

MENTOR CORP /MN/  
Form 10-Q  
November 14, 2002

**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 September 30, 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 41-0950791  
(State or other jurisdiction of (IRS Employer Identification

No.)

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

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 X No \_\_\_

Indicate by check mark whether the Registrant is an accelerated filer as defined in Rule 12b-2 of the Exchange Act). Yes X No \_\_\_

As of November 13, 2002 there were approximately 23,164,959 Common Shares outstanding.

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**MENTOR CORPORATION**

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- 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

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**PART I - FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements****Mentor Corporation  
Consolidated Balance Sheets  
(Unaudited)**

| (in thousands)                                  | <b>September 30,<br/>2002</b> | March 31,<br>2002 |
|-------------------------------------------------|-------------------------------|-------------------|
| <b><u>Assets</u></b>                            |                               |                   |
| Current assets:                                 |                               |                   |
| Cash and cash equivalents                       | \$ 74,981                     | \$ 60,398         |
| Marketable securities                           | 9,195                         | 14,106            |
| Accounts receivable, net                        | 61,786                        | 64,786            |
| Inventories                                     | 57,021                        | 47,404            |
| Deferred income taxes                           | 13,933                        | 11,950            |
| Prepaid expenses and other                      | 9,822                         | 12,488            |
| Total current assets                            | 226,738                       | 211,132           |
| Property and equipment, net                     | 61,726                        | 54,656            |
| Intangible assets, net                          | 36,254                        | 37,588            |
| Goodwill, net                                   | 15,103                        | 9,155             |
| Long-term marketable securities and investments | 10,581                        | 11,752            |
| Other assets                                    | 252                           | 353               |
|                                                 | <b>\$ 350,654</b>             | <b>\$ 324,636</b> |

See notes to condensed consolidated financial statements.

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**Mentor Corporation  
Consolidated Balance Sheets  
(Unaudited)**

| (in thousands)                                                                      | September 30,<br>2002 | March 31,<br>2002 |
|-------------------------------------------------------------------------------------|-----------------------|-------------------|
| <b><u>Liabilities and shareholders' equity</u></b>                                  |                       |                   |
| Current liabilities:                                                                |                       |                   |
| Account payable                                                                     | \$ 15,646             | \$ 17,558         |
| Warranty and related reserves                                                       | 18,056                | 16,252            |
| Accrued compensation                                                                | 14,079                | 15,129            |
| Short-term bank borrowings                                                          | 9,888                 | 9,470             |
| Sales returns                                                                       | 7,906                 | 7,806             |
| Income taxes payable                                                                | 1,110                 | 3,979             |
| Current portion of purchase price related to acquired technologies and acquisitions | 4,675                 | 4,675             |
| Dividends payable                                                                   | 696                   | 704               |
| Accrued royalties                                                                   | 581                   | 637               |

|                                                         |                   |            |
|---------------------------------------------------------|-------------------|------------|
| Other                                                   | <b>12,234</b>     | 8,366      |
| Total current liabilities                               | <b>84,871</b>     | 84,576     |
| Deferred income taxes                                   | <b>2,107</b>      | 3,009      |
| Long-term accrued liabilities                           | <b>14,612</b>     | 12,873     |
| Commitments and contingencies                           |                   |            |
| Shareholders' equity:                                   |                   |            |
| Common Stock, \$.10 par value:                          |                   |            |
| Authorized - 50,000,000 shares; Issued and outstanding- |                   |            |
| 23,213,015 shares at September 30, 2002;                |                   |            |
| 23,472,952 shares at March 31, 2002;                    | <b>2,321</b>      | 2,347      |
| Capital in excess of par value                          | -                 | -          |
| Foreign currency translation adjustments                | <b>(333)</b>      | (6,926)    |
| Net unrealized gains (losses) on securities             | <b>(1,258)</b>    | 439        |
| Retained earnings                                       | <b>248,334</b>    | 228,318    |
|                                                         | <b>249,064</b>    | 224,178    |
|                                                         | <b>\$ 350,654</b> | \$ 324,636 |

See notes to condensed consolidated financial statements.

