

GENCOR INDUSTRIES INC  
Form 10-Q  
February 06, 2015  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2014**

**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 Number: 001-11703**

**GENCOR INDUSTRIES, INC.**

**Delaware**  
**(State or other jurisdiction of**  
**incorporated or organization)**

**59-0933147**  
**(I.R.S. Employer**  
**Identification No.)**

**5201 North Orange Blossom Trail, Orlando, Florida**  
**(Address of principal executive offices)**

**32810**  
**(Zip Code)**

**(407) 290-6000**

**(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 and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated Filer

Non-accelerated Filer  (Do not check if a smaller reporting company)

Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at February 2, 2015
Common stock, \$.10 par value	8,010,132 shares
Class B stock, \$.10 par value	1,509,238 shares



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<b>Introductory Note: Caution Concerning Forward-Looking Statements</b>	

This Form 10-Q Report and the Company’s other communications and statements may contain forward-looking statements, including statements about the Company’s beliefs, plans, objectives, goals, expectations, estimates, projections and intentions. These statements are subject to significant risks and uncertainties and are subject to change based on various factors, many of which are beyond the Company’s control. The words *may*, *could*, *should*, *would*, *believe*, *anticipate*, *estimate*, *expect*, *intend*, *plan*, *target*, *goal*, and similar expressions are intended to identify forward-looking statements. All forward-looking statements, by their nature, are subject to risks and uncertainties. The Company’s actual future results may differ materially from those set forth in its forward-looking statements. For information concerning these factors and related matters, see Item 2, *Management’s Discussion and Analysis of Financial Condition and Results of Operations*, in this Report, and the following sections of the Company’s Annual Report on Form 10-K for the year ended September 30, 2014: (a) *Risk Factors* in Part I, and (b) *Management’s Discussion and Analysis of Financial Condition and Results of Operations* in Part II. However, other factors besides those referenced could adversely affect the Company’s results, and you should not consider any such list of factors to be a complete set of all potential risks or uncertainties. Any forward-looking statements made by the Company herein speak as of the date of this Report. The Company does not undertake to update any forward-looking statement, except as required by law.

Unless the context otherwise indicates, all references in this Report to the *Company*, *Gencor*, *we*, *us*, or *our*, or similar words are to Gencor Industries, Inc. and its subsidiaries.



**Table of Contents****Part I. Financial Information****GENCOR INDUSTRIES, INC.****Condensed Consolidated Balance Sheets**

	<b>December 31, 2014 (Unaudited)</b>	<b>September 30, 2014</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 5,629,000	\$ 7,193,000
Marketable securities at fair value (cost \$85,553,000 at December 31, 2014 and \$84,997,000 at September 30, 2014)	87,008,000	87,112,000
Accounts receivable, less allowance for doubtful accounts of \$235,000 at December 31, 2014 and \$244,000 at September 30, 2014	730,000	1,448,000
Costs and estimated earnings in excess of billings	2,358,000	344,000
Inventories, net	13,304,000	13,673,000
Prepaid expenses & other current assets	1,519,000	849,000
<b>Total Current Assets</b>	<b>110,548,000</b>	<b>110,619,000</b>
Property and equipment, net of accumulated depreciation	6,753,000	7,141,000
Other assets	66,000	68,000
<b>Total Assets</b>	<b>\$ 117,367,000</b>	<b>\$ 117,828,000</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 777,000	\$ 947,000
Customer deposits	1,522,000	324,000
Accrued expenses	1,475,000	1,689,000
<b>Total Current Liabilities</b>	<b>3,774,000</b>	<b>2,960,000</b>
Deferred and other income taxes	449,000	693,000
<b>Total Liabilities</b>	<b>4,223,000</b>	<b>3,653,000</b>
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, par value \$.10 per share; authorized 300,000 shares; none issued		
Common stock, par value \$.10 per share; 15,000,000 shares authorized; 8,010,132 shares issued and outstanding	801,000	801,000

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Class B Stock, par value \$.10 per share; 6,000,000 shares authorized; 1,509,238 shares issued and outstanding	151,000	151,000
Capital in excess of par value	10,629,000	10,566,000
Retained earnings	101,563,000	102,657,000
Total Shareholders Equity	113,144,000	114,175,000
Total Liabilities and Shareholders Equity	\$ 117,367,000	\$ 117,828,000

