

MENTOR CORP /MN/  
Form 10-Q  
February 14, 2003

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended December 31, 2002

or

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

For the transition period from \_\_\_\_ to \_\_\_\_

Commission File No. 0-7955

**MENTOR CORPORATION**

(Exact Name of Registrant as Specified in its Charter)

Minnesota

(State or other jurisdiction of  
incorporation or organization)

201 Mentor Drive, Santa Barbara, California 93111  
(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number including area code: 805/879-6000

41-0950791

(IRS Employer Identification  
No.)

Securities registered pursuant to Section 12(b) of the Act: NONE

Securities registered pursuant to Section 12(g) of the Act:

Common Shares, par value \$.10 per share

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

Edgar Filing: MENTOR CORP /MN/ - Form 10-Q

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of February 13, 2003 there were approximately 46,362,868 Common Shares outstanding.

---

**MENTOR CORPORATION**

**INDEX**

Part I. Financial Information

- Item 1. Consolidated Financial Statements (unaudited)
- Consolidated Balance Sheets - December 31, 2002 and March 31, 2002
- Consolidated Statements of Income - Three Months Ended December 31, 2002 and 2001
- Consolidated Statements of Income - Nine Months Ended December 31, 2002 and 2001
- Condensed Consolidated Statements of Cash Flows - Nine Months Ended December 31, 2002 and 2001
- Notes to Condensed Consolidated Financial Statements - December 31, 2002
- Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition
- Item 3. Quantitative and Qualitative Disclosures About Market Risk

Part II. Other Information

- Item 1. Legal Proceedings
- Item 2. Changes in Securities
- Item 3. Defaults upon Senior Securities
- Item 4. Submission of Matters to a Vote of Security Holders
- Item 5. Other Information
- Item 6. Exhibits and Reports on Form 8-K

Signatures

List of Exhibits

- 99.1 CEO Certification Pursuant To 18 U.S.C. Section 1350,  
As Adopted Pursuant To Section 906 Of The Sarbanes-Oxley Act Of 2002
- 99.2 CFO Certification Pursuant To 18 U.S.C. Section 1350,  
As Adopted Pursuant To Section 906 Of The Sarbanes-Oxley Act Of 2002

**PART I - FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements**

Mentor Corporation  
Consolidated Balance Sheets  
(Unaudited)

| (in thousands)                                  | December 31, 2002 | March 31,<br>2002 |
|---|-------------------|-------------------|
| <b><u>Assets</u></b>                            |                   |                   |
| Current assets:                                 |                   |                   |
| Cash and cash equivalents                       | \$ 77,740         | \$ 60,398         |
| Marketable securities                           | 8,005             | 14,106            |
|   | <b>66,255</b>     | <b>64,786</b>     |
| Accounts receivable, net                        |                   |                   |
| Inventories                                     | 59,967            | 47,404            |
| Deferred income taxes                           | 13,946            | 11,950            |
| Prepaid expenses and other                      | 10,350            | 12,488            |
| Total current assets                            | <b>236,263</b>    | <b>211,132</b>    |
| Property and equipment, net                     | 64,732            | 54,656            |
| Intangible assets, net                          | 36,158            | 37,588            |
| Goodwill, net                                   | 14,718            | 9,155             |
| Long-term marketable securities and investments | 12,784            | 11,752            |
| Other assets                                    | 266               | 353               |
|   | <b>\$ 364,921</b> | <b>\$ 324,636</b> |

See notes to condensed consolidated financial statements.

Page 3

Mentor Corporation  
Consolidated Balance Sheets  
(Unaudited)

| (in thousands)   | December 31, 2002 | March 31, 2002 |
|--|-------------------|----------------|
| <b><u>Liabilities and shareholders' equity</u></b>                                     |                   |                |
| Current liabilities:   |                   |                |
| Accounts payable   | \$ 15,017         | \$ 17,558      |
| Warranty and related reserves  | 18,901            | 16,252         |
| Accrued compensation   | 15,611            | 15,129         |
| Short-term bank borrowings   | 7,919             | 9,470          |
| Sales returns  | 9,209             | 7,806          |
| Income taxes payable   | -                 | 3,979          |
| Current portion of purchase price related to<br>acquired technologies and acquisitions | 4,675             | 4,675          |
| Dividends payable  | 927               | 704            |
| Accrued royalties  | 687               | 637            |
| Other  | 12,620            | 8,366          |
| Total current liabilities  | 85,566            | 84,576         |
| Deferred income taxes  | 2,034             | 3,009          |
| Long-term accrued liabilities  | 14,996            | 12,873         |
| Commitments and contingencies  |                   |                |
| Shareholders' equity:  |                   |                |
| Common Stock, \$.10 par value:   |                   |                |
| Authorized - 150,000,000 shares; Issued and<br>outstanding-                            |                   |                |
| 46,342,032 shares at December 31, 2002;  |                   |                |
| 46,945,904 shares at March 31, 2002;   | 4,634             | 4,695          |
| Capital in excess of par value   | -                 | -              |
| Foreign currency translation adjustments   | 4,113             | (6,926)        |
| Net unrealized gains (losses) on securities  | (1,318)           | 439            |
| Retained earnings  | 254,896           | 225,970        |
|  | 262,325           | 224,178        |
|  | \$ 364,921        | \$ 324,636     |

See notes to condensed consolidated financial statements.

















Mentor Corporation  
 Consolidated Statements of Income  
 Three Months Ended December 31, 2002 and 2001  
 (Unaudited)

| (in thousands, except per share data) | Three Months Ended<br>December 31, |           |
|---------------------------------------|------------------------------------|-----------|
|                                       | <b>2002</b>                        | 2001      |
| Net sales                             | \$ <b>94,039</b>                   | \$ 78,975 |
| Costs and expenses:                   |                                    |           |
| Cost of sales                         | <b>38,167</b>                      | 32,105    |
| Selling, general, and administrative  | <b>32,194</b>                      | 27,304    |
| Research and development              | <b>5,799</b>                       | 4,779     |
|                                       | <b>76,160</b>                      | 64,188    |
| Operating income                      | <b>17,879</b>                      | 14,787    |
| Interest expense                      | <b>(245)</b>                       | (152)     |
| Interest income                       | <b>599</b>                         | 565       |
| Other income (expense), net           | <b>526</b>                         | (826)     |
| Income before income taxes            | <b>18,759</b>                      | 14,374    |
| Income taxes                          | <b>5,777</b>                       | 4,557     |
| Net income                            | \$ <b>12,982</b>                   | \$ 9,817  |
| Basic earnings per share              | \$ <b>0.28</b>                     | \$ 0.21   |
| Diluted earnings per share            | \$ <b>0.27</b>                     | \$ 0.20   |

See notes to condensed consolidated financial statements.