**Mentor Corporation**  
**Consolidated Statements of Income**  
**Three Months Ended September 30, 2002 and 2001**  
**(Unaudited)**

| (in thousands, except per share data) | Three Months Ended<br>September 30, |           |
|---------------------------------------|-------------------------------------|-----------|
|                                       | <b>2002</b>                         | 2001      |
| Net sales                             | <b>\$ 89,586</b>                    | \$ 74,347 |
| Costs and expenses:                   |                                     |           |
| Cost of sales                         | <b>37,669</b>                       | 31,618    |
| Selling, general, and administrative  | <b>30,157</b>                       | 25,703    |
| Research and development              | <b>5,365</b>                        | 5,170     |
|                                       | <b>73,191</b>                       | 62,491    |
| Operating income                      | <b>16,395</b>                       | 11,856    |
| Interest expense                      | <b>(236)</b>                        | (198)     |
| Interest income                       | <b>672</b>                          | 699       |
| Other income, net                     | <b>158</b>                          | 96        |
| Income before income taxes            | <b>16,989</b>                       | 12,453    |
| Income taxes                          | <b>4,483</b>                        | 3,964     |
| Net income                            | <b>\$ 12,506</b>                    | \$ 8,489  |
| Basic earnings per share              | <b>\$ 0.54</b>                      | \$ 0.35   |
| Diluted earnings per share            | <b>\$ 0.52</b>                      | \$ 0.34   |

See notes to condensed consolidated financial statements.

**Mentor Corporation**  
**Consolidated Statements of Income**  
**Six Months Ended September 30, 2002 and 2001**  
**(Unaudited)**

| (in thousands, except per share data) | Six Months Ended<br>September 30, |            |
|---------------------------------------|-----------------------------------|------------|
|                                       | 2002                              | 2001       |
| Net sales                             | \$ 187,263                        | \$ 155,491 |
| Costs and expenses:                   |                                   |            |
| Cost of sales                         | 75,914                            | 64,349     |
| Selling, general, and administrative  | 62,042                            | 53,745     |
| Research and development              | 10,739                            | 11,242     |
|                                       | <b>148,695</b>                    | 129,336    |
| Operating income                      | <b>38,568</b>                     | 26,155     |
| Interest expense                      | (537)                             | (507)      |
| Interest income                       | 1,232                             | 1,301      |
| Other income, net                     | 1,205                             | 596        |
| Income before income taxes            | <b>40,468</b>                     | 27,545     |
| Income taxes                          | <b>11,213</b>                     | 8,766      |
| Net income                            | \$ <b>29,255</b>                  | \$ 18,779  |
| Basic earnings per share              | \$ 1.25                           | \$ 0.79    |
| Diluted earnings per share            | \$ 1.20                           | \$ 0.76    |

See notes to condensed consolidated financial statements.

**Mentor Corporation**  
**Consolidated Statements of Cash Flows**  
**Six Months Ended September 30, 2002 and 2001**  
**(Unaudited)**

| (in thousands)                                                         | 2002      | 2001      |
|------------------------------------------------------------------------|-----------|-----------|
| <b><u>Cash From Operating Activities:</u></b>                          |           |           |
| Income from continuing operations                                      | \$ 29,255 | \$ 18,779 |
| Adjustments to derive cash flows from continuing operating activities: |           |           |
| Depreciation                                                           | 5,913     | 4,943     |
| Amortization                                                           | 1,949     | 1,809     |
| Deferred income taxes                                                  | (2,332)   | 229       |
| Tax benefit from exercise of stock options                             | 1,103     | 2,127     |
| Loss (gain) on sale of assets                                          | (425)     | 374       |
| Imputed interest on long-term liabilities                              | 313       | 232       |
| (Gain) loss on long-term marketable securities                         | (403)     | (32)      |
| Changes in operating assets and liabilities:                           |           |           |
| Accounts receivable                                                    | 5,344     | 1,380     |
| Inventories and other current assets                                   | (903)     | (2,847)   |
| Accounts payable and accrued liabilities                               | 2,714     | 6,500     |

