MENTOR CORP /MN/
Form 10-Q
February 06, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended December 28, 2007

or

o **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. 001-31744

MENTOR CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Minnesota	41-0950791
(State or other jurisdiction of incorporation or organization)	(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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

As of February 1, 2008 there were approximately 33,737,437 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)	**December 31, 2007**	March 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	**$ 74,961**	$ 371,525
Marketable securities	**31,686**	116,215
Accounts receivable, net	**72,385**	65,419
Inventories	**46,697**	38,073
Deferred income taxes	**26,353**	25,892
Prepaid income taxes	**9,789**	13,495
Prepaid expenses and other	**7,994**	6,761
Total current assets	**269,865**	637,380
Property and equipment, net	**48,610**	34,683
Intangible assets, net	**32,067**	15,963
Goodwill, net	**46,197**	12,644
Other assets	**6,681**	9,098
Total assets	**$ 403,420**	$ 709,768

See notes to consolidated financial statements.

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Mentor Corporation
Consolidated Balance Sheets
(Unaudited)

(in thousands, except share data)	**December 31, 2007**	March 31, 2007
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable and accrued liabilities	**$ 38,709**	$ 32,147
Sales returns	**14,881**	18,590
Accrued compensation	**17,917**	14,022
Deferred revenue	**12,443**	11,863
Dividends payable	**6,745**	8,481
Product liability reserves	**7,322**	6,555
Short-term debt	**1,076**	
Warranty reserve	**2,393**	2,989
Interest payable	**2,063**	1,031
Accrued royalties	**250**	230
Other	**14,108**	16,823
Total current liabilities	**117,907**	112,731
Long-term accrued liabilities	**15,606**	12,169
Convertible subordinated notes	**150,000**	150,000
Other long-term debt	**2,735**	
Commitments and contingencies		
Shareholders equity:		
Common stock, $.10 par value:		
Authorized - 150,000,000 shares; issued and outstanding		
33,725,599 shares at December 31, 2007;		
42,400,483 shares at March 31, 2007;	**3,373**	4,240
Preferred stock, $.01 par value:		
Authorized - 25,000,000 shares; none issued and outstanding		
Accumulated other comprehensive income	**22,630**	11,342
Retained earnings	**91,169**	419,286
Total shareholders equity	**117,172**	434,868
Total liabilities and shareholders equity	**$ 403,420**	$ 709,768

See notes to consolidated financial statements.

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Mentor Corporation
Consolidated Statements of Income
Three Months Ended December 31, 2007 and 2006
(Unaudited)

(in thousands, except per share data)		2007		2006
Net sales	$	92,860	$	75,309
Cost of sales		26,138		18,925
Gross profit		66,722		56,384
Selling, general, and administrative		38,884		32,356
Research and development		9,690		7,780
		48,574		40,136
Operating income from continuing operations		18,148		16,248
Interest expense		(1,249)		(1,426)
Interest income		1,071		6,346
Other income (expense), net		(452)		(281)
Income from continuing operations before income taxes		17,518		20,887
Income taxes		5,406		6,137
Income from continuing operations		12,112		14,750
Loss from discontinued operations, net of tax benefit of $94 and $596, respectively		(170)		(1,102)
Loss on sale of discontinued operations, net of tax benefit of $13				(20)
Net income	$	11,942	$	13,628
Basic earnings (loss) per share				
Continuing operations	$	0.36	$	0.35
Discontinued operations		(0.01)		(0.03)
Basic earnings per share		0.36		0.33
Diluted earnings (loss) per share				
Continuing operations	$	0.32	$	0.32
Discontinued operations		(0.01)		(0.03)
Diluted earnings per share		0.32		0.29
Dividends per share	$	0.20	$	0.18

Weighted average shares outstanding		
Basic	**33,602**	41,916
Diluted	**39,848**	49,144

See notes to consolidated financial statements.

