DERMA SCIENCES, INC.
Form 10-Q
November 13, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2009

[ ] 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 1-31070

Derma Sciences, Inc.

(Exact name of small business issuer as specified in its charter)

Pennsylvania	23-2328753
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

214 Carnegie Center, Suite 300
Princeton, New Jersey 08540
(Address of principal executive offices)

(609) 514-4744
(Issuer's telephone number)

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 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. þ Yes o 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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. (Check one):

Large accelerated filer	o		Accelerated filer	o
Non-accelerated filer	o	(Do not check if a smaller reporting company)	Smaller reporting company	þ

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

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

Date: November 13, 2009 Class: Common Stock, par value $.01 per share
Shares Outstanding: 40,315,743

Part I

DERMA SCIENCES, INC.

FORM 10-Q

INDEX

Forward Looking Statements

This document includes certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on management s current expectations and are subject to uncertainty and changes in circumstances. Actual results may differ materially from these expectations due to changes in political, economic, business, competitive, market and regulatory factors.

Index

Part I Financial Information

Item 1. FINANCIAL STATEMENTS

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

ASSETS	**September 30, 2009 (Unaudited)**	**December 31, 2008**
Current Assets		
Cash and cash equivalents	$ 399,998	$ 391,038
Accounts receivable, net	3,743,290	3,892,523
Inventories	10,789,282	12,423,042
Prepaid expenses and other current assets	477,712	397,117
Total current assets	15,410,282	17,103,720
Cash - restricted	2,029,563	2,014,422
Equipment and improvements, net	3,873,046	3,977,853
Goodwill	7,119,726	7,119,726
Other intangible assets, net	4,322,750	5,310,129
Other assets, net	579,216	681,472
Total Assets	$ 33,334,583	$ 36,207,322
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit borrowings	2,835,589	3,446,605
Current maturities of long-term debt	1,773,401	1,298,207
Accounts payable	2,902,190	3,614,764
Accrued expenses and other current liabilities	1,233,958	2,004,493
Total current liabilities	8,745,138	10,364,069
Long-term debt	2,614,503	4,065,036
Other long-term liabilities	104,674	44,848
Deferred tax liability	363,141	340,871
Total Liabilities	11,827,456	14,814,824
Shareholders' Equity		
Convertible preferred stock, $.01 par value; 11,750,000 shares authorized; issued and outstanding: 2,280,407 shares (liquidation preference of $4,210,231 at September 30, 2009)	22,804	22,804
Common stock, $.01 par value; 150,000,000 authorized; issued and outstanding: 40,315,743 at September 30, 2009; 40,140,743 at December 31, 2008	403,157	401,407
Additional paid-in capital	40,709,352	40,027,645
Accumulated other comprehensive income - cumulative translation adjustments	1,214,615	604,465
Accumulated deficit	(20,842,801)	(19,663,823)

Total Shareholders' Equity	21,507,127	21,392,498
Total Liabilities and Shareholders' Equity	$ 33,334,583	$ 36,207,322

See accompanying consolidated notes.

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations (Unaudited)

	Three months ended September 30, 2009	2008
Net Sales	$ 12,882,425	$ 12,832,574
Cost of sales	8,838,154	9,006,021
Gross Profit	4,044,271	3,826,553
Operating Expenses		
Selling, general and administrative	3,677,182	4,115,154
Research and development	70,412	84,891
Total operating expenses	3,747,594	4,200,045
Operating income (loss)	296,677	(373,492)
Other expense, net:		
Interest expense	220,839	251,256
Other income	(69,002)	(1,419)
Total other expense	151,837	249,837
Income (loss) before provision for income taxes	144,840	(623,329)
Provision for income taxes	5,237	78,290
Net Income (Loss)	$ 139,603	$ (701,619)
Net income (loss) per common share - basic and diluted	$ 0.00	$ (0.02)
Shares used in computing net income (loss) per common share - basic	40,315,743	40,140,743
Shares used in computing net income (loss) per common share - diluted	42,931,301	40,140,743

See accompanying consolidated notes.

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations (Unaudited)

	Nine months ended September 30, 2009	Nine months ended September 30, 2008
Net Sales	$ 34,877,658	$ 37,641,362
Cost of sales	24,051,984	27,141,628
Gross Profit	10,825,674	10,499,734
Operating Expenses		
Selling, general and administrative	11,244,347	12,919,124
Research and development	288,338	239,199
Total operating expenses	11,532,685	13,158,323
Operating loss	(707,011)	(2,658,589)
Other expense, net:		
Interest expense	631,909	748,743
Other income	(112,791)	(21,897)
Total other expense	519,118	726,846
Loss before benefit for income taxes	(1,226,129)	(3,385,435)
Benefit for income taxes	(47,151)	(3,540)
Net Loss	$ (1,178,978)	$ (3,381,895)
Net loss per common share - basic and diluted	$ (0.03)	$ (0.09)
Shares used in computing net loss per common share - basic and diluted	40,231,128	38,091,726

See accompanying consolidated notes.

