Depreciation	**$ 455**	$ 319
Deferred revenue	**996**	129
Accruals and reserves	**297**	297
Net operating loss carryforwards	**—**	167
Capital loss carryforwards	**—**	149
Equity items	**(169)**	—
Other	**(636)**	—
Total deferred tax assets	**943**	1,061
Less- valuation allowance	**—**	(149)
Net deferred tax assets	**943**	912
Current deferred tax assets	**297**	—
Noncurrent deferred tax assets	**$ 646**	$ 912

6. Commitments and Contingencies

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.

The Company entered into an agreement to purchase a 135,000-square-foot laboratory facility on 27 acres of land in Bloomington, Minnesota, for $7.1 million. The purchase was completed in October 2001. It is the Company's intent to transfer its operations into the facility towards the end of 2002.

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 matches 50% of each dollar of the first 6% of the tax deferral elected by each employee. Company contributions totaling $166,000, $138,000 and $122,000 have been charged to income for the years ended September 30, 2001, 2000 and 1999, respectively.

8. Operating Segments *(Dollars in thousands)*

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

The Company manages its business on the basis of three business segments: licensing, manufacturing, and research and development. The licensing segment includes all license fees and royalty revenue generated from the transfer of the Company's technology. No expenses are allocated to the licensing segment. The manufacturing segment includes revenue from the sale of PhotoLink reagents, stabilization products and DNA slides. The expenses include all production costs, including analytical costs to verify quality of the finished products and certain technical support. The research and development segment includes the revenue generated from development projects for commercial customers and research revenue received from government grants. The expenses include all costs of the Company's technical personnel. Corporate includes all administrative, sales and marketing costs of the Company. These costs, along with interest income and income taxes, are not allocated to the other business segments. The Company's assets are not reviewed by business segment. The accounting policies for segment reporting are the same as for the Company as a whole (see Note 2).

	Licensing	Manufacturing	Research & Development	Corporate	Consolidated
Year Ended September 30, 2001					
Revenue:					
PhotoLink	$ 9,575	$ 2,638	$ 3,648	$ —	$ 15,861
Diagnostic	3,253	—	—	—	3,253
Stabilization & other	—	3,047	—	—	3,047
Government	—	—	532	—	532
Total revenue	12,828	5,685	4,180	—	22,693
Operating expenses	—	2,440	7,997	4,690	15,127
Operating income (loss)	12,828	3,245	(3,817)	(4,690)	7,566
Other income				3,055	3,055
Income tax provision				(3,807)	(3,807)
Income before cumulative effect of a change in accounting principle					$ 6,814
Year Ended September 30, 2000					
Revenue:					
PhotoLink	$ 8,233	$ 2,393	$ 1,445	$ —	$ 12,071
Diagnostic	2,917	—	—	—	2,917
Stabilization & other	—	2,687	—	—	2,687
Government	—	—	604	—	604
Total revenue	11,150	5,080	2,049	—	18,279
Operating expenses	—	1,903	6,797	4,246	12,946
Operating income (loss)	11,150	3,177	(4,748)	(4,246)	5,333
Other income				1,416	1,416
Income tax provision				(2,509)	(2,509)
Net income					$ 4,240
Year Ended September 30, 1999					
Revenue:					
PhotoLink	$ 4,557	$ 1,876	$ 1,122	$ —	$ 7,555
Diagnostic	2,758	—	—	—	2,758
Stabilization & other	—	2,261	—	—	2,261
Government	—	—	920	—	920
Total revenue	7,315	4,137	2,042	—	13,494
Operating expenses	—	1,511	5,248	4,316	11,075
Operating income (loss)	7,315	2,626	(3,206)	(4,316)	2,419
Other income				1,158	1,158
Income tax benefit				783	783
Net income					$ 4,360

Major Customers

Revenue from customers that exceed 10% of total revenue was as follows for the years ended September 30:

	2001	2000	1999
Company A	**19%**	20%	20%
Company B	**16%**	24%	12%
Company C	**16%**	9%	7%
Company D	**15%**	7%	—

The revenue from each of the customers is derived from all three business segments.

Geographic Revenue

Geographic revenue was as follows for the years ended September 30:

	2001	2000	1999
Domestic	**89%**	89%	87%
Foreign	**11%**	11%	13%

9. Quarterly Financial Data

The following is a summary of the unaudited quarterly results for the years ended September 30, 2001 and 2000 (in thousands, except per share data). The results for 2001 reflect the Company's adoption of SAB 101 in the fourth quarter of 2001 (see Note 2). The effect of the change on results previously reported for the first three quarters of 2001 are presented below. The pro forma effect assuming retroactive treatment of SAB 101 on each quarter of 2000 is also presented.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Fiscal 2001				
Revenue	$ 4,757	$ 5,443	$ 5,675	$ 6,818
Income from operations	1,256	1,698	1,884	2,728
Net income (loss)	(380)	1,610	1,675	2,204
Net income (loss) per share:				
Basic	(.02)	.10	.10	.13
Diluted	(.02)	.09	.09	.12
Net income originally reported	1,366	1,566	1,618	
Cumulative effect to September 30, 2000	(1,705)	—	—	
Effect of change	(41)	44	57	
Net income (loss) as restated	(380)	1,610	1,675	
Diluted net income per share originally reported	.08	.09	.09	
Cumulative effect to September 30, 2000	(.10)	—	—	
Effect of change	—	—	—	
Diluted net income per share as restated	(.02)	.09	.09	
Fiscal 2000				
Revenue	$ 4,149	$ 4,441	$ 4,165	$ 5,524
Income from operations	1,206	1,151	1,039	1,937
Net income	944	904	861	1,531
Net income per share:				
Basic	.06	.06	.06	.10
Diluted	.06	.05	.05	.09
Pro forma to reflect SAB 101:				
Net income	995	848	868	958
Diluted net income per share	.06	.05	.05	.06