Page 5

















Mentor Corporation  
 Consolidated Statements of Income  
 Nine Months Ended December 31, 2002 and 2001  
 (Unaudited)

| (in thousands, except per share data) | Nine Months Ended<br>December 31, |            |
|---------------------------------------|-----------------------------------|------------|
|                                       | <b>2002</b>                       | 2001       |
| Net sales                             | <b>\$ 281,302</b>                 | \$ 234,466 |
| Costs and expenses:                   |                                   |            |
| Cost of sales                         | <b>114,081</b>                    | 96,454     |
| Selling, general, and administrative  | <b>94,236</b>                     | 81,049     |
| Research and development              | <b>16,538</b>                     | 16,021     |
|                                       | <b>224,855</b>                    | 193,524    |
| Operating income                      | <b>56,447</b>                     | 40,942     |
| Interest expense                      | <b>(782)</b>                      | (659)      |
| Interest income                       | <b>1,831</b>                      | 1,866      |
| Other income, net                     | <b>1,731</b>                      | (230)      |
| Income before income taxes            | <b>59,227</b>                     | 41,919     |
| Income taxes                          | <b>16,990</b>                     | 13,323     |
| Net income                            | <b>\$ 42,237</b>                  | \$ 28,596  |
| Basic earnings per share              | <b>\$ 0.90</b>                    | \$ 0.60    |
| Diluted earnings per share            | <b>\$ 0.87</b>                    | \$ 0.58    |

See notes to condensed consolidated financial statements.

Page 6

















Mentor Corporation  
Consolidated Statements of Cash Flows  
Nine Months Ended December 31, 2002 and 2001  
(Unaudited)

| (in thousands)   | 2002      | 2001      |
|--|-----------|-----------|
| <b><u>Cash From Operating Activities:</u></b>                  |           |           |
| Net income   | \$ 42,237 | \$ 28,596 |
| Adjustments to derive cash flows from operating activities:    |           |           |
| Depreciation   | 8,884     | 7,330     |
| Amortization   | 2,915     | 2,846     |
| Deferred income taxes  | (2,481)   | 689       |
| Tax benefit from exercise of stock options                     | 2,567     | 2,193     |
| Loss (gain) on sale of assets                                  | (413)     | 379       |
| Imputed interest on long-term liabilities                      | 457       | 351       |
| (Gain) loss on long-term marketable securities                 | (403)     | 1,021     |
| Foreign currency transaction (gain) loss                       | (247)     | 83        |
| Changes in operating assets and liabilities:                   |           |           |
| Accounts receivable  | 2,275     | 308       |
| Inventories and other current assets                           | (3,275)   | (2,291)   |
| Accounts payable and accrued liabilities                       | 6,489     | 9,763     |
| Income taxes payable   | (4,006)   | 27        |
| Net cash provided by operating activities                      | 54,999    | 51,295    |
| <b><u>Cash From Investing Activities:</u></b>                  |           |           |
| Purchases of property and equipment                            | (11,960)  | (11,455)  |
| Purchases of intangibles                                       | (808)     | (4,297)   |
| Purchases of marketable securities                             | (3,215)   | (1,192)   |
| Sales of marketable securities                                 | 6,277     | (8,914)   |
| Acquisitions, net of cash acquired                             | (10,603)  | -         |
| Proceeds from sale of property, equipment and intangibles      | 500       | 11        |
| Other, net   | -         | 6         |
| Net cash used for investing activities                         | (19,809)  | (25,841)  |
| <b><u>Cash From Financing Activities:</u></b>                  |           |           |
| Repurchase of common stock                                     | (19,997)  | (18,715)  |
| Proceeds from exercise of stock options                        | 6,358     | 3,173     |
| Dividends paid   | (2,110)   | (2,125)   |
| Borrowings (repayments) under line of credit agreements, net   | (3,316)   | (8,975)   |
| Net cash used for financing activities                         | (19,065)  | (26,642)  |
| Effect of currency exchange rates on cash and cash equivalents | 1,217     | (60)      |
| Increase (decrease) in cash and cash equivalents               | 17,342    | (1,248)   |
| Cash and cash equivalents at beginning of year                 | 60,398    | 63,854    |
| Cash and cash equivalents at end of period                     | \$ 77,740 | \$ 62,606 |

---

**MENTOR CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2002**

**Note A - Business Activity**

Mentor Corporation, (the "Company"), was incorporated in April 1969. The Company develops, manufactures and markets a broad range of products for medical specialties in three reportable segments: aesthetic and general surgery, surgical urology, and clinical and consumer healthcare. Aesthetic and general surgery products include surgically implantable prostheses for plastic and reconstructive surgery and capital equipment used for liposuction. Surgical urology products include surgically implantable prostheses for the treatment of impotence and brachytherapy seeds for the treatment of prostate cancer. Clinical and consumer healthcare products include catheters and other products for the management of urinary incontinence and retention. The Company's products are sold to hospitals, physicians and through various health care dealers, wholesalers, distributors and retail outlets by multiple sales forces.

**Note B - Summary of Significant Accounting Policies**

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and all of its subsidiaries in which a controlling interest is maintained. For those subsidiaries where the Company owns less than 100%, the outside shareholders' interests are treated as minority interests. All intercompany accounts and transactions have been eliminated. Certain prior year amounts in previously issued financial statements have been reclassified to conform to the current year presentation.

**Use of Estimates**

Financial statements prepared in accordance with accounting principles generally accepted in the United States require management to make estimates and judgments that affect amounts and disclosures reported in the financial statements. Actual results could differ from those estimates.

**Stock Split**

On December 13, 2002 the Board of Directors authorized a two-for-one stock split in the form of a 100% stock dividend to be distributed on or about January 17, 2003 to shareholders of record on December 31, 2002. All references in the financial statements to the number of shares and per share amounts have been retroactively restated to reflect the increased number of common shares outstanding.

**Effects of Recent Accounting Pronouncements**

In June 2001, The Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting, and broadens the criteria for recording intangible assets apart from goodwill. Under SFAS No. 142, goodwill and intangible assets that have indefinite useful lives will no longer be amortized but will be tested at least annually for impairment. Intangible assets with finite useful lives will continue to be amortized over their useful lives. Other intangible assets, except those with indefinite lives, will continue to be amortized over their useful lives. The goodwill test for impairment consists of a two-step process that begins with an estimation of the fair value of the reporting unit. The first step of the test is a screen for potential impairment and the second step measures the amount of impairment, if any. SFAS No. 142 requires an entity to complete the first step of the transitional goodwill

impairment test within six months of adopting the statement. The Company adopted SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets" on April 1, 2002. The absence of goodwill amortization as a result of adopting SFAS No. 142 is expected to result in an increase in pretax income of approximately \$730,000 (\$0.02 per diluted share) in fiscal 2003. The required initial assessment for impairment indicators has been completed and there was no indication that goodwill was impaired.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of." SFAS No. 144 retained substantially all of the requirements of SFAS No. 121 while resolving certain implementation issues. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. Adoption of SFAS No. 144 in the first quarter of fiscal 2003 had no impact on the Company's consolidated results of operations or financial position.

In July 2002, FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This statement requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Statement 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. Management does not expect that adoption of this standard will have a material effect on the Company's consolidated results of operations or financial position.