|                                                                |           |           |
|----------------------------------------------------------------|-----------|-----------|
| Income taxes payable                                           | (3,071)   | (3,039)   |
| Foreign currency transaction gain                              | (113)     | -         |
| Net cash provided by continuing operating activities           | 39,344    | 30,455    |
| <b><u>Cash From Investing Activities:</u></b>                  |           |           |
| Purchases of property and equipment                            | (7,591)   | (6,589)   |
| Purchases of intangibles                                       | (665)     | 5         |
| Purchases of marketable securities                             | (914)     | (222)     |
| Sales of marketable securities                                 | 5,005     | -         |
| Acquisitions, net of cash acquired                             | (10,603)  | -         |
| Proceeds from sale of property, equipment and intangibles      | 500       | 11        |
| Other, net                                                     | -         | 6         |
| Net cash used for continuing investing activities              | (14,268)  | (6,788)   |
| <b><u>Cash From Financing Activities:</u></b>                  |           |           |
| Repurchase of common stock                                     | (12,199)  | (15,091)  |
| Proceeds from exercise of stock options                        | 3,203     | 5,425     |
| Dividends paid                                                 | (1,413)   | (1,430)   |
| Borrowings (repayments) under line of credit agreements, net   | (707)     | (12,770)  |
| Net cash used for financing activities                         | (11,116)  | (23,866)  |
| Effect of currency exchange rates on cash and cash equivalents | 623       | 86        |
| Increase (decrease) in cash and cash equivalents               | 14,583    | (113)     |
| Cash and cash equivalents at beginning of year                 | 60,398    | 63,854    |
| Cash and cash equivalents at end of period                     | \$ 74,981 | \$ 63,741 |

**MENTOR CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 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. Financial information presented in the Notes to Consolidated Financial Statements excludes discontinued operations, except where noted

**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.

**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.

**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 six-month periods ended September 30, 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 six months ended September 30, 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 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 September 30, 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 (FHLM bonds) with maturities of two to four years.

Available-for-sale investments at September 30, 2002 were as follows:

| (in thousands)                                                     | Adjusted<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--------------------------------------------------------------------|------------------|------------------------------|-------------------------------|----------------------------|
| Cash balances                                                      | \$16,380         | \$ -                         | \$ -                          | \$16,380                   |
| Bank time deposits                                                 | 488              | -                            | -                             | 488                        |
| Money market mutual funds                                          | 58,601           | -                            | -                             | 58,601                     |
| Marketable equity securities                                       | 2,393            | -                            | (1,961)                       | 432                        |
| U.S., State and Municipal agency obligations                       | 18,551           | 26                           | -                             | 18,577                     |
| Corporate debt securities                                          | 279              | -                            | -                             | 279                        |
| <b>Total available-for-sale investments</b>                        | <b>\$96,692</b>  | <b>\$ 26</b>                 | <b>\$(1,961)</b>              | <b>\$94,757</b>            |
| <b>Included in cash and cash equivalents</b>                       | <b>\$74,981</b>  | <b>\$ -</b>                  | <b>\$ -</b>                   | <b>\$74,981</b>            |
| <b>Included in current marketable securities</b>                   | <b>9,195</b>     | <b>-</b>                     | <b>-</b>                      | <b>9,195</b>               |
| <b>Included in long-term marketable securities and investments</b> | <b>12,516</b>    | <b>26</b>                    | <b>(1,961)</b>                | <b>10,581</b>              |
| <b>Total available-for-sale investments</b>                        | <b>\$96,692</b>  | <b>\$ 26</b>                 | <b>\$(1,961)</b>              | <b>\$94,757</b>            |