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Mentor Corporation
Consolidated Statements of Income
Nine Months Ended December 31, 2007 and 2006
(Unaudited)

(in thousands, except per share data)	**2007**	2006
Net sales	**$ 273,814**	$ 221,654
Cost of sales	**72,842**	59,491
Gross profit	**200,972**	162,163
Selling, general, and administrative	**108,326**	90,792
Research and development	**32,207**	24,654
	140,533	115,446
Operating income from continuing operations	**60,439**	46,717
Interest expense	**(4,160)**	(4,707)
Interest income	**7,218**	16,233
Other income (expense), net	**(1,421)**	494
Income from continuing operations before income taxes	**62,076**	58,737
Income taxes	**18,191**	17,490
Income from continuing operations	**43,885**	41,247
(Loss) income from discontinued operations, net of tax (benefit) expense of ($152) and $2,760, respectively	**(275)**	1,342
(Loss) gain on sale of discontinued operations, net of taxes of ($5) and $138,341, respectively	**(12)**	222,162
Net income	**$ 43,598**	$ 264,751
Basic earnings (loss) per share		
Continuing operations	**$ 1.22**	$ 0.98
Discontinued operations	**(0.01)**	5.33
Basic earnings per share	**1.21**	6.32
Diluted earnings (loss) per share		
Continuing operations	**$ 1.09**	$ 0.89
Discontinued operations	**(0.01)**	4.57
Diluted earnings per share	**1.08**	5.46

Dividends per share	**$**	**0.60**	$	0.54
Weighted average shares outstanding				
Basic		**36,033**		41,898
Diluted		**42,499**		48,948

See notes to consolidated financial statements.

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Mentor Corporation
Consolidated Statements of Cash Flows
Nine Months Ended December 31, 2007 and 2006
(Unaudited)

(in thousands)	**2007**	2006
Operating Activities:		
Income from continuing operations	$ **43,885**	$ 41,247
Adjustments to derive cash flows from continuing operating activities:		
Depreciation	**6,024**	5,640
Amortization	**3,734**	1,889
Deferred income taxes	**(2,527)**	3,477
Non-cash compensation	**9,128**	8,203
Tax benefit from exercise of stock options	**2,054**	8,465
Excess tax benefits from equity compensation	**(2,256)**	
Loss on sale of assets	**29**	162
Loss (gain) on long-term marketable securities, net	**(28)**	132
Cash provided by (used in) changes in operating assets and liabilities:		
Accounts receivable	**(1,151)**	(2,351)
Inventories	**3,360**	(725)
Other current assets	**2,869**	285
Accounts payable and accrued liabilities	**4,503**	3,933
Income taxes payable		(5,137)
Net cash provided by continuing operating activities	**69,624**	65,220
Net cash used for discontinued operating activities	**(287)**	(95,111)
Net cash provided by (used for) operating activities	**69,337**	(29,891)
Investing Activities:		
Purchases of property and equipment	**(13,683)**	(4,435)
Purchases of intangibles		(3,505)
Purchases of marketable securities	**(44,150)**	(65,609)
Sales of marketable securities	**128,294**	53,666
Acquisition, net of cash acquired	**(53,437)**	
Proceeds from the sale of the urology business		458,066
Other, net		5
Net cash provided by continuing investing activities	**17,024**	438,188
Net cash used for discontinued investing activities		(50)
Net cash provided by investing activities	**17,024**	438,138
Financing Activities:		
Repurchase of common stock	**(367,701)**	(88,198)
Proceeds from exercise of stock options and ESPP	**4,982**	22,194
Excess tax benefits from equity compensation	**2,256**	

Dividends paid	**(22,780)**	(22,842)
Repayments under line of credit agreements	**(420)**	(14,000)
Net cash used for continuing financing activities	**(383,663)**	(102,846)
Net cash used for financing activities	**(383,663)**	(102,846)
Effect of currency exchange rates of continuing operations	**738**	413
Effect of currency exchange rates of discontinued operations		(120)
(Decrease) increase in cash and cash equivalents	**(296,564)**	305,694
Cash and cash equivalents at beginning of year	**371,525**	98,713
Cash and cash equivalents at end of period	**$ 74,961**	$ 404,407

See notes to consolidated financial statements.