On December 31, 2002, the Financial Accounting Standards Board issued FASB Statement No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*. Statement 148 amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition to Statement 123's fair value method of accounting for stock-based employee compensation. Statement 148 also amends the disclosure provisions of Statement 123 and APB Opinion No. 28, *Interim Financial Reporting*, to require disclosure in the summary of significant accounting policies of the effects of an entity's accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. While the Statement does not amend Statement 123 to require companies to account for employee stock options using the fair value method, the disclosure provisions of Statement 148 are applicable to all companies with stock-based employee compensation, regardless of whether they account for that compensation using the fair value method of Statement 123 or the intrinsic value method of Opinion 25. Statement No. 148 is effective for fiscal years ending after December 15, 2002. The Company will continue to account for stock-based employee compensation under the intrinsic value method of Opinion 25 but will adopt the disclosure provisions of Statement No. 148 in the fourth quarter of fiscal 2003. Management does not expect that adoption of this standard will have a material effect on the Company's consolidated results of operations or financial position.

### Note C - Interim Reporting

The Company's three quarterly interim reporting periods are each thirteen-week periods ending on the Friday nearest the end of the third calendar month of each calendar quarter. The fiscal year end remains March 31<sup>st</sup>. To facilitate ease of presentation, each interim period is shown as if it ended on the last day of the appropriate calendar month. The actual dates for each of the three interim quarter-ends are shown below:

|                | <u>Fiscal 2003</u> | <u>Fiscal 2002</u> |
|----------------|--------------------|--------------------|
| First Quarter  | June 28, 2002      | June 29, 2001      |
| Second Quarter | September 27, 2002 | September 28, 2001 |
| Third Quarter  | December 27, 2002  | December 28, 2001  |

The accompanying unaudited condensed consolidated financial statements for the three and nine-month periods ended December 31, 2002 and 2001 have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals, unless otherwise indicated) considered necessary for a fair presentation of the results of operations for the indicated periods have been included. Certain amounts recorded in previous periods have been reclassified to conform to the current period presentation. Operating results for the nine months ended December 31, 2002 are not necessarily indicative of the results for the full fiscal year.



The balance sheet at March 31, 2002 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

The condensed consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended March 31, 2002.

**Note D - Cash Equivalents, Marketable Securities, and Long-Term Marketable Securities and Investments**

All highly liquid investments with original maturities of three months or less at the date of purchase are considered to be cash equivalents.

The Company considers its marketable securities available-for-sale as defined in Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Realized gains and losses and declines in value considered to be other than temporary are included in income. The cost of securities sold is based on the specific identification method. For short-term marketable securities, there were no material realized or unrealized gains or losses nor any material differences between estimated fair values (based on quoted market prices) and the costs of securities in the investment portfolio as of December 31, 2002 and March 31, 2002. Short-term investments, except auction rate securities, mature between three months and one year from the purchase date. The Company's short-term marketable securities consist primarily of U.S., state and municipal government obligations, auction rate securities, and investment grade corporate obligations including commercial paper. Auction rate securities carry interest or dividend rates that reset every 28 days but have contractual maturities of greater than one year. The Company's long-term marketable securities and investments include investments in Federal Home Loan Bank and Mortgage Association bonds (FHLA bonds) with maturities of two to four years.

Available-for-sale investments at December 31, 2002 were as follows:

| (in thousands)   | Adjusted<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|------------------|------------------------------|-------------------------------|----------------------------|
| <b>Cash balances</b>   | \$ 15,953        | \$ -                         | \$ -                          | \$ 15,953                  |
| <b>Bank time deposits</b>  | -                | -                            | -                             | -                          |
| <b>Money market mutual funds</b>                                   | 61,787           | -                            | -                             | 61,787                     |
| <b>Marketable equity securities</b>                                | 2,393            | -                            | (2,049)                       | 344                        |
| <b>U.S., State and Municipal agency obligations</b>                | 20,143           | 23                           | -                             | 20,166                     |
| <b>Corporate debt securities</b>                                   | 279              | -                            | -                             | 279                        |
| <b>Total available-for-sale investments</b>                        | \$ 100,555       | \$ 23                        | \$(2,049)                     | \$ 98,529                  |
| <b>Included in cash and cash equivalents</b>                       | \$ 77,740        | \$ -                         | \$ -                          | \$ 77,740                  |
| <b>Included in current marketable securities</b>                   | 8,005            | -                            | -                             | 8,005                      |
| <b>Included in long-term marketable securities and investments</b> | 14,810           | 23                           | (2,049)                       | 12,784                     |
| <b>Total available-for-sale investments</b>                        | \$ 100,555       | \$ 23                        | \$(2,049)                     | \$ 98,529                  |

Available-for-sale investments at March 31, 2002 were as follows:

| (in thousands)                                      | Adjusted<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|------------------|------------------------------|-------------------------------|----------------------------|
| <b>Cash balances</b>                                | \$11,417         | \$ -                         | \$ -                          | \$11,417                   |
| <b>Bank time deposits</b>                           | 1,175            | -                            | -                             | 1,175                      |
| <b>Money market mutual funds</b>                    | 48,981           | -                            | -                             | 48,981                     |
| <b>Marketable equity securities</b>                 | 2,076            | 774                          | -                             | 2,850                      |
| <b>U.S., State and Municipal agency obligations</b> | 21,653           | -                            | (98)                          | 21,555                     |
| <b>Corporate debt securities</b>                    | 278              | -                            | -                             | 278                        |
| <b>Total available-for-sale investments</b>         | \$85,580         | \$774                        | \$(98)                        | \$86,256                   |

Edgar Filing: MENTOR CORP /MN/ - Form 10-Q

|   |          |       |        |          |
|---|----------|-------|--------|----------|
| Included in cash and cash equivalents                       | \$60,398 | \$ -  | \$ -   | \$60,398 |
| Included in current marketable securities                   | 14,106   | -     | -      | 14,106   |
| Included in long-term marketable securities and investments | 11,076   | 774   | (98)   | 11,752   |
| Total available-for-sale investments                        | \$85,580 | \$774 | \$(98) | \$86,256 |

Page 10

**Note E - Inventories**

Inventories are stated at the lower of cost or market, cost determined by the first-in, first-out (FIFO) method. The Company writes down its inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions.

Inventories at December 31, 2002 and March 31, 2002 consisted of:

| (in thousands)  | <b>December 31,</b> | March 31, |
|-----------------|---------------------|-----------|
| Raw materials   | <b>\$ 14,042</b>    | \$ 10,194 |
| Work in process | <b>10,513</b>       | 9,908     |
| Finished goods  | <b>35,412</b>       | 27,302    |
|                 | <b>\$ 59,967</b>    | \$ 47,404 |

**Note F - Property and Equipment**

Property and equipment is stated at cost. Depreciation is based on the useful lives of the properties and computed using the straight-line method. Buildings are depreciated over 30 years, furniture and equipment over 3 to 10 years and leasehold improvements over the shorter of their estimated remaining lives or lease term. Significant improvements and betterments are capitalized while maintenance and repairs are charged to operations as incurred.