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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 |
|-------------------------------------------------------------|------------------|------------------------------|-------------------------------|----------------------------|
| Cash balances                                               | \$11,417         | \$ -                         | \$ -                          | \$11,417                   |
| Bank time deposits                                          | 1,175            | -                            | -                             | 1,175                      |
| Money market mutual funds                                   | 48,981           | -                            | -                             | 48,981                     |
| Marketable equity securities                                | 2,076            | 774                          | -                             | 2,850                      |
| U.S., State and Municipal agency obligations                | 21,653           | -                            | (98)                          | 21,555                     |
| Corporate debt securities                                   | 278              | -                            | -                             | 278                        |
| Total available-for-sale investments                        | \$85,580         | \$774                        | \$(98)                        | \$86,256                   |
| 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                   |

**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 September 30, 2002 and March 31, 2002 consisted of:

| (in thousands)  | September 30, | March 31, |
|-----------------|---------------|-----------|
| Raw materials   | \$ 11,226     | \$ 10,194 |
| Work in process | 11,026        | 9,908     |
| Finished goods  | 34,769        | 27,302    |
|                 | \$ 57,021     | \$ 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 September 30, 2002 and March 31, 2002 consisted of:

| (in thousands)                                 | September 30, | March 31, |
|------------------------------------------------|---------------|-----------|
| Land                                           | \$ 447        | \$ 429    |
| Buildings                                      | 18,090        | 14,601    |
| Leasehold improvements                         | 22,198        | 24,030    |
| Furniture, fixtures and equipment              | 74,201        | 63,860    |
| Construction in progress                       | 6,786         | 6,032     |
|                                                | 121,722       | 108,952   |
| Less accumulated depreciation and amortization | (59,996)      | (54,296)  |
|                                                | \$ 61,726     | \$ 54,656 |

**Note G - Other Comprehensive Income**

The components of comprehensive income are listed below:

| (in thousands)                                                                    | Three Months Ended |           | Six Months Ended |           |
|-----------------------------------------------------------------------------------|--------------------|-----------|------------------|-----------|
|                                                                                   | September 30,      |           | September 30,    |           |
|                                                                                   | 2002               | 2001      | 2002             | 2001      |
| Net income                                                                        | \$ 12,506          | \$ 8,489  | \$ 29,255        | \$ 18,779 |
| Foreign currency translation adjustment                                           | (926)              | 3,367     | 6,593            | 673       |
| Unrealized gains (losses) on marketable securities and investment activities, net | (628)              | (492)     | (1,697)          | (13)      |
| Comprehensive income                                                              | \$ 10,952          | \$ 11,364 | \$ 34,151        | \$ 19,439 |

**Note H - Income Taxes**

The effective rate of corporate income taxes was 27.7% and 31.8% for the six-month periods ended September 30, 2002 and 2001 respectively. The effective tax rate for the six-month period ended September 2002 reflects refunds received in the first and second 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 |        | Six Months Ended |        |
|---------------------------------------------------|--------------------|--------|------------------|--------|
|                                                   | September 30,      |        | September 30,    |        |
|                                                   | 2002               | 2001   | 2002             | 2001   |
| Weighted average outstanding shares: basic        | 23,305             | 23,982 | 23,418           | 23,876 |
| Shares issuable through exercise of stock options | 836                | 837    | 992              | 798    |
| Weighted average outstanding shares: diluted      | 24,141             | 24,819 | 24,410           | 24,674 |

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 six-month periods ended September 30, 2002 and 2001, and as of March 31, 2002 is as follows:

| (in thousands)                   | Three Months Ended<br>September 30, |           | Six Months Ended<br>September 30, |            |
|----------------------------------|-------------------------------------|-----------|-----------------------------------|------------|
|                                  | 2002                                | 2001      | 2002                              | 2001       |
| <b>Net Sales</b>                 |                                     |           |                                   |            |
| Aesthetic and General Surgery    | \$ 42,748                           | \$ 36,388 | \$ 96,428                         | \$ 79,326  |
| Surgical Urology                 | 25,746                              | 22,535    | 51,988                            | 46,182     |
| Clinical and Consumer Healthcare | 21,092                              | 15,424    | 38,847                            | 29,983     |
| Total consolidated revenues      | \$ 89,586                           | \$ 74,347 | \$ 187,263                        | \$ 155,491 |