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MENTOR CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

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 these notes, we are referring to Mentor Corporation and its subsidiaries on a consolidated basis. Presently, the Company develops, manufactures, licenses and markets a range of products serving the aesthetic and general surgery markets, including plastic and reconstructive surgery.

Historically, the Company s products were categorized into three primary segments:

Aesthetic and General Surgery This segment includes surgically implantable breast implants for plastic and reconstructive surgery, capital equipment and consumables used for soft tissue aspiration or body contouring (liposuction), and facial rejuvenation products including various types of products for skin restoration.

Surgical Urology This segment includes 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 This segment includes catheters and other products for the management of urinary incontinence and retention.

On June 2, 2006, the Company completed a transaction for the sale of the Surgical Urology and the Clinical and Consumer Healthcare segments (together referred to as the Urology Business) to Coloplast A/S (Coloplast). Please see Note P and Note R to the consolidated financial statements for further information.

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. All intercompany accounts and transactions have been eliminated.

Basis of Presentation

The financial information for the three and nine months ended December 31, 2007 and 2006 is unaudited, but in the opinion of management 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 this period. Interim results are not necessarily indicative of results for the full fiscal year. The balance sheet at March 31, 2007 has been derived from the audited financial statements as of that date, but does not include all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements.

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.

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Revenue Recognition

The Company recognizes product revenue, net of discounts, returns, rebates, and taxes collected from customers in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When the Right of Return Exists, and Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. As required by these standards, revenue is recorded when persuasive evidence of a sales arrangement exists, delivery has occurred, the buyer s price is fixed or determinable, contractual obligations have been satisfied, and collectibility is reasonably assured. These requirements are met, and sales and related cost of sales are recognized upon the shipment of products, or in the case of consignment inventories, upon the notification of usage by the customer. The Company records estimated reductions to revenue for customer programs and other volume-based incentives. Should the actual level of customer participation in these programs differ from those estimated, additional adjustments to revenue may be required. The Company also allows credit for products returned within its policy terms. The Company records an allowance for estimated returns at the time of sale based on historical experience, recent gross sales levels, any notification of pending returns and other relevant information. Should the actual returns differ from those estimated, additional adjustments to revenue and cost of sales may be required.

The Company has current and long term deferred revenue, which include funds received in connection with purchases of the Company s Enhanced Advantage Limited Warranty program for breast implants. The fees received in connection with the Enhanced Advantage Limited Warranty are deferred and recognized evenly over the life of the warranty term.

Warranty Reserves

The Company offers limited warranty coverage on some of its products (see Note G for details). While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component and raw material suppliers, the limited warranty obligation is affected by reported rates of warranty claims and levels of financial assistance specified in the limited warranties. Should actual patient claim rates reported differ from the Company s estimates and/or changes in claim rates result in revised actuarial assumptions, additional adjustments to the estimated limited warranty liability may be required. These adjustments would be included in cost of sales. The Company s limited warranty programs may be modified in the future in response to the competitive market environment. Such changes may impact the amount and timing of the associated revenue and expense for these programs.

Product Liability Reserves

The Company has product liability reserves for product-related claims to the extent those claims may result in litigation expenses, settlements or judgments within the Company s self-insured retention limits. The Company has also established additional reserves, through its wholly-owned captive insurance company, for estimated liabilities for product-related claims based on actuarially determined estimated liabilities taking into account its excess insurance coverages. The actuarial valuations are based on historical information and certain assumptions about future events. Product liability costs are recorded in selling, general and administrative expenses as they are directly under the control of its General Counsel and other general and administrative staff and are directly impacted by the Company s overall risk management strategy; or in the case of products related to discontinued operations, including urology products or ophthalmic products, product liability costs are recorded in discontinued operations. Should actual product liability experience differ from the estimates and assumptions used to develop these reserves, subsequent changes in reserves will be recorded in selling, general and administrative expenses, and may affect the Company s operating results in future periods.