Property and equipment at December 31, 2002 and March 31, 2002 consisted of:

| (in thousands)                    | <b>December 31,</b> | March 31, |
|-----------------------------------|---------------------|-----------|
| Land                              | <b>\$ 457</b>       | \$ 429    |
| Buildings                         | <b>18,637</b>       | 14,601    |
| Leasehold improvements            | <b>22,692</b>       | 24,030    |
| Furniture, fixtures and equipment | <b>77,061</b>       | 63,860    |
| Construction in progress          | <b>8,567</b>        | 6,032     |
|                                   | <b>127,414</b>      | 108,952   |
| Less accumulated depreciation     | <b>(62,682)</b>     | (54,296)  |
|                                   | <b>\$ 64,732</b>    | \$ 54,656 |

**Note G - Other Comprehensive Income**

The components of comprehensive income are listed below:

| (in thousands)   | Three Months Ended<br>December 31, |          | Nine Months Ended<br>December 31, |           |
|--|------------------------------------|----------|-----------------------------------|-----------|
|  | <b>2002</b>                        | 2001     | <b>2002</b>                       | 2001      |
| Net income   | <b>\$ 12,982</b>                   | \$ 9,817 | <b>\$ 42,237</b>                  | \$ 28,596 |
| Foreign currency translation adjustment  | <b>4,446</b>                       | (1,598)  | <b>11,039</b>                     | 673       |
| Unrealized (losses) on marketable securities<br>and investment activities, net | <b>(60)</b>                        | (331)    | <b>(1,757)</b>                    | (13)      |
| Comprehensive income   | <b>\$ 17,368</b>                   | \$ 7,888 | <b>\$ 51,519</b>                  | \$ 29,256 |

**Note H - Income Taxes**

The effective rate of corporate income taxes was 28.7% and 31.8% for the nine-month periods ended December 31, 2002 and 2001 respectively. The effective tax rate for the nine-month period ended December 2002 reflects refunds received in the first, second and third quarters of fiscal 2003 related to the amendment of prior year tax returns for the Company's foreign sales corporation.



**Note I - Earnings per Share**

A reconciliation of weighted average shares outstanding, used to calculate basic earnings per share, to weighted average shares outstanding assuming dilution, used to calculate diluted earnings per share, follows:

| (in thousands)                                    | Three Months Ended          |        | Nine Months Ended           |        |
|---|-----------------------------|--------|-----------------------------|--------|
|   | December 31,<br><b>2002</b> | 2001   | December 31,<br><b>2002</b> | 2001   |
| Weighted average outstanding shares: basic        | <b>46,380</b>               | 46,766 | <b>46,685</b>               | 47,752 |
| Shares issuable through exercise of stock options | <b>2,073</b>                | 1,452  | <b>2,012</b>                | 1,596  |
| Weighted average outstanding shares: diluted      | <b>48,453</b>               | 48,218 | <b>48,697</b>               | 49,348 |

Shares issuable through options are determined using the treasury stock method.

Certain employee stock options have been excluded from the computation of diluted earnings per share because their effect would be anti-dilutive.

**Note J - Acquisition**

On May 6, 2002, the Company purchased the assets of the urology business of Portex Ltd., a subsidiary of Smiths Group plc. The acquired business, now named Mentor Medical, Ltd., manufactures and markets incontinence and ostomy products primarily for the home healthcare market. The products are sold mainly in the UK, Germany and the Netherlands. The acquisition was valued at \$11,232,000, of which \$10,603,000 was paid in cash, plus an acquired liability of \$629,000. The acquisition was accounted for using SFAS No. 141, "Business Combinations," using the purchase method of accounting, and the purchase price was preliminarily allocated to the tangible and intangible net assets acquired on the basis of their respective fair values on the acquisition date. The total purchase price was preliminarily allocated to inventory of \$3,547,000, buildings of \$636,000, production equipment of \$1,185,000, leasehold improvements of \$585,000, customer base of \$548,000 and goodwill and other intangibles with indefinite lives of \$4,731,000.

**Note K - Business Segment Information**

The Company's operations are principally managed and reported on a product basis. There are three reportable segments: aesthetic and general surgery, surgical urology, and clinical and consumer healthcare. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies except that certain expenses such as interest and certain corporate expenses are not allocated to the segments.

The aesthetic and general surgery products segment consists primarily of breast implants, tissue expanders and the Company's body contouring (liposuction) equipment and disposables. The surgical urology segment includes penile implants, surgical incontinence products and brachytherapy seeds for the treatment of prostate cancer. The clinical and consumer healthcare segment includes catheters and other disposable products for the management of urinary incontinence and retention.

Selected financial information for the Company's reportable segments for the three and nine-month periods ended December 31, 2002 and 2001, and as of March 31, 2002 is as follows:

| (in thousands)                   | Three Months Ended December 31, |           | Nine Months Ended December 31, |            |
|----------------------------------|---------------------------------|-----------|--------------------------------|------------|
|                                  | 2002                            | 2001      | 2002                           | 2001       |
| <b>Net Sales</b>                 |                                 |           |                                |            |
| Aesthetic and General Surgery    | \$ 44,105                       | \$ 38,169 | \$ 140,533                     | \$ 117,495 |
| Surgical Urology                 | 27,302                          | 23,569    | 79,290                         | 69,751     |
| Clinical and Consumer Healthcare | 22,632                          | 17,237    | 61,479                         | 47,220     |
| Total consolidated revenues      | \$ 94,039                       | \$ 78,975 | \$ 281,302                     | \$ 234,466 |

| (in thousands)                   | Three Months Ended December 31, |           | Nine Months Ended December 31, |           |
|----------------------------------|---------------------------------|-----------|--------------------------------|-----------|
|                                  | 2002                            | 2001      | 2002                           | 2001      |
| <b>Operating profit</b>          |                                 |           |                                |           |
| Aesthetic and General Surgery    | \$ 14,777                       | \$ 12,108 | \$ 49,133                      | \$ 34,340 |
| Surgical Urology                 | 2,076                           | 779       | 5,170                          | 3,050     |
| Clinical and Consumer Healthcare | 3,821                           | 4,015     | 10,280                         | 9,721     |
| Total reportable segments        | \$ 20,674                       | \$ 16,902 | \$ 64,583                      | \$ 47,111 |

| (in thousands)             | Three Months Ended December 31, |           | Nine Months Ended December 31, |           |
|----------------------------|---------------------------------|-----------|--------------------------------|-----------|
|                            | 2002                            | 2001      | 2002                           | 2001      |
| <b>Operating income</b>    |                                 |           |                                |           |
| Reportable segments        | \$ 20,674                       | \$ 16,902 | \$ 64,583                      | \$ 47,111 |
| Corporate operating loss   | (2,797)                         | (2,115)   | (8,136)                        | (6,169)   |
| Interest expense           | (245)                           | (152)     | (782)                          | (659)     |
| Interest income            | 599                             | 565       | 1,831                          | 1,866     |
| Other income               | 526                             | (826)     | 1,731                          | (230)     |
| Income before income taxes | \$ 18,759                       | \$ 14,374 | \$ 59,227                      | \$ 41,919 |

| (in thousands)                   | As of             |                |
|----------------------------------|-------------------|----------------|
|                                  | December 31, 2002 | March 31, 2002 |
| <b>Identifiable assets</b>       |                   |                |
| Aesthetic and General Surgery    | \$ 105,927        | \$ 95,763      |
| Surgical Urology                 | 102,824           | 88,488         |
| Clinical and Consumer Healthcare | 47,772            | 43,506         |
| Total reportable segments        | \$ 256,523        | \$ 227,757     |

#### Note L - Event Subsequent to December 31, 2002

On February 1, 2003, the Company completed the acquisition of Mills Biopharmaceuticals, Inc., a manufacturer of iodine brachytherapy seeds for the treatment of prostate cancer. The acquisition was valued at \$5,300,000, which was

paid in cash. The acquisition will be accounted for using SFAS No. 141, "Business Combinations," using the purchase method of accounting, and the purchase price will be allocated to the tangible and intangible net assets acquired on the basis of their respective fair values on the acquisition date.



