

MENTOR CORP /MN/
Form 10-Q
August 09, 2005

**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
June 30, 2005

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)

41-0950791
(IRS Employer Identification No.)

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

(805) 879-6000
(Registrant's telephone number including area code)

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 ☐

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 August 5, 2005 there were approximately 43,138,344 Common Shares, \$.10 par value per share, outstanding.

MENTOR CORPORATION

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PART I - FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

Mentor Corporation
Consolidated Balance Sheets
(Unaudited)

(in thousands, except share data)	June 30, 2005	March 31, 2005
<u>Assets</u>		
Current assets:		
Cash and cash equivalents	\$ 136,395	\$ 76,666
Marketable securities	34,275	36,228
Accounts receivable, net	109,227	110,749
Inventories	72,450	74,679
Deferred income taxes	24,207	23,976
Prepaid income taxes	7,566	1,500
Prepaid expenses and other	15,484	15,074
Total current assets	399,604	338,872
Property and equipment, net	68,197	72,287
Intangible assets, net	30,871	32,155
Goodwill, net	23,392	24,080
Other assets	10,225	10,207
	\$ 532,289	\$ 477,601

See notes to consolidated financial statements.

Mentor Corporation
Consolidated Balance Sheets
(Unaudited)

(in thousands, except share data)	June 30, 2005	March 31, 2005
<u>Liabilities and shareholders' equity</u>		
Current liabilities:		
Accounts payable	\$ 31,894	\$ 31,290
Accrued compensation	33,933	28,680
Warranty and related reserves	26,524	25,728
Short-term bank borrowings	9	3,182
Sales returns	13,144	13,612
Deferred revenue	10,272	10,111
Income taxes payable	-	2,917
Current portion of purchase price related to acquired		
technologies and acquisitions	1,167	1,812
Interest payable	72	1,083
Dividends payable	7,311	6,927
Other	17,030	16,517
Total current liabilities	141,356	141,859
Long-term accrued liabilities	10,056	10,587
Convertible subordinated notes	150,000	150,000
Shareholders' equity:		
Common Stock, \$.10 par value:		
Authorized - 150,000,000 shares; Issued and outstanding		
43,027,472 shares at June 30, 2005;		
40,745,626 shares at March 31, 2005;	4,303	4,075
Capital in excess of par value	57,106	8,419
Accumulated other comprehensive income	16,805	25,162
Retained earnings	152,663	137,499
	230,877	175,155
	\$ 532,289	\$ 477,601

See notes to consolidated financial statements.

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Mentor Corporation
Consolidated Statements of Income
Three Months Ended June 30, 2005 and 2004
(Unaudited)

(in thousands, except per share data)	2005	2004
Net sales	\$ 135,311	\$ 122,432
Cost of sales	45,790	43,975
Gross profit	89,521	78,457
Selling, general and administrative expense	47,619	43,252
Research and development expense	8,037	8,030
	55,656	51,282
Operating income	33,865	27,175
Interest expense	(1,416)	(1,408)
Interest income	738	415
Other income (expense), net	46	(188)
Income before income taxes	33,233	25,994
Income taxes	10,758	8,340
Net income	\$ 22,475	\$ 17,654
Basic earnings per share	\$ 0.53	\$ 0.42
Diluted earnings per share ¹	\$ 0.47	\$ 0.37
Dividends per share	\$ 0.17	\$ 0.15
Weighted average shares outstanding		
Basic	42,234	42,163
Diluted ¹	49,423	50,157

See notes to consolidated financial statements.

¹ We adopted the provisions of EITF 04-8 in December 2004 which requires that the dilutive impact of contingently issuable shares from our \$150 million of convertible subordinated notes be included in the diluted earnings per share calculation, on a retrospective basis.