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Employee Stock-Based Payments

The Company has employee compensation plans under which various types of stock-based instruments have been granted. These instruments principally include stock options, restricted stock and performance units. As of December 31, 2007, these plans have instruments outstanding that might require the issuance of 4.9 million shares of common stock to its employees and directors. Stock-based awards under the Company s employee compensation plans are made with authorized, but unissued, shares reserved for this purpose.

Effective April 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), Share-Based Payment . In addition to recognizing compensation expense related to restricted stock and performance units, SFAS No. 123(R) also requires the Company to recognize compensation expense related to the estimated fair value of stock options and other equity based compensation instruments. The Company adopted SFAS No. 123(R) using the modified-prospective-transition method. Under that transition method, compensation expense recognized subsequent to adoption includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested, as of April 1, 2006, based on the values estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted subsequent to April 1, 2006 based on the grant-date fair values estimated in accordance with the provisions of SFAS No. 123(R).

Effects of Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosure about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements. Accordingly, this statement does not require any new fair value measurements. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the requirements of SFAS No. 157 and has not yet determined the impact on the Company s consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which became effective for the Company as of April 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing rules for recognition, measurement and classification in the financial statements of tax positions taken or expected to be taken in a tax return.

For tax benefits to be recognized under FIN 48, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. As of April 1, 2007, the gross amount of the Company s liabilities for unrecognized tax benefits (UTBs) was approximately $4.6 million and accrued interest related to these UTBs totaled approximately $0.6 million. Virtually all of this balance of $4.6 million of UTBs (net of the federal benefit on state taxes), if recognized, would affect the Company s annual effective tax rate. The cumulative effect of applying the recognition and measurement provisions upon adoption of FIN 48 was not material.

FIN 48 also provides guidance on the balance sheet classification of liabilities for UTBs as either current or non-current depending on the expected timing of payments. Upon adoption of FIN 48, the Company reclassified approximately $1.4 million and $3.8 million of UTBs and related accrued interest from prepaid income taxes payable to current and non-current liabilities, respectively.

As of adoption of FIN 48, the Company believed that it was reasonably possible that our liabilities for UTBs may decrease by $0.6 million to $1.6 million within the succeeding twelve months due to potential tax settlements and resolution of tax issues and examinations.

Interest and penalties related to UTBs are classified as a component of our provision for income taxes.

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In February 2007, FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to choose to measure certain financial assets and liabilities at fair value. Unrealized gains and losses, arising subsequent to adoption, are reported in earnings. The Company is required to adopt SFAS 159 for the first fiscal year beginning after November 15, 2007. The Company is currently evaluating if it will elect the fair value option for any of its eligible financial instruments and other items.

In June 2007, FASB ratified Emerging Issues Task Force Issue No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities (EITF No. 07-3). EITF No. 07-3 requires that nonrefundable advance payments for goods and services that will be used or rendered in future research and development activities pursuant to executory contractual arrangements should be deferred and recognized as an expense in the period that the related goods are delivered or services are performed. The Company will adopt EITF No. 07-3 in the first quarter of fiscal 2009, and it is not expected to have a material impact on the Company s results of operations or financial position.

In December 2007, FASB ratified Emerging Issues Task Force Issue No. 07-1, Accounting for Collaborative Arrangements . EITF No. 07-1 requires a company in a collaborative arrangement to present the results of activities for which it acts as the principal on a gross basis and to report any payments received from (made to) other collaborators based on other applicable generally accepted accounting principles (GAAP) or, in the absence of other applicable GAAP, based on analogy to authoritative literature or a reasonable, rational, and consistently applied accounting policy election. The Company is required to adopt EITF No. 07-1 for annual periods beginning after December 15, 2008. The Company is currently evaluating the requirements of EITF No. 07-1 and has not yet determined the impact on the Company s consolidated financial statements.

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 quarter ends are shown below:

	Fiscal 2008	Fiscal 2007
First Quarter	June 29, 2007	June 30, 2006
Second Quarter	September 28, 2007	September 29, 2006
Third Quarter	December 28, 2007	December 29, 2006

The accompanying unaudited consolidated financial statements for the three and nine months ended December 31, 2007 and 2006 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 notes required by accounting principles generally accepted in the United States for complete financial statements.