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

Except for the historical information contained herein, the matters discussed in this Management's Discussion contain certain forward-looking statements that involve risk and uncertainty. Such forward-looking statements are characterized by future or conditional verbs and include statements regarding new and existing products, technologies and opportunities, market and industry segment growth and demand and acceptance of new and existing products. Such statements are only predictions and the Company's actual results may differ materially from those anticipated in these forward-looking statements. Factors that may cause such differences include, but are not limited to, increased competition, changes in product demand, changes in market acceptance, new product development, United States Food and Drug Administration ("FDA") approval or rescission of approval, delay or rejection of new or existing products, changes in agreements with governmental agencies, changes in government regulation, supply of raw materials, changes in reimbursement practices, adverse results of litigation and other risks identified in Form 10-Q or in other documents filed by the Company with the Securities and Exchange Commission. Specific attention should be directed to the sections entitled "Government Regulation", "Legal Proceedings", and "Factors that May Effect Future Results of Operations" in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2002. The Company assumes no obligation to update forward-looking statements as circumstances change.

**APPLICATION OF CRITICAL ACCOUNTING POLICIES**

Management's Discussion and Analysis of Financial Condition and Results of Operations addresses Mentor Corporation's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the 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. Management has identified the critical accounting policies as those that involve the most complex or subjective decisions, estimates or assessments. On an ongoing basis, management evaluates its estimates, assessments and judgments. Management evaluates estimates and judgments based on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Management has identified the critical accounting policies to be those related to revenue recognition, accounts receivable, inventories, warranties and related reserves, and goodwill and intangible asset impairment. These accounting policies are discussed in the Management's Discussion and Analysis and notes to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2002.

On December 12, 2002 the Board of Directors authorized a two-for-one stock split in the form of a 100% stock dividend to be distributed on or about January 17, 2003 to shareholders of record on December 31, 2002. All references to the number of shares and per share amounts have been retroactively restated to reflect the increased number of common shares outstanding.

**RESULTS OF OPERATIONS**

**Sales**

Sales for the three months ended December 31, 2002 increased to \$94.0 million from \$79.0 million for the same period in 2001, an increase of 19%. The increase in sales was in both domestic and international markets. Approximately three percentage points of the growth was the effect of a stronger euro on reported sales and approximately six percentage points related to the May 2002 acquisition of Portex Ltd.

Sales of aesthetic and general surgery products increased 16% to \$44.1 million for the quarter from \$38.2 million in the same quarter of the prior year. Total sales of breast implants products increased 16% to \$39.6 million from \$34.3 million in the same quarter of the prior year. Sales of body contouring products increased 41% over the same period in the prior year. Sales growth was primarily attributable to strong product demand both domestically and internationally, the introduction of an improved tissue expander in the fourth quarter of fiscal 2002, and the benefit from the effect of the strong euro.

Sales of surgical urology products increased 16% to \$27.3 million for the quarter from \$23.6 million in the same quarter of the prior year. Penile implant sales increased 14% to \$6.4 million from \$5.6 million in the comparable period in the prior year. Sales growth is primarily attributable to the introduction of the Titan™ in the previous quarter and marketing program efforts to increase consumer awareness. Brachytherapy sales decreased 1% from the same period in the prior year as unit sales increases were offset by competitive pressures, which decreased average selling prices. Sales of products used in pelvic floor reconstruction and incontinence including the Suspend® sling increased 6% from the same period in the prior year.

Sales of clinical and consumer healthcare products increased 31% to \$22.6 million for the quarter from \$17.2 million in the same quarter of the prior year. This growth primarily resulted from the inclusion of sales of products acquired in the May 2002 acquisition of the urology business of Portex Ltd. Sales of Portex products accounted for 26 percentage points of the year-to-year growth.

For the nine months ended December 31, 2002 sales increased 20% from \$234.5 million to \$281.3 million. Increased sales were recorded in each major segment and market. International sales were aided by a generally weaker dollar and by the May 2002 acquisition of Portex Ltd., which accounted for approximately three percentage points and five percentage points of the increase, respectively. Surgical urology product revenue increased 14% primarily due to the sales of disposable surgical product lines. Aesthetic and General surgery products increased 20% reflecting growth in augmentation and reconstruction mammary implant products and increases in body contouring revenues. Clinical and Consumer Healthcare revenue increased 30% primarily due to sales of products acquired in the May 2002 acquisition of Portex, Ltd. and growth in disposable products acquired in the Porges acquisition.

|   | Sales by Principal Product Line         |           |                |  |            |                |
|---|---|-----------|----------------|--|------------|----------------|
|   | For the Three Months Ended December 31, |           |                | For the Nine Months Ended December 31, |            |                |
|   | 2002                                    | 2001      | Percent Change | 2002                                   | 2001       | Percent Change |
| Aesthetic & General Surgery Products    | \$ 44,105                               | \$ 38,169 | 15.6%          | \$ 140,533                             | \$ 117,495 | 19.6%          |
| Surgical Urology Products               | 27,302                                  | 23,569    | 15.8%          | 79,290                                 | 69,751     | 13.7%          |
| Clinical & Consumer Healthcare Products | 22,632                                  | 17,237    | 31.3%          | 61,479                                 | 47,220     | 30.2%          |
|   | \$ 94,039                               | \$ 78,975 | 19.1%          | \$ 281,302                             | \$ 234,466 | 20.0%          |

### Cost of Sales

Cost of sales as a percentage of net sales for the three and nine-month periods ended December 31, 2002 were 40.6% for each compared to 40.7% and 41.1% for the same periods a year ago. This decrease in costs as a percentage of sales is primarily attributable to aesthetic and surgical urology product manufacturing efficiencies achieved during the prior year and sales growth increased at a higher percentage rate than manufacturing support costs.

### Selling, General and Administrative

Selling, general and administrative expenses were 34.2% of net sales for the quarter ended December 31, 2002, a slight decrease from 34.6% for the same period a year ago. For the nine months ended December 31, 2002, selling, general and administrative expenses were 33.5% of net sales compared to 34.6%. Overall spending on selling, general and administrative expenses increased by 16.3% from the prior year. The decrease as a percentage of net sales reflects efficiencies in general and administrative expenses and the impact of the recent acquisition of Portex (now Mentor Medical, Ltd.). Mentor Medical Ltd. has a lower percentage of selling, general and administrative expenses to net

sales than the historical percentage rate of the Company.