*See accompanying Notes to Condensed Consolidated Financial Statements*

**Table of Contents****GENCOR INDUSTRIES, INC.****Condensed Consolidated Statements of Operations***(Unaudited)*

	<b>For the Quarters Ended December 31,</b>	
	<b>2014</b>	<b>2013</b>
Net revenue	\$ 6,287,000	\$ 10,019,000
Costs and expenses:		
Production costs	5,942,000	8,487,000
Product engineering and development	329,000	380,000
Selling, general and administrative	1,650,000	1,734,000
	7,921,000	10,601,000
Operating loss	(1,634,000)	(582,000)
Other income (expense), net:		
Interest and dividend income, net of fees	323,000	940,000
Realized and unrealized gains (losses) on marketable securities, net	(427,000)	538,000
Other	(1,000)	(15,000)
	(105,000)	1,463,000
Income (loss) before income tax expense (benefit)	(1,739,000)	881,000
Income tax expense (benefit)	(643,000)	435,000
Net Income (Loss)	\$ (1,096,000)	\$ 446,000
Basic Income (Loss) per Common Share:		
Net income (loss) per share	\$ (0.12)	\$ 0.05
Diluted Income (Loss) per Common Share:		
Net income (loss) per share	\$ (0.12)	\$ 0.05

*See accompanying Notes to Condensed Consolidated Financial Statements*



Table of Contents**GENCOR INDUSTRIES, INC.****Condensed Consolidated Statements of Cash Flows***(Unaudited)*

	<b>For the Quarters Ended December 31,</b>	
	<b>2014</b>	<b>2013</b>
Cash flows from operations:		
Net income (loss)	\$ (1,096,000)	\$ 446,000
Adjustments to reconcile net income (loss) to cash used in operating activities:		
Purchases of marketable securities	(134,896,000)	(13,903,000)
Proceeds from sale and maturity of marketable securities	134,567,000	12,983,000
Change in fair value of marketable securities	433,000	(558,000)
Deferred income taxes	(244,000)	220,000
Depreciation and amortization	325,000	334,000
Stock-based compensation	63,000	59,000
Changes in assets and liabilities:		
Accounts receivable	718,000	233,000
Costs and estimated earnings in excess of billings	(2,014,000)	(2,326,000)
Inventories	434,000	95,000
Prepaid expenses & other current assets	(670,000)	(23,000)
Accounts payable	(170,000)	(237,000)
Customer deposits	1,198,000	(816,000)
Accrued expenses	(212,000)	(811,000)
Total adjustments	(468,000)	(4,750,000)
Cash flows used in operating activities	(1,564,000)	(4,304,000)
Cash flows used in investing activities:		
Capital expenditures		(251,000)
Cash flows used in investing activities		(251,000)
Net decrease in cash and cash equivalents	(1,564,000)	(4,555,000)
Cash and cash equivalents at:		
Beginning of period	7,193,000	9,557,000
End of period	\$ 5,629,000	\$ 5,002,000

*See accompanying Notes to Condensed Consolidated Financial Statements*



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**GENCOR INDUSTRIES, INC.**

**Notes to Condensed Consolidated Financial Statements**

**For the Quarter Ended December 31, 2014**

*(Unaudited)*

**Note 1 Basis of Presentation**

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all material adjustments (consisting of normal, recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the quarter ended December 31, 2014 are not necessarily indicative of the results that may be expected for the year ending September 30, 2015.

The accompanying Condensed Consolidated Balance Sheet at September 30, 2014 has been derived from the audited financial statements at that date but does not include all of the information and notes required by generally accepted accounting principles for complete financial statements.

For further information, refer to the consolidated financial statements and notes thereto included in the Gencor Industries, Inc. Annual Report on Form 10-K for the year ended September 30, 2014.