Mentor Corporation
Consolidated Statements of Cash Flows
Three Months Ended June 30, 2005 and 2004
(Unaudited)

(in thousands)

	2005	2004
<u>Operating Activities:</u>		
Net income	\$ 22,475	\$ 17,654
Adjustments to derive cash flows from operating activities:		
Depreciation	3,714	3,584
Amortization	1,048	1,177
Deferred income taxes	58	122
Tax benefit from exercise of stock options	18,406	1,899
Loss on sale of assets	24	1,360
Imputed interest on long-term liabilities	-	15
Changes in operating assets and liabilities:		
Accounts receivable	(1,438)	(662)
Inventories	(744)	(2,263)
Prepaid income taxes and other current assets	(11,207)	265
Accounts payable and accrued liabilities	7,954	(1,632)
Income taxes payable	-	4,321
Net cash provided by operating activities	40,290	25,840
<u>Investing Activities:</u>		
Purchases of property and equipment	(2,101)	(1,490)
Purchases of intangibles	-	(1,512)
Purchases of marketable securities	(97,464)	(50,835)
Sales of marketable securities	100,155	25,006
Net cash provided by (used) for investing activities	590	(28,831)
<u>Financing Activities:</u>		
Proceeds from exercise of stock options	30,508	2,643
Dividends paid	(6,927)	(6,346)
Borrowings (repayments) under line of credit agreements, net	(3,199)	345
Net cash (used) provided by financing activities	20,382	(3,358)
Effect of currency exchange rates on cash and cash equivalents	(1,533)	(8)
Increase (decrease) in cash and cash equivalents	59,729	(6,357)
Cash and cash equivalents at beginning of year	76,666	118,225
Cash and cash equivalents at end of period	\$ 136,395	\$ 111,868

See notes to consolidated financial statements.

MENTOR CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2005

Note A - Business Activity

Mentor Corporation was incorporated in April 1969. Unless the context indicates otherwise, when we refer to "Mentor," "we," "us," "our," or the "Company" in this Form 10-Q, we are referring to Mentor Corporation and its subsidiaries on a consolidated basis. We develop, manufacture and market a broad range of products serving the medical specialties market. Our products are utilized by three primary segments, aesthetic and general surgery (plastic and reconstructive surgery), surgical urology, and clinical and consumer healthcare. Aesthetic and general surgery products include surgically implantable prostheses for plastic and reconstructive surgery, capital equipment and consumables used for soft tissue aspiration or body contouring (liposuction), and the recently introduced non-animal based, hyaluronic acid dermal filler. Surgical urology products include surgically implantable prostheses for the treatment of impotence, surgically implantable incontinence products, urinary care products 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.

Note B - Summary of Significant Accounting Policies

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 inter-company accounts and transactions have been eliminated. Certain prior year amounts in previously issued financial statements have been reclassified or restated to conform to the current year presentation.

Basis of Presentation

The financial information for the three months ended June 30, 2005 and 2004 is unaudited, but includes all adjustments (consisting only of normally recurring accruals, unless otherwise indicated) that the Company considers necessary for a fair presentation of the results of operations for these periods. Interim results are not necessarily indicative of results for the full fiscal year.

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. A discussion of the Company's significant accounting policies is described in the "Application of Critical Accounting Policies" section of "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Effects of Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards (SFAS) No. 154, Accounting Changes and Error Corrections, which replaces APB Opinion No. 20, Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. This pronouncement applies to all voluntary changes in accounting principle, and revises the requirements for accounting for and reporting a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle, unless it is impracticable to do so. This pronouncement also requires that a change in the method of depreciation, amortization, or depletion for long-lived, non-financial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. SFAS No. 154 retains many provisions of APB Opinion 20 without change, including those related to reporting a change in accounting estimate, a change in the reporting entity, and correction of an error. The pronouncement also carries forward the provisions of SFAS No. 3 which govern reporting accounting changes in interim financial statements. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Statement does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of SFAS No. 154. The Company intends to apply the provisions of this statement effective April 1, 2006.