| (in thousands)                   | Three Months Ended<br>September 30, |           | Six Months Ended<br>September 30, |           |
|----------------------------------|-------------------------------------|-----------|-----------------------------------|-----------|
|                                  | 2002                                | 2001      | 2002                              | 2001      |
| <b>Operating profit</b>          |                                     |           |                                   |           |
| Aesthetic and General Surgery    | \$ 14,415                           | \$ 9,456  | \$ 34,356                         | \$ 22,232 |
| Surgical Urology                 | 848                                 | 1,269     | 3,093                             | 2,272     |
| Clinical and Consumer Healthcare | 3,678                               | 3,160     | 6,459                             | 5,706     |
| Total reportable segments        | \$ 18,941                           | \$ 13,885 | \$ 43,908                         | \$ 30,210 |

| (in thousands)             | Three Months Ended<br>September 30, |           | Six Months Ended<br>September 30, |           |
|----------------------------|-------------------------------------|-----------|-----------------------------------|-----------|
|                            | 2002                                | 2001      | 2002                              | 2001      |
| <b>Operating income</b>    |                                     |           |                                   |           |
| Reportable segments        | \$ 18,941                           | \$ 13,885 | \$ 43,908                         | \$ 30,210 |
| Corporate operating loss   | (2,546)                             | (2,029)   | (5,340)                           | (4,055)   |
| Interest expense           | (236)                               | (198)     | (537)                             | (507)     |
| Interest income            | 672                                 | 699       | 1,232                             | 1,301     |
| Other income               | 158                                 | 96        | 1,205                             | 596       |
| Income before income taxes | \$ 16,989                           | \$ 12,453 | \$ 40,468                         | \$ 27,545 |

| (in thousands)                | As of                 |                   |
|-------------------------------|-----------------------|-------------------|
|                               | September 30,<br>2002 | March 31,<br>2002 |
| <b>Identifiable assets</b>    |                       |                   |
| Aesthetic and General Surgery | \$ 101,954            | \$ 95,763         |
| Surgical Urology              | 97,091                | 88,488            |

|                                  |            |            |
|----------------------------------|------------|------------|
| Clinical and Consumer Healthcare | 47,718     | 43,506     |
| Total reportable segments        | \$ 246,763 | \$ 227,757 |

**Note L - Event Subsequent to September 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 will be completed in February 2003 and is expected to be paid from existing cash balances.

**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.

**RESULTS OF OPERATIONS****Sales**

Sales for the three months ended September 30, 2002 increased to \$89.6 million from \$74.3 million for the same period in 2001, an increase of 20%. 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 five percentage points related to the May 2002 acquisition of Portex Ltd. Sales in the comparable periods of the prior year were negatively affected by the events of September 11, 2001. The effect of the disruption to air shipments and postponed and cancelled surgeries was estimated to be over \$2 million.

Sales of aesthetic and general surgery products increased 17% to \$42.7 million for the quarter from \$36.4 million in the same quarter of the prior year. Sales of products used in cosmetic augmentation and for reconstruction each increased 18% 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 14% to \$25.7 million for the quarter from \$22.5 million in the same quarter of the prior year. Increases in sales of disposable surgical products over sales in the comparable period of the prior year were partially offset by a 7% decrease in penile implant sales. Brachytherapy sales increased 6% over the same period in the prior year as unit sales increases were partially offset by competitive pressures, which decreased average selling prices. Sales of products used in pelvic floor reconstruction and incontinence including the Suspend® sling increased 9% from the same period in the prior year.

Sales of clinical and consumer healthcare products increased 37% to \$21.1 million for the quarter from \$15.4 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. Increased sales of disposable products acquired in the Porges acquisition accounted for approximately three percentage points of the year-to-year growth. Strong growth in the international sales of male external catheters was diluted by a modest increase in the sales of self-catheter products.