**Note 2 Marketable Securities**

Marketable debt and equity securities are categorized as trading securities and are thus marked to market and stated at fair value. Fair value is determined using the quoted closing or latest bid prices for Level 1 investments and market standard valuation methodologies for Level 2 investments. Realized gains and losses on investment transactions are determined by specific identification and are recognized as incurred in the consolidated statements of operations. Net unrealized gains and losses are reported in the consolidated statements of operations in the current period and represent the change in the fair value of investment holdings during the period.

*Fair Value Measurements*

The fair value of financial instruments is presented based upon a hierarchy of levels that prioritizes the inputs of valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

The fair value of marketable equity securities, mutual funds, exchange-traded funds and government securities are substantially based on quoted market prices (Level 1). Corporate and municipal bonds are valued using market standard valuation methodologies, including: discounted cash flow methodologies, and matrix pricing or other similar techniques. The inputs to these market standard valuation methodologies include, but are not limited to: interest rates, credit standing of the issuer or counterparty, industry sector of the issuer, coupon rate, call provisions, maturity, estimated duration and assumptions regarding liquidity and estimated future cash flows. In addition to bond

characteristics, the valuation methodologies incorporate market data, such as actual trades completed, bids and actual dealer quotes, where such information is available. Accordingly, the estimated fair values are based on available market information and judgments about financial instruments (Level 2). Fair values of the Level 2 investments are provided by the Company's professional investment management firm.

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The following table sets forth, by level, within the fair value hierarchy, the Company's assets measured at fair value as of December 31, 2014:

	Fair Value Measurements			Total
	Level 1	Level 2	Level 3	
Equities	\$ 17,963,000	\$	\$	\$ 17,963,000
Mutual Funds	11,658,000			11,658,000
Exchange-Traded Funds	2,028,000			2,028,000
Government Securities	44,032,000			44,032,000
Cash and Money Funds	11,327,000			11,327,000
Total	\$ 87,008,000	\$	\$	\$ 87,008,000

Net unrealized gains and (losses) recognized during the quarter ended December 31, 2014 on trading securities still held as of December 31, 2014 were \$(661,000). There were no transfers of investments between Level 1 and Level 2 during the quarter ended December 31, 2014.

The following table sets forth by level, within the fair value hierarchy, the Company's assets measured at fair value as of September 30, 2014:

	Fair Value Measurements			Total
	Level 1	Level 2	Level 3	
Equities	\$ 17,102,000	\$	\$	\$ 17,102,000
Mutual Funds	19,088,000			19,088,000
Exchange-Traded Funds	1,764,000			1,764,000
Government Securities	43,999,000			43,999,000
Cash and Money Funds	5,159,000			5,159,000
Total	\$ 87,112,000	\$	\$	\$ 87,112,000

Net unrealized gains and (losses) recognized during the quarter ended December 31, 2013 on trading securities still held as of December 31, 2013 were \$494,000. Estimated interest accrued on the corporate and municipal bond portfolio was \$426,000 at December 31, 2013. There were no transfers of investments between Level 1 and Level 2 during the quarter ended December 31, 2013.

The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable approximate fair value because of the short-term nature of these items.

**Note 3 Inventories**

Inventories are valued at the lower of cost or market, with cost being determined principally by using the last-in, first-out ( LIFO ) method and market defined as replacement cost for raw materials and net realizable value for work in process and finished goods. Appropriate consideration is given to obsolescence, excessive levels, deterioration, possible alternative uses and other factors in determining net realizable value. The cost of work in process and

finished goods includes materials, direct labor, variable costs and overhead. The Company evaluates the need to record inventory allowances on all inventories, including raw material, work in process, finished goods, spare parts and used equipment. Used equipment acquired by the Company on trade-in from customers is carried at estimated net realizable value. Unless specific circumstances warrant different treatment regarding inventory obsolescence, the cost basis of inventories three to four years old is reduced by 50%, while the cost basis of inventories four to five years old is reduced by 75% and the cost basis of inventories greater than five years old is reduced to zero. Inventory is typically reviewed for obsolescence on an annual basis computed as of September 30, the Company's fiscal year end. If significant known changes in trends, technology or other specific circumstances that warrant consideration occur during the year, then the impact on obsolescence is considered at that time.