Report of Independent Public Accounts

To SurModics, Inc.:

We have audited the accompanying balance sheets of SurModics, Inc. (a Minnesota corporation) as of September 30, 2001 and 2000, and the related statements of income, stockholders' equity and cash flows for each of the three years in the period ended September 30, 2001. 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 auditing standards generally accepted in the United States. 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, 2001 and 2000, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2001 in conformity with accounting principles generally accepted in the United States.

As explained in Note 2 to the financial statements, effective October 1, 2000, the Company changed its method of accounting for revenue recognition of license fees.

Arthur Andersen LLP

Minneapolis, Minnesota,
October 23, 2001

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

Dale R. Olseth
Chairman and Chief Executive Officer

Stephen C. Hathaway
Vice President and Chief Financial Officer

SurModics, Inc. Corporate Information

Board of Directors

Dale R. Olseth
Chairman and Chief Executive Officer
SurModics, Inc.

Donald S. Fredrickson, M.D. [1]
President and Chief Executive Officer
D.S. Fredrickson Associates, Inc.

James J. Grierson [2]
Retired Vice President of Business Development
Honeywell, Inc.

Patrick E. Guire, Ph.D.
Senior Vice President and Chief Scientific Officer
SurModics, Inc.

Kenneth H. Keller, Ph.D. [1, 2]
Professor of Science and Technology Policy
Hubert H. Humphrey Institute of Public Affairs
University of Minnesota

David A. Koch [1, 2]
Chairman of the Board
Graco Inc.

Kendrick B. Melrose [1, 2]
Chairman of the Board and Chief Executive Officer
The Toro Company

John A. Meslow [1]
Retired Corporate Senior Vice President
Medtronic, Inc.

[1] Member of the Compensation Committee
[2] Member of the Audit Committee

Officers

Dale R. Olseth
Chairman and Chief Executive Officer

James C. Powell
President and Chief Operating Officer

Richard C. Carlson
Vice President of Marketing and Sales

Walter H. Diers, Jr.
Vice President of Corporate Development

Lise W. Duran, Ph.D.
Vice President of Product Development

Patrick E. Guire, Ph.D.
Senior Vice President and Chief Scientific Officer

Stephen C. Hathaway
Vice President and Chief Financial Officer

Marie J. Versen
Vice President of Quality Management
and Regulatory Compliance

Headquarters

SurModics, Inc.
9924 West 74th Street
Eden Prairie, Minnesota 55344-3523
(952) 829-2700
(952) 829-2743 fax
www.surmodics.com

Transfer Agent

Firstar Bank
1555 North RiverCenter Drive, Suite 301
Milwaukee, Wisconsin 53212
(800) 637-7549

Legal Counsel

Fredrikson & Byron, P.A., Minneapolis, Minnesota

Independent Public Accountants

Arthur Andersen LLP, Minneapolis, Minnesota

Investor Relations Counsel

Padilla Speer Beardsley Inc., Minneapolis, Minnesota

Annual Meeting

The annual meeting of SurModics, Inc. shareholders will take place on Monday, January 28, 2002, beginning at 4:00 p.m. at the Hotel Sofitel in Bloomington, Minnesota.

Information Requests

Shareholders, securities analysts and investors seeking additional information about the Company should contact Stephen C. Hathaway, Vice President and Chief Financial Officer, at (952) 829-2700.

Requests for copies of news releases describing significant company events, quarterly financial results and Form 10-K and Form 10-Q Reports as filed with the Securities and Exchange Commission may be obtained from Investor Relations at the Company's principal address.

You may also learn more about SurModics at our Web site: www.surmodics.com.

Stock Listing and Price History

SurModics' stock is traded on the Nasdaq National Market under the symbol "SRDX." The table below sets forth the range of high and low closing sale prices for the Company's Common Stock, as reported by Nasdaq, since the date of the Company's initial public offering in March 1998.

According to the records of the Company's transfer agent, as of November 26, 2001, the Company had 262 holders of record of the Company's Common Stock and approximately 5,000 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.

Stock Price History by Quarter

Share prices have been retroactively restated to reflect the 2-for-1 stock split effected on December 6, 2000.

SurModics, Inc.
9924 West 74th Street
Eden Prairie, Minnesota 55344-3523
(952) 829-2700
(952) 829-2743 Fax
www.surmodics.com