The consolidated financial statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended March 31, 2007.

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 SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. Available-for-sale securities are reported at fair market value. 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. Unrealized gains and losses are excluded from income, and are reported as a net amount in Accumulated Other Comprehensive Income in Shareholders Equity. The Company s short-term marketable securities consist primarily of state and municipal government and government agency obligations, Federal Home Loan Bank and Mortgage Association bonds, and investment-grade corporate obligations, including commercial paper.

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Cash and available-for-sale investments at December 31, 2007 were as follows:

(in thousands)	Adjusted Cost		Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash balances	**$ 56,315**		**$**	**$**	**$ 56,315**
Money market funds	**18,646**				**18,646**
U.S. Government and agency obligations	**16,799**		**6**	**(1)**	**16,804**
State and Municipal agency obligations	**14,596**				**14,596**
Corporate debt securities	**285**		**1**		**286**
Total available-for-sale investments	**$ 106,641**		**$ 7**	**$ (1)**	**$ 106,647**
Included in cash and cash equivalents	**$ 74,961**		**$**	**$**	**$ 74,961**
Included in current marketable securities	**31,680**	&nbsDISPLAY: inline; FONT-FAMILY: times new roman; FONT-SIZE: 10pt; FONT-WEIGHT: bold">	26		
Foreign currency (loss) gain	(75)		(14)	(71)	47
Income before income taxes	585		41	591	287
Income taxes provision	(80)		(14)	(81)	(101)
Net income	505		27	510	186
Basic income per share	$.15		$.01	$.15	$.06
Fully diluted income per share	$.15		$.01	$.15	$.06

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)
Tech/Ops Sevcon, Inc. and Subsidiaries

	(in thousands of dollars)			
	Three months ended		Six months ended	
	April 2, 2011	April 3, 2010	April 2, 2011	April 3, 2010
Net income	505	27	510	186
Foreign currency translation adjustment	190	(206)	137	(249)
Pension liability adjustment, net of tax	842	8	900	17
Comprehensive income (loss)	$1,537	$(171)	$1,547	$(46)

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
Tech/Ops Sevcon, Inc. and Subsidiaries

	(in thousands of dollars)	
	Six months ended	
	April 2, 2011	April 3, 2010
Cash flow from operating activities:		
Net income	$510	$186
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation	316	283
Gain on sale of fixed assets	(451)	-
Stock-based compensation	79	63
Pension contributions less than pension expense	150	258
Deferred tax provision	90	23
Increase (decrease) in cash resulting from changes in operating assets and liabilities:		
Receivables	(733)	(1,644)
Inventories	(1,303)	34
Prepaid expenses and other current assets	(42)	(133)
Accounts payable	351	1,656
Accrued expenses	555	(119)
Accrued and deferred taxes on income	(113)	528
Net cash (used by) generated from operating activities	(591)	1,135
Cash flow generated from (used by) investing activities:		
Acquisition of property, plant and equipment	(414)	(267)
Proceeds of sale of fixed assets	1,278	-
Net cash generated from (used by) investing activities	864	(267)
Cash flow used by financing activities:		
Repayment of long term debt	(18)	-
Net cash used by financing activities	(18)	-
Effect of exchange rate changes on cash	56	(188)
Net increase in cash	311	680
Beginning balance - cash and cash equivalents	803	632
Ending balance - cash and cash equivalents	$1,114	$1,312
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$-	$-
Cash paid for interest	$31	$10

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

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TECH/OPS SEVCON, INC.