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Net inventories at December 31, 2014 and September 30, 2014 consist of the following:

	December 31, 2014	September 30, 2014
Raw materials	\$ 5,837,000	\$ 6,097,000
Work in process	2,149,000	2,414,000
Finished goods	5,150,000	4,988,000
Used equipment	168,000	174,000
	\$ 13,304,000	\$ 13,673,000

**Note 4 Costs and Estimated Earnings in Excess of Billings**

Costs and estimated earnings in excess of billings on uncompleted contracts as of December 31, 2014 and September 30, 2014 consist of the following:

	December 31, 2014	September 30, 2014
Costs incurred on uncompleted contracts	\$ 2,740,000	\$ 846,000
Estimated earnings	910,000	279,000
	3,650,000	1,125,000
Billings to date	1,292,000	781,000
Costs and estimated earnings in excess of billings	\$ 2,358,000	\$ 344,000

**Note 5 Earnings per Share Data**

The following table sets forth the computation of basic and diluted earnings (loss) per share for the quarters ended December 31, 2014 and 2013:

	December 31, 2014	December 31, 2013
Earnings (loss)	\$ (1,096,000)	\$ 1,096,000
Shares:		
Weighted average		
Basic shares		
Weighted average	9,519,000	9,519,000
Dilutive		
Options		
	9,519,000	9,519,000

average  
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<u>INDEX</u>	<u>03/31/99</u>	<u>03/31/00</u>	<u>03/31/01</u>	<u>03/31/02</u>	<u>03/31/03</u>	<u>03/31/04</u>
Mentor Corporation	\$ 100.00	\$ 184.60	\$ 154.59	\$ 248.94	\$ 237.07	\$ 424.75
NASDAQ Index	100.00	130.54	122.53	131.45	135.78	221.12
MG Group Index	100.00	195.66	80.80	63.59	51.95	87.02
NYSE Composite	100.00	142.34	141.20	149.39	123.56	217.84

Notwithstanding anything to the contrary set forth in any of the Company's previous filings under the Securities Act of 1933 or the Securities Exchange Act of 1934 that might incorporate future filings, including this Proxy Statement, in whole or in part, the preceding Compensation Committee Report on Executive Compensation and the preceding Company Stock Performance Graph are not to be incorporated by reference into any such filings, nor are such Report or Graph to be incorporated by reference into any future filings.



**SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE**

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's directors and executive officers, among others, to file with the Securities and Exchange Commission (the "SEC") and New York Stock Exchange an initial report of ownership of the Company's stock on Form 3 and reports of changes in ownership on a Form 4 or a Form 5. Persons subject to Section 16 are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms that they file. Under SEC rules, certain forms of indirect ownership and ownership of Company stock by certain family members are covered by these reporting rules. As a matter of practice, the Company's administrative staff assists the Company's executive officers and directors in preparing initial reports of ownership, reports of changes in ownership and in filing these reports on their behalf.

To the Company's knowledge, based solely upon a review of the copies of such reports furnished to the Company and written representations that no other reports were required, during the fiscal year ended March 31, 2004, all Section 16(a) filing requirements applicable to its officers, directors and greater than ten percent beneficial owners were complied with, except that Mr. Michael and Mr. Levine each failed to timely file a Form 4 to report the grant of Company stock options and Mr. Levine also failed to file a Form 4 to report the purchase of Company stock. Form 4s reporting these transactions were subsequently filed.

**CERTAIN TRANSACTIONS**

Since 1991 the Company has had an exclusive agreement with Rochester Medical Corporation ("Rochester") a publicly traded company, to market and distribute certain external catheter products developed by Rochester. The Company purchased \$3,506,000 of products from Rochester under the agreement during fiscal year 2004. Three siblings of Christopher J. Conway, the Chairman and former Chief Executive Officer of the Company, own approximately 23% of Rochester shares and also serve as directors of Rochester. Two of the siblings serve as executive officers of Rochester.

Dr. Maher Michael, M.D., Vice President and Medical Director of the Company, is the brother of Mr. Adel Michael, Vice Chairman of the Company and formerly Chief Financial Officer and Treasurer. In fiscal 2004, Dr. Michael was paid \$212,083, which included a bonus of \$1,000. Dr. Michael also received options to purchase 25,000 shares of Mentor's common stock at an exercise price of \$21.00 per share.