**Research and Development**

Research and development expenses as a percent of net sales for the three and nine-month periods ended December 31, 2002 were 6.2% and 5.9%, respectively, compared to 6.1% and 6.8% for the same periods a year ago. The decrease in research and development costs as a percentage of net sales for the nine-month period is due to unusually high levels of development costs in the prior year related to the Company's automated brachytherapy workstation, accelerated product enhancement projects for existing products and new product development, along with strong sales growth in the current year. Total spending on research and development increased 3.2% over the comparable nine-month period in the prior year; but at a slower rate than the increase in revenues; consequently the research and development expenses as a percentage of net sales have decreased. The Company is committed to a variety of clinical and laboratory studies in connection with its gel-filled and saline filled mammary implants and other products.

**Interest and Other Income and Expense**

Interest expense increased to \$245 thousand in the third quarter of fiscal 2003, compared to \$152 thousand in the same period of the prior year. Interest expense includes imputed interest on long-term liabilities recorded at net present value related to the acquisitions of assets of SouthBay Medical and ProSurg Inc. during fiscal 2001 and 2002, respectively.

Interest income increased to \$599 thousand in the third quarter of fiscal 2003 from \$565 thousand in the same period of the prior year. The increase is due to higher cash balances available for investment partially offset by lower prevailing interest rates on short-term investments.

Other income, net primarily includes gains or losses on sales of marketable securities, and foreign currency gains or losses related to the Company's foreign operations. Other income, net for the nine months ending December 31, 2002 totals \$1.7 million and includes, among other items, a \$500 thousand gain on the sale of an intangible asset, approximately \$400 thousand on gains on sales of marketable securities, unrealized losses on short-term marketable securities, and approximately \$324 thousand gain on foreign currency translation.

**Income Taxes**

The effective rate of corporate income taxes for the three and nine months ended December 31, 2002 was 30.8% and 28.7% as compared to 31.7% and 31.8% for the comparable periods in the prior year. The decrease in the effective tax rate from the comparable periods in the prior year is a result of a higher proportion of income from foreign operations with lower tax rates, tax credits related to research and development, and refunds received in the first and second quarters of fiscal year 2003 related to the amendment of prior year tax returns for the Company's foreign sales corporation.

**Net Income**

Net income for the three-month period ended December 31, 2002 increased 32.2% to \$13.0 million from \$9.8 million in the comparable period in the prior year. Net income increased 47.7% from \$28.6 million reported in the previous year to \$42.2 million for the nine-months ended December 31, 2002. Diluted earnings per share increased 35% to \$0.27 for the three-month period compared to \$0.20 for the comparable period last year. Increased sales, lower cost of goods sold and operating expenses as a percentage of net sales, the gain on sale of an intangible asset, and a tax refund all contributed to the increased net income.

---

## **LIQUIDITY AND CAPITAL RESOURCES**

The Company had cash, cash equivalents and short-term marketable securities of \$86 million at December 31, 2002 compared to \$75 million at March 31, 2002. Cash provided by operating activities has been and is expected to continue to be the Company's primary recurring source of funds. The Company's working capital was \$151 million at December 31, 2002 compared to \$127 million at March 31, 2002. The Company generated \$55.0 million of cash from continuing operating activities during the nine months ended December 31, 2002, compared to \$51 million the same period the previous year. Increased cash flow from operating activities was primarily the result of increased net income, partially offset by an increase in inventory and a decrease in income taxes payable.

During the nine months ended December 31, 2002, the Company invested \$12.0 million in manufacturing equipment at the new facility in the Netherlands and at U.S. locations, and in information technology systems. The Company anticipates investing approximately \$3 million in the fourth quarter of fiscal 2003 to expand production equipment and facilities for brachytherapy seed production, purchase other production equipment and upgrade and replace information technology systems.

The Company receives cash from the exercise of employee stock options. Employee stock option exercises provided \$6.4 million during the nine months ended December 31, 2002 compared to \$3.2 million in the same period the previous year. Proceeds from the exercise of employee stock options will vary from period to period based upon, among other factors, fluctuations in the market value of the Company's common stock relative to the exercise price of such options.

The Company's Board of Directors has authorized an ongoing stock repurchase program. The objectives of the program, among other items, are to offset the dilutive effect of the Company's employee stock option program, provide liquidity to the market and to reduce the overall number of shares outstanding. Repurchases are subject to market conditions and cash availability. The Company repurchased 1,280 thousand shares for cash of \$20 million in the nine months ended December 31, 2002. The Company intends to continue the share repurchase program in the remainder of fiscal 2003 and 1.9 million shares remain authorized for repurchase.

In January 2001, the Company completed the acquisition of SouthBay Medical, a development stage company focused on the development of a new technology for a computer-based workstation and automated cartridge-based needle loading system for use in brachytherapy procedures. The total consideration included \$2 million in cash, 470,586 restricted shares of the Company's common stock having a fair market value of \$4 million at the time of acquisition, and \$13.6 million to be paid in cash or the Company's common stock over the next several years. These future payments have been recorded as an acquisition obligation liability at net present value (\$11.5 million at December 31, 2002), and will continue to increase as imputed interest is recorded. Approximately \$5.9 million of the acquisition obligation liability is to be paid in shares of the Company's common stock valued at fair market value on the date of issuance.

In December 2001, the Company entered into several agreements with ProSurg, Inc. to purchase certain patent rights and a supply of a bio-absorbable co-polymer product to be used in the surgical treatment of incontinence. The total consideration included \$2.0 million in cash and \$2.7 million in short and long-term payments due over the next several years. The future payments have been recorded as an acquisition obligation liability at net present value and will increase with imputed interest to \$3.0 million due over the next several years.

The Company has a secured line of credit ("25M Credit Agreement") for borrowings of up to \$25 million, which accrue interest at the prevailing prime rate or at a mark-up over LIBOR at the Company's discretion. The 25M Credit Agreement includes certain covenants that, among other things, limit the dividends the Company may pay and requires maintenance of certain levels of tangible net worth and debt service ratios. During fiscal 2002, the Company used the 25M Credit Agreement to guarantee the secured loan of a vendor in the amount of \$5.3 million to facilitate

the ramp-up of production capacity related to a new product. Accordingly, although there were no borrowings outstanding under the \$25M Credit Agreement at December 31, 2002, only \$19.7 million was available for additional borrowings.

In addition, several lines of credit were established with local foreign lenders to facilitate operating cash flow needs at our foreign subsidiaries. These lines are at market rates of interest, are unsecured and guaranteed by Mentor Corporation, and total \$5.6 million, of which \$ 3.8 million was outstanding, and \$1.8 million additional borrowings were available at December 31, 2002.

In fiscal 2002, a line of credit of \$6.5 million was established to finance the construction of a new facility in Leiden, the Netherlands. The borrowings accrue interest at EURIBOR plus 0.75% and are secured by the new facility and other assets in the Netherlands. At December 31, 2002, \$4.1 million was outstanding and \$2.4 million was available under this line.