For the six months ended September 30, 2002 sales increased 20% from \$155.5 million to \$187.3 million. Increased sales were recorded in each major segment and market. International sales were aided by a generally weaker dollar and the May 2002 acquisition Portex Ltd., which accounted for approximately four percentage points and two percentage points of the increase, respectively. Surgical urology product revenue increased 13% primarily due to the sales of disposable surgical product lines. Aesthetic and General surgery products increased 22% 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 external catheter sales.

|                                         | Sales by Principal Product Line          |           |                |                                        |            |                |
|-----------------------------------------|------------------------------------------|-----------|----------------|----------------------------------------|------------|----------------|
|                                         | For the Three Months Ended September 30, |           |                | For the Six Months Ended September 30, |            |                |
|                                         | 2002                                     | 2001      | Percent Change | 2002                                   | 2001       | Percent Change |
| Aesthetic & General Surgery Products    | \$ 42,748                                | \$ 36,388 | 17.5%          | \$ 96,428                              | \$ 79,326  | 21.6%          |
| Surgical Urology Products               | 25,746                                   | 22,535    | 14.2%          | 51,988                                 | 46,182     | 12.6%          |
| Clinical & Consumer Healthcare Products | 21,092                                   | 15,424    | 36.7%          | 38,847                                 | 29,983     | 29.6%          |
|                                         | \$ 89,586                                | \$ 74,347 | 20.5%          | \$187,263                              | \$ 155,491 | 20.4%          |

#### Cost of Sales

Cost of sales as a percentage of net sales for the three and six-month periods ended September 30, 2002 were 42.0% and 40.5% compared to 42.5% and 41.4% 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 33.7% of net sales for the quarter ended September 30, 2002, a slight decrease from 34.6% for the same period a year ago. For the six months ended September 30, 2002, selling, general and administrative expenses were 33.1% of net sales compared to 34.6%. Overall spending on selling, general and administrative expenses increased by 15.4% 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 six-month periods ended September 30, 2002 were 6.0% and 5.7%, respectively, compared to 7.0% and 7.2% for the same periods a year ago. The decrease in research and development costs as a percentage of net sales 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 decreased 4% over the comparable six-month period in the prior year; 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 \$236 thousand in the second quarter of fiscal 2003, compared to \$198 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 decreased to \$672 thousand in the second quarter of fiscal 2003 from \$699 thousand in the same period of the prior year. The decrease is due to lower prevailing interest rates on short-term investments partially offset by higher cash balances available for investment.

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 six months ending September 30, 2002 totals \$1.2 million and includes 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 \$504 thousand gain on foreign currency translation.

### **Income Taxes**

The effective rate of corporate income taxes for the three and six months ended September 30, 2002 was 26.4% and 27.7% as compared to 31.8% in both 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 September 30, 2002 increased 47% to \$12.5 million from \$8.5 million in the comparable period in the prior year. Net income increased 56% from \$18.8 million reported in the previous year

to \$29.3 million for the six-months ended September 30, 2002. Diluted earnings per share increased 53% to \$.52 for the three-month period compared to \$.34 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 \$84 million at September 30, 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 \$142 million at September 30, 2002 compared to \$127 million at March 31, 2002. The Company generated \$39.3 million of cash from continuing operating activities during the six months ended September 30, 2002, compared to \$30 million the same period the previous year. Increased cash flow from operating activities was primarily the result of increased net income from continuing operations, an increase in accrued liabilities and a decrease in other current assets due to the receipt of \$5.4 million in connection with the settlement of litigation. These amounts were partially offset by increases in accounts receivable and inventory.

During the six months ended September 30, 2002, the Company invested \$7.6 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 \$15 million in fiscal 2003 to complete the new facility in the Netherlands, invest in an existing facility, purchase 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 \$3.2 million during the six months ended September 30, 2002 compared to \$5.4 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 433 thousand shares for cash of \$12.2 million in the six months ended September 30, 2002. The Company intends to continue the share repurchase program in the remainder of fiscal 2003 and 1.1 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, 235,293 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 (\$11.4 million at September 30, 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 September 30, 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 \$6.0 million, which was outstanding, and no additional borrowings were available at September 30, 2002.