**DEADLINE FOR RECEIPT OF SHAREHOLDER PROPOSALS**

Proposals of shareholders of the Company that are intended to be presented by such shareholders at the Company's 2005 Annual Meeting must be received no later than April 1, 2005, in order to be included in the proxy statement and form of proxy relating to that meeting. However, if the date of the 2005 Annual Meeting is changed by more than 30 days from the date of this year's Annual Meeting (September 15th), then the deadline for submission of shareholder proposals would be reasonable time before the Company begins to print and mail its proxy materials.

Pursuant to the proxy rules under the Securities Exchange Act of 1934, the Company's shareholders are notified that the deadline for providing the Company with timely notice of any shareholder proposal to be submitted outside the Rule 14a-8 process for consideration at the 2005 Annual Meeting will be June 15, 2005. As to matters which the Company does not have notice on or prior to that date, discretionary authority to vote on such proposals shall be granted to the persons designated in the Company's proxy related to the 2005 Annual Meeting.

**SHAREHOLDERS COMMUNICATIONS WITH DIRECTORS**

Company shareholders who want to communicate with the Board of Directors or any individual director can write to the following address:

Mentor Corporation  
Attention: Corporate Secretary  
201 Mentor Drive  
Santa Barbara, CA 93111

**OTHER MATTERS**

The Company knows of no other matters that will be presented for consideration at the Annual Meeting. If any other matters properly come before the Annual Meeting, it is the intention of the persons named in the enclosed form of Proxy to vote the shares they represent as the Board of Directors may recommend. Discretionary authority with respect to such other matters is granted by the execution of the enclosed Proxy.

BY  
ORDER  
OF  
THE  
BOARD  
OF  
DIRECTORS

A.  
Christopher  
Fawzy  
*Secretary*

Dated: July 30, 2004

A COPY OF THE COMPANY'S ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED MARCH 31, 2004 AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION IS AVAILABLE WITHOUT CHARGE UPON WRITTEN REQUEST TO: MENTOR CORPORATION, 201 MENTOR DRIVE, SANTA BARBARA, CALIFORNIA, 93111. OUR SEC FILINGS ARE ALSO AVAILABLE ON THE COMPANY'S WEBSITE UNDER "INVESTOR RELATIONS" AT <http://www.mentorcorp.com> AND THE SEC'S WEBSITE AT <http://www.sec.gov>.

**APPENDIX A**

**MENTOR CORPORATION**

**Charter for Audit Committee  
(as adopted on July 26, 2004)**

**ARTICLE I  
FORMATION**

The Board of Directors of Mentor Corporation (the "Company") has established the Audit Committee pursuant to the Minnesota Business Corporation Act and the Company's Bylaws.

**ARTICLE II  
COMPOSITION**

The Audit Committee (the "Committee") shall be comprised of not less than three members of the Board of Directors of the Company. Subject to the foregoing, the exact number of members of the Committee shall be fixed and may be changed from time to time by resolution duly adopted by the Board of Directors. The Committee members will be appointed by the Board of Directors and may be removed by the Board in its discretion. Each member shall be independent as defined in the listing standards of the New York Stock Exchange in effect from time to time (referred to below as the "Listing Standards") and the Board of Directors shall have affirmatively determined that the member is independent. As more clearly set forth in the Listing Standards, members must not have any current or past relationships with the Company which would interfere with their exercise of independent judgment or otherwise fail to meet the independent standards set forth in the Listing Standards. In addition, the members of the Committee also shall satisfy the following requirements:

- Each member shall be "financially literate" as determined by the Board of Directors. A director shall be considered "financially literate" if by reason of his or her educational, professional or business background, the director is able to read and understand fundamental financial statements, including a company's balance sheet, income statement and statement of cash flows.
- At least one member of the Committee must have accounting or related financial management expertise and, to the extent reasonably possible, otherwise satisfy the standards of an "audit committee financial expert" as defined in Regulation S-K Item 401(e) adopted by the Securities and Exchange Commission (the "SEC").
- Other than in his or her capacity as a member of the Board of Directors or of a committee thereof, no director who, directly or indirectly, accepts any consulting, advisory, or other compensatory fee from the Company as determined pursuant to SEC Rule 10A-3(b)(1) shall be eligible to serve as a member of the Committee.
- No director who is an "affiliated person" of the Company as defined by SEC Rule 10A-3(e)(i) shall be eligible to serve as a member of the Committee.