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows (Unaudited)

	Nine months ended September 30,	
	2009	**2008**
Operating Activities		
Net loss	$ (1,178,978)	$ (3,381,895)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation of equipment and improvements	622,171	661,001
Amortization of intangible assets	987,380	865,920
Amortization of deferred financing costs	108,512	93,583
Recovery of bad debts	(87,044)	36,351
Allowance for sales adjustments	630,679	504,938
Provision for inventory obsolescence	257,702	184,323
Deferred rent expense	51,529	(43,808)
Compensation charge for employee stock options	668,658	593,446
Compensation charge for restricted stock	18,148	36,315
Gain on sale of equipment	(59,031)	-
Deferred income taxes	(21,363)	(3,540)
Changes in operating assets and liabilities:		
Accounts receivable	(394,402)	(882,229)
Inventories	1,630,394	(2,804,745)
Prepaid expenses and other current assets	(70,629)	372,001
Other assets	(452)	(7,661)
Accounts payable	(802,634)	(140,550)
Accrued expenses and other current liabilities	(763,821)	(1,754,745)
Other long-term liabilities	8,788	40,069
Net cash provided by (used in) operating activities	1,605,607	(5,631,226)
Investing Activities		
Costs of acquiring businesses	-	(120,484)
Purchase of equipment and improvements	(185,222)	(353,344)
Refund of acquired business escrow funds	-	1,193,187
Proceeds from sale of equipment	61,000	-
Net cash (used in) provided by investing activities	(124,222)	719,359
Financing Activities		
Net change in bank line of credit	(611,016)	3,469,395
Deferred financing costs	-	(269,235)
Long-term debt repayments	(975,339)	(983,335)
Net change in restricted cash	(15,142)	(2,004,304)
Proceeds from issuance of stock, net of costs	(9,290)	5,728,506
Net cash (used in) provided by financing activities	(1,610,787)	5,941,027

Effect of exchange rate changes on cash	138,362	(33,544)
Net increase in cash and cash equivalents	8,960	995,616
Cash and cash equivalents		
Beginning of period	391,038	577,096
End of period	$ 399,998	$ 1,572,712
Supplemental disclosures of cash flow information:		
Equipment obtained with capital lease	$ -	$ 96,324
Cash paid during the period for:		
Interest	$ 494,704	$ 618,027

See accompanying consolidated notes.

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiaries (the Company) is a full line provider of wound care, wound closure and specialty securement devices and skin care products. The Company markets its products principally through independent distributors servicing the long-term care, home health and acute care markets in the United States, Canada and other select international markets. The Company s U.S. distribution facilities are located in St. Louis, Missouri and Houston, Texas, while the Company s Canadian distribution facility is located in Toronto. The Company has manufacturing facilities in Toronto, Canada and Nantong, China.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2009, are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. Information included in the condensed balance sheet as of December 31, 2008 has been derived from the consolidated financial statements and footnotes thereto for the year ended December 31, 2008, included in Form 10-K previously filed with the Securities and Exchange Commission. For further information, refer to that Form 10-K.

Recent Accounting Pronouncements

Effective January 1, 2009, the Financial Accounting Standards Board (FASB) issued new guidance related to assessing whether an equity-linked financial instrument (or embedded feature) is indexed to an entity s own stock for the purposes of determining whether such equity-linked financial instrument (or embedded feature) is subject to derivative accounting. We adopted this new guidance effective January 1, 2009 which had no impact on the consolidated financial statements.

In April 2009, the FASB issued additional guidance requiring fair value disclosures in both interim as well as annual financial statements in order to provide more timely information about the effects of current market conditions on financial instruments. The guidance is effective for interim and annual periods ending after June 15, 2009, and we adopted this guidance commencing with our June 30, 2009 consolidated financial statements. The implementation of this standard did not have a material impact on our consolidated balance sheet and operating results.

In May 2009, the FASB issued new guidance on the reporting of subsequent events which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This statement sets forth the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements. The guidance also requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date that is, whether that date represents the date the financial statements were issued or were available to be issued. We adopted this standard during the three months ended June 30, 2009 and have evaluated subsequent event activity through the date and time the quarter ended September 30, 2009 financial statements were issued on November 13, 2009.

On July 1, 2009, the FASB issued the FASB Accounting Standards Codification (the Codification). The Codification became the single source of authoritative nongovernmental U.S. GAAP, superseding existing literature of the FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force and other sources. The Codification was effective for interim and annual periods ending after September 15, 2009. We adopted the Codification for the quarter ended September 30, 2009. There was no impact on our consolidated balance sheet and results of operations as this change is disclosure-only in nature.

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

In September 2009, the FASB issued amendments to the accounting and disclosure for revenue recognition. These amendments, effective for fiscal years beginning on or after June 15, 2010 (early adoption is permitted), modify the criteria for recognizing revenue in multiple element arrangements and the scope of what constitutes a non-software deliverable. The impact of the adoption of these amendments will depend on the nature of the arrangements that we enter into subsequent to the date we adopt the amendments.