At December 31, 2002, the total of short-term borrowings under all lines of credit was \$ 7.9 million and the weighted-average interest rate was 3.3%. The total amount of additional borrowings available to the Company under all lines of credit was \$23.9 million at December 31, 2002.

The Company has historically paid a quarterly cash dividend of \$.03 per share. In December 2002, the Company's Board of Directors authorized a 2-for-1 stock split and increased the quarterly dividend on a post-split basis from \$.015 per share to \$.02 per share. At the new annual rate of \$.08 per share, the aggregate annual dividend would equal approximately \$3.7 million. It is the Company's intent to continue to pay dividends for the foreseeable future subject to among other things, Board approval, cash availability and alternative cash needs. The \$25M Credit Agreement limits the aggregate amount of dividends payable in any year to one-half of the net income of the preceding year.

On May 6, 2002, the Company announced that it had completed the acquisition of the urology business of Portex Ltd., a subsidiary of Smiths Group plc. The acquired business manufactures and markets incontinence and ostomy products primarily for the home healthcare market. The cash consideration paid for Portex Ltd. was \$10.6 million from available cash balances in the quarter ended June 30, 2002.

On November 4, 2002, the Company announced that it had reached an agreement to acquire Mills Biopharmaceuticals, Inc., a manufacturer of iodine brachytherapy seeds for the treatment of prostate cancer. The transaction was completed on February 1, 2003 and \$5.3 million was paid from existing cash balances.

The following table summarizes contractual cash and other commercial commitments at December 31, 2002:

| (in thousands)                      |           | Less Than | 1-3      | 4-5      | After 5  |
|-------------------------------------|-----------|-----------|----------|----------|----------|
| <b>Contractual Cash Obligations</b> | Total     | 1 Year    | Years    | Years    | Years    |
| Operating leases                    | \$ 37,690 | \$ 4,014  | \$12,052 | \$ 7,607 | \$14,017 |
| Total Contractual Cash Obligations  | \$ 37,690 | \$ 4,014  | \$12,052 | \$ 7,607 | \$14,017 |
| <b>Commercial Commitments</b>       |           |           |          |          |          |
| Lines of credit                     | \$ 7,919  | \$ 7,919  | \$ -     | \$ -     | \$ -     |
| Guarantees                          | 5,300     | 5,300     | -        | -        | -        |
| Other commercial commitments        | 20,021    | 4,675     | 11,148   | 700      | 3,498    |
| Total Commercial Commitments        | \$33,240  | \$17,894  | \$11,148 | \$ 700   | \$ 3,498 |

The "Less Than 1 Year" column of Other commercial commitments includes \$5.3 million towards the acquisition of a potential supplier. In addition, the Company, in the ordinary course of business, has at any one time, purchase orders for raw materials and other supplies, which may in aggregate be significant but for which usage does not exceed one year.



The Company's principal source of liquidity at December 31, 2002 consisted of \$86 million in cash, cash equivalents and short-term marketable securities, plus \$23.9 million available under the existing lines of credit. The Company believes that funds generated from operations, its cash, cash equivalents and marketable securities and funds available under its line of credit agreements will be adequate to meet its working capital needs, capital expenditure requirements and commitments for at least the next 12 months. However, it is possible that the Company may need to raise additional funds to finance its activities beyond the next 12 months or to consummate acquisitions of other businesses, products or technologies. Additional funds could be raised by selling equity or debt securities to the public or to selected investors, or by borrowing money from financial institutions. In addition, even though the Company may not need additional funds, it may still elect to sell additional equity or debt securities or obtain credit facilities for other reasons. The Company may not be able to obtain additional funds on terms that would be favorable to the Company and its shareholders, or at all. If additional funds were raised by issuing additional equity securities or convertible debt securities, the ownership percentage of existing shareholders would be reduced. In addition, the equity or debt securities issued by the Company may have rights, preferences or privileges senior to those of the Company's common stock.

## **FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS**

### **Forward-Looking Information Under the Private Securities Litigation Reform Act of 1995**

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. The Act was designed to encourage companies to provide prospective information about them without fear of litigation. The prospective information must be identified as forward-looking and must be accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statements. The statements about the Company, plans, strategies, intentions, expectations and prospects contained throughout this document are based on current expectations. These statements are forward-looking and actual results may differ materially from those predicted as of the date of this report in the forward-looking statements, which involve risks and uncertainties. In addition, past financial performance is not necessarily a reliable indicator of future performance and investors should not use historical performance to anticipate results or future period trends. The Company does not undertake to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

### **Distribution Agreement with North American Scientific, Inc.**

The Company has had an exclusive worldwide distribution agreement with North American Scientific Inc. ("NASI"), to market and sell radioactive brachytherapy seeds for the treatment of prostate cancer. Under the agreement the products were manufactured by NASI and to be exclusively marketed and sold by the Company under the names IoGold® and PdGold® for iodine and palladium seeds, respectively. Sales of radioactive seeds supplied to the Company by NASI were \$6.4 million in the quarter ended December 31, 2002. The agreement included a one-time unilateral option for the Company to extend the agreement for three years subject to certain performance criteria; however in August 2002, the Company notified NASI that it did not intend to exercise its option to extend the agreement under the same terms but was willing to negotiate a new agreement with NASI on different terms. A new agreement was not negotiated and the distribution agreement was to expire on January 31, 2003. NASI has begun to directly market its brachytherapy seeds, resulting in additional competition.

On November 4, 2002 the Company announced it had reached an agreement to purchase Mills Biopharmaceutical Inc. (Mills), a manufacturer of iodine brachytherapy seeds. The purchase was completed February 1, 2003 after the expiration of the agreement with NASI and the Company has begun to supply customers with seeds manufactured by Mills. In addition, on January 8, 2003 the Company announced that it had reached a nonexclusive agreement to distribute Best™ Palladium-103 brachytherapy seeds. In addition, the Company believes that other satisfactory sources for similar radioactive seeds for use in brachytherapy treatment of the prostate can be manufactured or obtained.

There is no assurance that such seeds can be manufactured or obtained on terms satisfactory to the Company, without interruption or regulatory delay, or that such additional seeds will ultimately be acceptable to customers. Interruption of the supply of seeds, additional competition, regulatory delay, additional costs to procure seeds, or loss of customers and market share may have a negative effect on revenues and the results of operations.

---

**United States Food and Drug Administration**

On August 12, 2002 the Company received a letter from the United States Food and Drug Administration, ("FDA"), regarding the April 1992 agreement (commonly known as the Adjunct Study) between Mentor Corporation and the FDA that sets forth the terms and conditions under which Mentor may sell silicone gel-filled breast implants to physicians participating in the Adjunct Study. The FDA requested a fifth addendum to the agreement to revise the method of distribution of gel-filled breast implants to physicians, provide for certain procedures for site monitoring of protocol compliance, reconciliation and accountability of field inventory, and a right to limit the number of physicians, sites, and/or patients participating in the Adjunct Study if the FDA so desires. The Company has worked closely with the FDA to comply with the existing agreement and to address the FDA concerns. On October 10, 2002 the Company received a letter from the FDA recognizing the Company's efforts to address the FDA concerns and outlining conditions for continuing participation in the Adjunct study. The FDA is not requiring a fifth addendum to the Adjunct Study agreement at this time. The additional conditions to the method of distribution and monitoring of protocol compliance will require additional procedures and expenses and may have a negative effect on physician purchases of product used in the study and consequently affect revenue. The Company cannot currently estimate the impact of the additional conditions on revenue and the results of operations. If the Company is unable meet the additional conditions outlined by the FDA, the FDA can require additional conditions, a fifth addendum to the agreement, or terminate the agreement (i.e., the Adjunct Study) if the FDA so desires. Additional procedures or termination of the Adjunct Study may have a material negative effect on the Company's revenue, and results of operations.