In fiscal 2002, a line of credit of \$5.4 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 September 30, 2002, \$3.9 million was outstanding and \$1.4 million was available under this line. The line of credit provides for conversion to a term loan at prevailing interest rates when construction of the new facility is completed. Conversion is expected to be in the third quarter of fiscal 2003.

At September 30, 2002, the total of short-term borrowings under all lines of credit was \$ 9.9 million and the weighted-average interest rate was 4.0%. The total amount of additional borrowings available to the Company under all lines of credit was \$21.1 million at September 30, 2002.

The Company has paid a quarterly cash dividend of \$.03 per share. At the current annual rate of \$.12 per share, the aggregate annual dividend would equal approximately \$2.8 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.

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 will be completed in February 2003 and is expected to be paid from existing cash balances.

The following table summarizes contractual cash and other commercial commitments at September 30, 2002:

| (in thousands)                      |           | Less Than | 1-3      | 4-5      | After 5  |
|-------------------------------------|-----------|-----------|----------|----------|----------|
|                                     | Total     | 1 Year    | Years    | Years    | Years    |
| <b>Contractual Cash Obligations</b> |           |           |          |          |          |
| Operating leases                    | \$ 38,682 | \$ 4,000  | \$12,081 | \$ 7,635 | \$14,966 |
| Total Contractual Cash Obligations  | \$ 38,682 | \$ 4,000  | \$12,081 | \$ 7,635 | \$14,966 |
| <b>Commercial Commitments</b>       |           |           |          |          |          |
| Lines of credit                     | \$ 9,888  | \$ 9,888  | \$ -     | \$ -     | \$ -     |
| Guarantees                          | 5,300     | 5,300     | -        | -        | -        |
| Other commercial commitments        | 25,080    | 9,975     | 11,145   | 700      | 3,260    |
| Total Commercial Commitments        | \$40,268  | \$25,163  | \$11,145 | \$ 700   | \$ 3,260 |



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 September 30, 2002 consisted of \$84 million in cash, cash equivalents and short-term marketable securities, plus \$21 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 an exclusive worldwide distribution agreement with North American Scientific Inc. ("NASI"), to market and sell radioactive brachytherapy seeds for the treatment of prostate cancer. The products are manufactured by NASI and are exclusively marketed and sold by the Company under the names IoGold<sup>®</sup> and PdGold<sup>®</sup> for iodine and palladium seeds, respectively. Sales of radioactive seeds supplied to the Company by NASI were \$6.8 million in the quarter ended September 30, 2002. The distribution agreement expires on January 31, 2003 but included a one-time unilateral option for the Company to extend the agreement for three years subject to certain performance criteria. In August 2002, the Company notified NASI that it did not intend to exercise its option to extend the current agreement under the current terms but is willing to negotiate a new agreement with NASI on different terms. A new agreement has not been negotiated as of November 14, 2002. NASI has announced that it is hiring key personnel to directly market and distribute its brachytherapy products. If a new agreement cannot be negotiated before the expiration of the original agreement, NASI can cease to supply the radioactive seeds to the Company upon expiration of the original agreement. Following the expiration of the Agreement, NASI will be entitled to directly market its brachytherapy seeds, resulting in additional competition. On November 4, 2002 the Company announced it has

reached an agreement to purchase Mills Biopharmaceutical Inc., a manufacturer of iodine brachytherapy seeds. The purchase will be completed after the expiration of the existing agreement with NASI. In addition, the Company believes that additional 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 without interruption, or regulatory delay, on terms satisfactory to the Company 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.

The distribution agreement also provides that NASI can terminate the Company's exclusivity with respect to any product for which Mentor fails to achieve target market share in certain designated markets, subject to curing provisions whereby exclusivity can be maintained. NASI has notified the Company that it believes the required target market share has not been achieved with respect to palladium and iodine seeds. The agreement specifies curing provisions and timelines once the Company has received notice. The timelines and curing provisions currently extend beyond the scheduled end of the agreement, January 31, 2003, and while they could have resulted in NASI's ability to terminate the Company's right of exclusivity, the agreement is scheduled to expire before the end of the applicable cure periods, although NASI has taken a contrary position with respect to palladium seeds. Loss of exclusivity to palladium seeds before the agreement expires could result in additional competition as to that product (NASI has already commenced efforts to compete), which may have a negative effect on revenue and 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.