**ARTICLE III  
PURPOSE AND RESPONSIBILITIES**

The primary purpose of the Committee shall be to: (i) assist the Board of Directors in discharging its responsibilities to oversee the integrity of the Company's financial statements, the Company's compliance with legal and regulatory requirements, the independent auditors' qualifications and independence, and the performance of the Company's internal audit function and independent auditors; (ii) have direct responsibility for the appointment, compensation, retention and oversight of the work of any independent auditors employed by the Company for the purpose of preparing or issuing an audit report or performing other audit, review or attestation services; and (iii) produce an audit committee report for inclusion in the Company's proxy statement. The Committee's responsibilities shall include the following:

A. Pre-Approval of Auditor Services

- All audit services, including the provision of comfort letters in connection with securities offerings, and non-audit services provided to the Company by the Company's auditors shall be approved in advance by the Committee, except with respect to non-audit, review or attestation services if:
  - ◆ The aggregate amount of all such non-audit services provided to the Company constitute less than 5% of the total amount of revenues paid by the Company to its auditor during the fiscal year in which the non-audit services are provided;
  - ◆ The services were not recognized by the Company at the time of the engagement to be non-audit services; and
  - ◆ The services are promptly brought to the attention of the Committee and approved prior to the completion of the audit by the Committee or by one or more members of the Committee to whom authority to grant such approvals has been delegated by the Committee.

If the Committee approves an audit service within the scope of engagement of the independent auditor, the audit service shall be deemed to have been preapproved for purposes of this Article III, A. The Committee may delegate to one or more of its members the authority to grant pre-approvals. Any decision by a member to whom such authority has been delegated shall be presented to the Committee at its next meeting.

- The independent auditor and any person associated with the independent auditor (to the extent determined appropriate by the SEC) shall not provide contemporaneously with the audit, and the Committee shall not approve, any of the following as defined under SEC Reg. S X, Rule 2 01(c)(4):
  - Bookkeeping or other services related to the accounting records or financial statements of the Company;
  - Financial information systems design and implementation;
  - Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
  - Actuarial services;
  - Internal audit outsourcing services;
  - Management functions or human resources;
  - Broker or dealer, investment adviser, or investment banking services;
  - Legal services and expert services unrelated to the audit; and
  - Any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible.

B. Oversight of Independent Auditing Services

- Meet with the independent auditors to review and approve the plan and scope for each audit of the Company's financial statements and related services, including proposed fees to be incurred with respect thereto.
- Review and recommend action with respect to the results of each independent audit of the Company's financial statements, including problems encountered in connection with such audit, difficulties with management's response and recommendations of the independent auditors arising as a result of such audit.
- Discuss with the Company's independent auditors the matters required to be communicated pursuant to Statement on Auditing Standards No. 61 ("SAS 61"), as may be amended or supplemented.
- At least annually, discuss with the independent auditors their independence and receive each of the following in writing:
  - Disclosure of all relationships between the auditors and their related entities and the Company and its related entities that in the auditors' professional judgment may reasonably be thought to bear on independence; and
  - Confirmation that, in the auditors' professional judgment, they are independent of the Company within the meaning of the federal securities laws.
  - The independent auditor's internal quality-control procedures and any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues.

- Discuss with the Company's independent auditors any relationships or services disclosed by the independent auditors that may impact the objectivity and independence of the independent auditors and recommend to the Board of Directors any actions in response to the independent auditors' disclosures to satisfy itself of the independent auditors' independence.
- Evaluate the performance of the Company's independent auditors and present its conclusions and any recommendation to the Board of Directors regarding the Company's independent auditors.
- Obtain and review the reports of the Public Company Accounting Oversight Board with respect to the Company's independent auditors when such reports are made publicly available.