**Medicare Reimbursement**

In August of 2002, the Centers for Medicare and Medicaid Services ("CMS") published for comment its Proposed Rule of Changes to the Medicare Outpatient Prospective Payment System (OPPS) and payment rates for calendar year 2003. The rule determines the amount that hospitals will be reimbursed for procedures performed on an outpatient basis and is important, as it determines the profitability of certain procedures for the hospital and which may impact the procedures that the facility will choose to perform. The Company commented directly and through industry groups on the proposed reimbursement of outpatient procedures that include the Company's products. The products affected include penile implants for the treatment of impotence, iodine and palladium brachytherapy seeds for the treatment of prostate cancer, and other products. On November 1, 2002 CMS issued its final rule concerning reimbursement of outpatient procedures for 2003. CMS considered the Company's comments and increased its reimbursement for these procedures and committed to addressing certain other reimbursement issues related to the Company's products. However, the final rule results in an overall reduction in the amount of reimbursement for outpatient procedures which include our penile implants for erectile dysfunction and made certain changes to the reimbursement for brachytherapy procedures which include the Company's radioactive seed products. Most of the Company's domestic sales of brachytherapy seeds are reimbursed under these rules; however the effect of the changes in reimbursement procedures and amounts is expected to be minimal. The Company estimates that approximately \$14 million of annual revenue for its penile implants for the treatment of erectile dysfunction is reimbursed under this rule or approximately four percent of total Company revenues. The rule takes effect on January 1, 2003. The Company cannot estimate the effect of the final rule on the Company's penile implant customers who are reimbursed under the rule, on revenue, on the Company's ability to secure additional reimbursement for new or improved implants, or ultimately, on operating results; however, the reduction in reimbursement may negatively impact the Company's results.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

There has been no material changes in the Company's exposure to market risk as reported in Item 7A in the annual report on Form 10-K for the fiscal year ended March 31, 2002.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

In 1998, the Company learned that the FDA's Office of Criminal Investigations ("OCI") was conducting an investigation involving the Company. The Company understood that the investigation was dormant until April 2000 when OCI issued a letter requesting that the Company provide OCI with manufacturing data and other corporate records, which the Company provided to OCI. The Company cooperated fully with the OCI investigation.

On July 9, 2002, the Company presented the five-year follow-up data to the FDA advisory panel related to its saline mammary implant clinical studies. The presentation of this data was a condition of the PMA approval received in May of 2000. Subsequent to the presentation, the Company became aware through the media that the Chairman of the Committee on Energy and Commerce and the Chairman of the Subcommittee on Oversight and Investigations (the "Committee") sent a letter to the Deputy Commissioner of the FDA requesting data related to the saline breast implant studies, records related to Mentor Corporation and the OCI investigation. On September 27, 2002 media articles announced that the FDA had completed and closed its criminal investigation of Mentor. The Company has received confirmation from the FDA Office of Criminal investigation that the criminal investigation has been closed.

The Company believes that it is in compliance with all applicable laws, rules and regulations and has responded to all requests received to date.

In November 2002, the Company filed a lawsuit against North American Scientific, Inc., (NASI) for, among other things, breach of the exclusive distribution agreement, which was to expire on January 31, 2003. In response, NASI filed a counterclaim against the Company alleging various breaches and other actions, which the Company believes are baseless and without merit. The Company believes that it has been in compliance with all contractual obligations and intends to vigorously defend itself against all allegations and to continue to pursue its aforementioned claims against NASI.

Page 21

**Item 2. Changes in Securities**

On December 13, 2002 the Board of Directors authorized a two-for-one stock split in the form of a 100% stock dividend to be distributed on or about January 17, 2003 to shareholders of record on December 31, 2002.

**Item 3. Defaults Upon Senior Securities**

No event constituting a material default has occurred respecting any senior security of the Registrant.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

**Controls and Procedures**

a) **Evaluation of disclosure controls and procedures.** Our chief executive officer and chief financial officer, after evaluating the effectiveness of the Company's "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 Rules 13a-14(c) and 15-d-14(c)) as of a date (the "Evaluation Date") within 90 days before the filing date of this quarterly report on Form 10-Q, have concluded that, as of the Evaluation Date, our disclosure controls and procedures were adequate and designed to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities.

b) **Changes in internal controls.** There were no significant changes in the Company's internal controls or, to the Company's knowledge, in other factors that could significantly affect the Company's disclosure controls and procedures subsequent to the Evaluation Date.

**Item 6. Exhibits and Reports on Form 8-K**

**(a) Exhibits**

99.1 CEO Certification Pursuant To 18 U.S.C. Section 1350,  
As Adopted Pursuant To Section 906 of The Sarbanes-Oxley Act of 2002

99.2 CFO Certification Pursuant To 18 U.S.C. Section 1350,  
As Adopted Pursuant To Section 906 of The Sarbanes-Oxley Act of 2002

**(b) Reports on Form 8-K**

There were no reports on Form 8-K in the quarter ended December 31, 2002.

**SIGNATURES**

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

**MENTOR CORPORATION**

(Registrant)

Date: February 13, 2003      By: /S/CHRISTOPHER; J. CONWAY  
Christopher J. Conway  
President and Chief Executive Officer

Date: February 13, 2003      By: /S/ADEL MICHAEL  
Adel Michael  
Executive Vice President  
Chief Financial Officer

Page 23

**§ 302 CERTIFICATION**

I, Christopher J. Conway, certify that:

1. I have reviewed this quarterly report on Form 10 Q of Mentor Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: February 13, 2003

/S/CHRISTOPHER J. CONWAY  
Christopher J. Conway  
President and Chief Executive Officer

















**§ 302 CERTIFICATION**

I, Adel Michael, certify that:

1. I have reviewed this quarterly report on Form 10 Q of Mentor Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: February 13, 2003

/S/ADEL MICHAEL  
Adel Michael  
Chief Financial Officer

















**EXHIBIT 99.1**

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Mentor Corporation (the "Company") on Form 10 Q for the period ending December 31, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Christopher J. Conway, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/S/CHRISTOPHER J. CONWAY

Christopher J. Conway  
Chief Executive Officer

February 13, 2003

















**EXHIBIT 99.2**

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Mentor Corporation (the "Company") on Form 10 Q for the period ending December 31, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Adel Michael, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/S/ADEL MICHAEL

Adel Michael  
Chief Financial Officer

February 13, 2003

Page 27