In December 2004, the FASB issued FASB Staff Position (FSP) No. 109-1- Application of SFAS No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 (FSP No. 109-1). The FSP provides that the Deduction on Qualified Production Activities will be treated as a "special deduction" as described in SFAS No. 109, Accounting for Income Taxes. Accordingly, the tax effect of this deduction will be reported as a component of the Company's tax provision and will not have an effect on deferred tax assets and liabilities. The Company anticipates that the Department of the Treasury may issue clarifying guidance with respect to the Deduction on Qualified Production Activities. The adoption of FSP No. 109-1 is not expected to have a material effect on the Company's consolidated financial statements; however, the Company will continue to evaluate the tax effect of the special deduction as further guidance is issued by the Department of the Treasury.

In December 2004, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)"). SFAS 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123(R) covers a wide range of share-based compensation arrangements and requires that the compensation cost related to these types of payment transactions be recognized in financial statements. Cost will be measured based on the fair value of the equity or liability instruments issued.

In March 2005, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107") which provides guidance regarding the application of SFAS 123(R). SAB 107 expresses views of the Staff regarding the interaction between SFAS No. 123(R), Share-Based Payment, and certain SEC rules and regulations, and provides the Staff's views regarding the valuation of share-based payment arrangements for public companies. In particular, SAB 107 provides guidance related to share-based payment transactions with nonemployees, the transition from nonpublic to public entity status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of SFAS 123(R) in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS 123(R), the modification of employee share options prior to adoption of SFAS 123(R), and disclosures in Management's Discussion and Analysis subsequent to adoption of SFAS 123(R).

On April 14, 2005, the SEC approved a new rule that delays the effective date for SFAS 123(R) to annual periods beginning after June 15, 2005, thereby rendering it effective as to the Company on April 1, 2006. The adoption of SFAS 123(R) on April 1, 2006 is expected to have a material impact on the Company's consolidated net income and earnings per share. The Company has not completed its analysis of the impact of the adoption of 123(R); however, the effect of the adoption is estimated to approximate that shown in Note K- "Stock Options" in the Notes to Consolidated Financial Statements.

In November 2004, the FASB issued Statement No. 151, Inventory Costs, which amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing. This amendment clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). This Statement requires that those items be recognized as current-period charges, regardless of whether they meet the criteria specified in ARB 43 of "so abnormal". In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. This Statement is effective for financial statements for fiscal years beginning after June 15, 2005. The impact upon adoption of SFAS No. 151 is not expected to have a material impact on the results of operations or the financial position of the Company.

In September 2004, the FASB confirmed Emerging Issue Task Force ("EITF") Issue No. 04-8, "The Effect of Contingently Convertible Debt on Diluted Earnings per Share," with an effective date of December 15, 2004. The EITF reflects the Task Force's conclusion that contingently convertible debt should be included in diluted earnings per share calculations, regardless of whether or not the trigger price has been reached. The Company adopted EITF 04-8 in the quarter ended December 31, 2004 and retroactively applied its provisions to the interim periods ending June 30 and September 30, 2004 due to the Company's December 2003 issuance of convertible subordinated notes. The impact of the EITF changed the diluted earnings per share calculation by increasing net income used in the numerator by the after-tax amount of interest expense related to the convertible notes (approximately \$802,000 per quarter), and by increasing weighted average shares outstanding used in the denominator by approximately 5.1 million shares, the number of shares to be issued upon full conversion of the convertible notes. The effect of the restatement was a decrease in diluted earnings per share of approximately \$0.02 cents per share for the interim periods ending June 30 and September 30, 2004.

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 31st. 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 quarters-ends are shown below:

	<u>Fiscal 2006</u>	<u>Fiscal 2005</u>
First Quarter	July 1, 2005	July 2, 2004
Second Quarter	September 30, 2005	October 1, 2004
Third Quarter	December 30, 2005	December 31, 2004

The accompanying unaudited consolidated financial statements for the three-month periods ended June 30, 2005 and 2004 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