C. Financial Statements

- Resolve any disagreements between management and the independent auditors regarding financial reporting.
- Receive the report of the independent auditor that performs for the Company any audit required by the Exchange Act with respect to each of the following:
  - All critical accounting policies and practices to be used;
  - All alternative treatments of financial information within Generally Accepted Accounting Principles that have been discussed with management officials of the Company, the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent auditor; and
  - Other material written communications between the independent auditor and the Company such as any management letter or schedule of unadjusted differences.
- Review and discuss with the Company's independent auditors and management the Company's audited financial statements, including the Company's disclosures under "Management Discussion and Analysis of Financial Conditions and Results of Operations."
- Based on (1) its review and discussions with management of the Company's audited financial statements; (2) its discussion with the independent auditors of the matters to be communicated pursuant to SAS 61; and (3) the written disclosures from the Company's independent auditors regarding independence, recommend to the Company's Board of Directors whether the Company's audited financial statements should be included in the Company's Annual Report on Form 10-K for the last fiscal year for filing with the SEC.
- Review and discuss with the Company's independent auditors and management the Company's quarterly financial statements, including the Company's disclosures under "Management Discussion and Analysis of Financial Condition and Results of Operations."
- Review and discuss the Company's earnings press releases, as well as financial information and earnings guidance provided to analysts and ratings agencies.

D. Internal Controls

- Review with the Company's independent auditors and financial management the adequacy and effectiveness of the Company's system of internal accounting controls, including the adequacy of such controls to expose any payments, transactions or procedures that might be deemed illegal or otherwise improper.
- Prior to the Company's filing of any Quarterly Report on Form 10-Q or Annual Report on Form 10-K, receive the following disclosures from the Company's principal executive officer and principal financial officer with respect to the following:
  - All significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data;
  - All material weaknesses in internal controls identified by such officers to the Company's independent auditors; and
  - Any fraud, whether material or not material, that involves management of the Company or other employees who have a significant role in the Company's internal controls.
- Obtain the attestation and report of the Company's independent auditors on the assessment made by the Company's management in the Company's Annual Report on Form 10-K of the effectiveness of the Company's internal control structure and procedures for financial reporting.
- Review the scope and results of the Company's internal auditing procedures and practices and oversee the effectiveness thereof.

E. Management Conduct Policies

- Establish procedures for:
  - The receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters; and
  - The confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters.
- Review from time to time the code of ethics for senior financial officers of the Company which includes those standards that the Committee has determined to be reasonably necessary to promote:
  - ◆ Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
  - ◆ Full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the Company under the Exchange Act; and
  - ◆ Compliance with applicable governmental rules and regulations.

- Make interpretations from time to time as to the scope and application of the Company's senior financial officer conduct policies.
- Review and approve or disapprove proposed transactions between the Company and its employees (other than employment related transactions) or directors.
- Receive any report required to be made by the Company's attorneys pursuant to the standards adopted by the SEC for professional conduct of attorneys appearing and practicing before the SEC.

F. Other Duties

- Meet separately, periodically, with management, with internal auditors and with independent auditors.
- Discuss policies with respect to risk assessment and risk management.
- Produce an annual report for inclusion in the proxy statement as the Audit Committee Report.
- Set clear hiring policies for employees or former employees of the Company's independent auditors.
- Make regular reports to the Board and propose any necessary action to the Board.
- Evaluate its performance as the Audit Committee on an annual basis.
- At least annually, review the adequacy of this Charter and recommend to the Company's Board of Directors any changes to this Charter that the Committee deems necessary or desirable.
- Perform such other specific functions as the Company's Board of Directors may from time to time direct, and make such investigations and reviews of the Company and its operations as the Chief Executive Officer or the Board of Directors may from time to time request.