Notes to Consolidated Financial Statements – April 2, 2011

(Unaudited)

(1) Basis of presentation

Tech/Ops Sevcon, Inc. ("Tech/Ops" or the "Company") is a Delaware corporation organized on December 22, 1987 to carry on the electronic controls business previously performed by Tech/Ops, Inc. Through wholly-owned subsidiaries located in the United States, the United Kingdom, France, South Korea and Japan, the Company designs and sells, under the Sevcon name, microprocessor based controls for zero emission and hybrid electric vehicles. The controls are used to vary the speed and movement of vehicles, to integrate specialized functions and to prolong the shift life of vehicles' power source. The Company's customers are manufacturers of on-road, off-road and industrial vehicles including automobiles, buses, fork lift trucks, aerial lifts, mining vehicles, airport ground support vehicles, utility vehicles, sweepers and other battery powered vehicles. Through another subsidiary located in the United Kingdom, Tech/Ops manufactures special metalized film capacitors that are used as components in the power electronics, signaling and audio equipment markets.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of only normally recurring accruals) necessary to present fairly the financial position of Tech/Ops as of April 2, 2011 and the results of operations and cash flows for the six months ended April 2, 2011. These unaudited interim financial statements should be read in conjunction with the 2010 annual consolidated financial statements and related notes included in the 2010 Tech/Ops Annual Report filed on Form 10-K (the "2010 10-K"). Unless otherwise indicated, each reference to a year means the Company's fiscal year, which ends on September 30.

Certain prior period balances have been reclassified to conform with current period presentation.

The results of operations for the six month period ended April 2, 2011 are not necessarily indicative of the results to be expected for the full year.

(2) Summary of significant accounting policies

Other than the following update to the Company's revenue recognition policy, there have been no changes since the end of 2010 to the significant accounting policies followed by Tech/Ops.

Revenue Recognition

The Company recognizes revenue in certain circumstances before delivery has occurred (commonly referred to as bill and hold transactions). In such circumstances, among other things, risk of ownership has passed to the buyer, the buyer has made a written fixed commitment to purchase the finished goods, the buyer has requested the finished goods be held for future delivery as scheduled and designated by them, and no additional performance obligations exist by the Company. For these transactions, the finished goods are segregated from inventory and normal billing and credit terms are granted.

Infrequently the Company enters into fixed-price non-recurring engineering contracts. Revenue from these contracts is recognized in accordance with the percentage-of-completion method of accounting.

(3) Stock-based compensation plans

Under the Company's 1996 Equity Incentive Plan (the "Plan") there were 238,000 shares reserved and available for grant at April 2, 2011. There were no options granted or exercised in the periods ended April 2, 2011 and April 3, 2010.

Recipients of grants must execute a standard form of non-competition agreement. The Plan provides for the grant of Restricted Stock, Restricted Stock Units, Options, and Stock Appreciation Rights ("SARs"). SARs may be awarded either separately, or in relation to options granted, and for the grant of bonus shares. Options granted are exercisable at a price not less than fair market value on the date of grant.

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A summary of option activity for all plans for the six months ended April 2, 2011 is as follows:

	Options No. of shares	Weighted average Exercise Price	Weighted average remaining contractual life (years)	Aggregate Intrinsic Value
Outstanding at September 30, 2010	46,000	$5.62	2.3 years	$25,400
Granted	-	-	-	$-
Exercised	-	-	-	$-
Cancelled	-	-	-	$-
Outstanding at April 2, 2011	46,000	$5.62	1.7 years	$44,000
Exercisable at April 2, 2011	37,500	$5.72	1.6 years	$35,000
Exercisable and expected to vest at April 2, 2011	46,000	$5.62	1.7 years	$44,000

The aggregate intrinsic value included in the table above represents the difference between the exercise price of the options and the market price of the Company's common stock for the options that had exercise prices that were lower than the $5.74 and $5.19 closing market price of the Company's common stock at April 2, 2011 and September 30, 2010 respectively.