In August of this year, 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 others 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 our penile implants for the treatment of erectile dysfunction is reimbursed under this rule or approximately four percent of total Company revenues. The Company cannot currently 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.

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### **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.

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## **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. The OCI declined to identify the specific focus of its investigation involving the Company, and except as noted below, the Company has had no direct contact with OCI regarding the investigation since January 2001 when certain additional documents were requested and provided.

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. Both the Company and its primary domestic competitor, McGhan Medical Corporation, a subsidiary of INAMED, Inc., presented data on their respective studies. 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 of both manufacturers presented to the FDA advisory panel. The letter further requested that the FDA provide records related to Mentor Corporation since January 2001, excluding the FDA's criminal investigative file. In addition, the letter requested that the Deputy Commissioner obtain a briefing directly from the FDA's Office of Regulatory Affairs and the Office of Criminal Investigations "concerning the true status of the long-standing and ongoing criminal investigation of allegations relating to Mentor Corporation." If the Deputy Commissioner "ascertains that this investigation is in fact still ongoing, [the chairmen] request that [FDA] then brief the Committee members and/or Committee staff with appropriate information . . . to assure the Committee that FDA is actively conducting a criminal investigation."

On September 27, 2002 media articles announced that the FDA had completed and closed its criminal investigation of Mentor. The media also reported that the Chairmen of the House Subcommittee on Oversight and Investigations wrote the FDA and asked for "all records relating to the FDA's criminal investigation of Mentor Corporation."

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.

**Item 2. Changes in Securities**

None

**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**

At the Company's 2002 Annual Meeting of Shareholders held on September 12, 2002, the following proposals were presented and approved:

(1) A proposal to elect a Board of Directors of the Company to serve until the next annual meeting, or until their successors are elected, as follows:

| <b>Name of Director</b> | <b>Votes For</b> | <b>Votes Withheld</b> |
|-------------------------|------------------|-----------------------|
| Christopher J. Conway   | 10,283,248       | 45,712                |
| Eugene G. Glover        | 20,384,358       | 45,712                |
| Walter W. Faster        | 15,458,569       | 4,971,501             |
| Michael Nakonechny      | 20,304,058       | 126,012               |
| Dr. Richard W. Young    | 20,253,806       | 176,264               |
| Ronald J. Rossi         | 20,306,058       | 126,012               |

There were no broker non-votes.

(2) A proposal to approve an amendment of the Company's restated Articles of Incorporation to increase the authorized shares from 50,000,000 to 150,000,000. The proposal received 12,896,164 votes for, and 7,504,265 votes against ratification. There were 29,638 abstentions and 3 broker non-votes. The Company intends to file its amended restated Articles of Incorporation to the State of Minnesota in the near future.

(3) A proposal to ratify the appointment of Ernst & Young LLP to act as independent auditors of the Company for the fiscal year ending March 31, 2003. The proposal received 20,272,888 votes for, and 29,638 against ratification. There were 36,633 abstentions and 1 broker non-votes.

**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 September 30, 2002.

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**SIGNATURES**

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

**MENTOR CORPORATION**

(Registrant)

Date: November 13, 2002 By: /S/CHRISTOPHER J. CONWAY  
Christopher J. Conway  
President and Chief Executive Officer

Date: November 13, 2002 By: /S/ADEL MICHAEL  
Adel Michael  
Executive Vice President  
Chief Financial Officer

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**§ 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: November 13, 2002

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

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**§ 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: November 13, 2002

/S/ADEL MICHAEL  
Adel Michael  
Chief Financial Officer

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**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 September 30, 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  
November 13, 2002

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**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 September 30, 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  
November 13, 2002