## **ARTICLE IV AUTHORITY AND PROCEDURES**

The Committee shall meet at least four times a year and shall keep regular minutes of its meetings. The Committee, as it may determine to be appropriate, may meet in separate executive sessions with other directors, the CEO and other Company employees, agents or representatives invited by the Committee. The Committee's Chairman shall be designated by the full Board or, if it does not do so, the Committee members shall elect a Chairman by vote of a majority of the full Committee. The Chairman of the Committee will preside at each meeting of the Committee and, in consultation with the other members of the Committee, shall set the frequency and length of each meeting and the agenda of items to be addressed at each meeting. The Committee is at all times authorized to have direct, independent access to the Company's other directors and management. The Committee shall have the power to hire independent legal, financial or other advisors, as it deems necessary, without consulting or obtaining the approval of any officer of the Company in advance. Such power shall include, but not be limited to, authorizing such expenditures by the Company as it shall determine necessary for payment to (1) the independent auditor employed by the Company for purposes of rendering or issuing an audit report, and (2) any advisors employed by the Committee. The Company's independent auditors shall report directly to the Committee. The Committee shall have the authority to delegate any of its responsibilities to subcommittees as the Committee may deem appropriate, provided the subcommittee is composed entirely of independent directors and has a published committee charter.



**MENTOR CORPORATION  
ANNUAL MEETING - SEPTEMBER 15, 2004**

**PROXY SOLICITED BY THE BOARD OF DIRECTORS**

The undersigned revokes all previous proxies, acknowledges receipt at the notice of the 2004 Annual Meeting of Shareholders to be held September 15, 2004 and the proxy statement, and hereby appoints Christopher J. Conway and Adel Michael, and each of them, as attorneys-in-fact, proxies with power of substitution to vote on behalf of the undersigned all shares which the undersigned may be entitled to vote at the Annual Meeting of Shareholders of the Company to be held at the Minneapolis Hilton and Towers, 1001 Marquette Avenue, Minneapolis, Minnesota, at 10:00 a.m. (local time), on September 15, 2004, and any adjournments or postponements thereof, with all powers the undersigned would possess if personally present, with respect to the following:

1. Approve an increase in the authorized number of members of the Board of Directors from seven to eleven

FOR  AGAINST  ABSTAIN

2. To elect seven directors and, if Proposal 1 is approved at the meeting increasing the authorized number of directors to eleven, to elect an additional four directors to serve on the Company's Board of Directors until the next annual meeting or until their successors are duly elected and qualified.

FOR ALL nominees listed below\*  WITHHOLD AUTHORITY for all nominees listed below\*  EXCEPTIONS\*

**\*INSTRUCTION: To vote for or withhold authority to vote for all nominees, check the appropriate box above; to withhold authority to vote for an individual while voting for others, check the "Exceptions" box and line through or otherwise strike out the name of the nominee(s) for whom authority is withheld.**

Christopher J. Conway; Walter W. Faster; Eugene G. Glover; Michael Nakonechny;  
Ronald J. Rossi; Jeffrey W. Ubben; Dr. Richard W. Young

**Additional Nominees if Proposal 1 is Approved**

Michael L. Emmons; Joshua H. Levine; Adel Michael; Joseph E. Whitters

3. Ratify the Appointment of Ernst & Young LLP as the Principal Independent Auditors of the Company for the Fiscal Year Ending March 31, 2005.

FOR  AGAINST  ABSTAIN

4. In their discretion, the proxies are authorized to vote upon such other business as may properly come before the Annual Meeting or any adjournments or postponements thereof:

**This proxy will be voted as directed. If no direction is indicated, it will be voted FOR the approval of Proposal No. 1, FOR the nominees listed in Proposal No. 2, including the four additional nominees if Proposal 1 is approved, and FOR the approval of Proposal No. 3. The proxies are authorized to vote in their discretion with respect to other matters which may come before the meeting.** A majority of the proxies or substitutes present at the meeting may exercise all powers granted hereby.

(Continued and to be signed on the other side)

(Continued from other side)

The undersigned hereby ratifies and confirms all that said attorneys-in-fact and proxies shall lawfully do or cause to be done by virtue hereof, and hereby revokes any and all proxies heretofore given by the undersigned to vote at the annual meeting or any adjournment thereof.

Please mark, date and sign exactly as name appears hereon, including designation as executor, trustee, etc., if applicable. A corporation must sign in its name by the president or other authorized officer. All co-owners must sign.

Date: \_\_\_\_\_, 2004

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Signature or Signatures

Please MARK, SIGN, DATE and RETURN this PROXY in the enclosed self-addressed envelope.