A summary of restricted stock activity for the six months ended April 2, 2011 is as follows:

	Number of shares of Restricted Stock	Weighted Average Grant – Date Fair Value
Outstanding at September 30, 2010	60,000	$3.20
Granted	20,000	$8.75
Vested	(30,000)	$3.56
Outstanding at April 2, 2011	50,000	$5.21

In January 2011, the Company granted 20,000 shares of restricted stock to eight non-employee directors, which will vest on the day before the 2012 annual meeting providing that the grantee remains a director of the Company, or as otherwise determined by the Compensation Committee. The aggregate fair value of the stock measured on the date of grant was $175,000, based on the closing sale price of the stock on the date of grant. Compensation expense is being charged to income on a straight line basis over the twelve month period during which the forfeiture conditions lapse. The charge to income for these restricted stock grants in the first six months of fiscal 2011 was $29,000 and the subsequent charge will be approximately $44,000 on a quarterly basis.

Stock based compensation expense for the three and six month periods ended April 2, 2011 was $43,000 and $79,000, respectively and for the three and six month periods ended April 3, 2010 was $24,000 and $63,000, respectively. At April 2, 2011 there was $234,000 of unrecognized compensation expense related to share options and restricted stock granted under the plan. The Company expects to recognize that cost over a weighted average period of 1.7 years.

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(4) Cash dividends

The Company suspended the payment of dividends at the beginning of 2009 in order to conserve cash to meet the needs of the business during the global recession. The Board of Directors will consider whether to resume paying dividends as conditions and the Company's operating results improve.

(5) Calculation of earnings per share and weighted average shares outstanding

Basic and fully diluted earnings per share were calculated as follows:

	(in thousands except per share data)			
	Three Months ended		Six Months ended	
	April 2, 2011	April 3, 2010	April 2, 2011	April 3, 2010
Net income	$505	$27	$510	$186
Weighted average shares outstanding - basic	3,307	3,277	3,296	3,265
Basic income per share	$.15	$.01	$.15	$.06
Common stock equivalents	28	9	36	12
Weighted average shares outstanding - diluted	3,335	3,286	3,332	3,277
Diluted income per share	$.15	$.01	$.15	$.06
No. of options that are anti-dilutive excluded from calculation of common stock equivalents	10	46	10	46

(6) Segment information

The Company has two reportable segments: electronic controls and capacitors. The electronic controls segment produces microprocessor based control systems for zero emission and hybrid electric vehicles. The capacitors segment produces metalized film capacitors for sale to electronic equipment manufacturers. Each segment has its own management team and sales force and the capacitors segment has its own manufacturing facility.

The significant accounting policies of the segments are the same as those described in Note 1 to the 2010 10-K. Inter-segment revenues are accounted for at current market prices. The Company evaluates the performance of each segment principally based on operating income. The Company does not allocate income taxes, interest income and expense or foreign currency translation gains and losses to segments. Information concerning operations of these businesses is as follows:

	(in thousands of dollars)			
	Three months ended April 2, 2011			
	Controls	Capacitors	Corporate	Total
Sales to external customers	$7,154	$633	$-	$7,787
Inter-segment revenues	-	15	-	15
Operating income (loss)	796	151	(289)	658
Identifiable assets	20,142	1,084	246	21,472

	Three months ended April 3, 2010			
	Controls	Capacitors	Corporate	Total
Sales to external customers	$5,802	$369	$-	$6,171
Inter-segment revenues	-	7	-	7
Operating income (loss)	105	16	(58)	63
Identifiable assets	17,032	846	260	18,138

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(in thousands of dollars)

Six months ended April 2, 2011	Controls	Capacitors	Corporate	Total
Sales to external customers	$13,540	$1,130	$-	$14,670
Inter-segment revenues	-	18	-	18
Operating income (loss)	799	208	(316)	691
Identifiable assets	20,142	1,084	246	21,472

Six months ended April 3, 2010	Controls	Capacitors	Corporate	Total
Sales to external customers	$11,767	$765	$-	$12,532
Inter-segment revenues	-	14	-	14
Operating income (loss)	320	37	(133)	224
Identifiable assets	17,032	846	260	18,138

In the electronic controls segment, the revenues were derived from the following products and services:

(in thousands of dollars)

	Three Months ended		Six Months ended	
	April 2, 2011	April 3, 2010	April 2, 2011	April 3, 2010
Electronic controls for zero emission and hybrid electric vehicles	$6,207	$3,315	$9,908	$7,182