Net Income (Loss) per Share Net income (loss) per common share basic is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Net income (loss) per common share diluted reflects the potential dilution of earnings by including the effects of the assumed exercise, conversion or issuance of potentially issuable shares of common stock (potentially dilutive securities), including those attributable to stock options, warrants, convertible preferred stock and restricted common stock in the weighted average number of common shares outstanding for a period, if dilutive. The effects of the assumed exercise of warrants and stock options are determined using the treasury stock method. Potentially dilutive securities have not been included in the computation of diluted loss per share for the nine months ended September 30, 2009 and three and nine months ended September 30, 2008 as the effect would be anti-dilutive.

Total dilutive shares that have or would have been used to compute diluted income per common share for the three and nine months ended September 30, 2009 and 2008 are outlined below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Weighted average common shares outstanding basic	40,315,743	40,140,743	40,231,128	38,091,726
Dilutive shares attributable to:				
Convertible preferred stock	2,280,407			
Restricted common stock				
Warrants	12,598			
Stock options	322,553			
Sub-total dilutive shares	2,615,558			
Weighted average common shares outstanding diluted	42,931,301	40,140,743	40,231,128	38,091,726

Potentially dilutive shares excluded as a result of the effects being anti-dilutive are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Dilutive shares:				
Convertible preferred stock		2,280,407	2,280,407	2,280,407
Restricted common stock		175,000		175,000
Warrants	8,782,661	11,405,259	8,795,259	11,405,259
Stock options	9,110,572	8,331,480	9,433,125	8,331,480
Total dilutive shares	17,893,233	22,192,146	20,508,791	22,192,146

Reclassifications Certain reclassifications have been made to prior period reported amounts to conform with the 2009 presentation.

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

2. Inventories

Inventories include the following:

	September 30, 2009	December 31, 2008
Finished goods	$ 6,867,008	$ 9,001,269
Work in process	319,128	443,511
Packaging materials	642,270	700,948
Raw materials	2,960,876	2,277,314
Total inventory	$ 10,789,282	$ 12,423,042

3. Line of Credit Borrowings

In November 2007, the Company entered into a new five-year revolving credit agreement providing for maximum borrowings of $8,000,000 with a U.S. lender. Advances under the revolving credit agreement may be drawn, from time to time, up to the amount of 85% of eligible receivables (as defined) and 44% of eligible inventory (as defined). Interest on outstanding advances under the revolving credit agreement was payable at the LIBOR monthly rate (the Base Rate) plus 2.75% (the Base Rate Margin). In addition, the Company pays a monthly unused line fee of 0.5% per annum on the difference between the daily average amount of advances outstanding under the agreement and $8,000,000 together with a monthly collateral management fee of $2,000. Outstanding balances under the agreement are secured by all of the Company s and its subsidiaries existing and after-acquired tangible and intangible assets located in the United States and Canada.

On March 31, 2009, the Company s U.S. lender agreed to amend the credit and security agreement to allow the Company to enter into a forbearance agreement with Western Medical to postpone payment of its promissory note due April 18, 2009 and to allow subsequent payments on the subordinated debt beginning in April 2010 provided the Company achieves predetermined liquidity and free cash flow objectives (as defined) and provided Western Medical further extends for one year the payment of the principal balance, if any, remaining on the promissory note after giving effect to the April, 2010 payment. In return for the amendment, the Company agreed to change its base rate for interest charged to a three month LIBOR rate from a one month LIBOR rate. Further, effective April 1, 2009 the base rate margin was increased 150 basis points on the revolving line of credit from 2.75% to 4.25%, on the term loan from 4.25% to 5.75% and on the portion of the term loan secured by restricted cash from 2.25% to 3.75%. In addition, the Company is obligated to increase the revolving loan availability on its revolving line of credit to a minimum of $3,000,000 by December 31, 2009. Failure to achieve the minimum revolving loan availability amount will result in the base rate changing to the greater of 3.00% or the actual rate in effect. At September 30, 2009 the effective interest rate was 4.53% and the outstanding balance was $2,835,589 under the amended credit and security agreement.

The revolving credit agreement, as amended, is subject to financial covenants which require maintaining a minimum cumulative EBITDA level and certain ratios of fixed charge coverage, senior debt leverage and total debt leverage as defined in the agreement. Additional covenants governing permitted investments, indebtedness and liens, together with payments of dividends and protection of collateral, are also included in the agreement. The amended revolving credit agreement contains a subjective acceleration provision whereby the lender can declare a default upon a material adverse change in the Company s business operations.

Effective August 13, 2008, the Company s lender agreed to waive all prior financial and reporting covenant defaults and amend the existing minimum EBITDA, fixed charge coverage, senior debt leverage and total debt leverage covenants to allow the Company to continue to implement its growth strategy in line with the lender s minimum liquidity terms. Amendment of the covenants was predicated upon the Company segregating $2,000,000 in a restricted account the use of which is subject to the approval of the lender. The Company s maximum revolver

borrowing capacity remained unchanged. The Company incurred fees of $25,000 associated with the granting of the covenant amendment.

Effective March 28, 2008, the Company s U.S. lender agreed to waive all prior financial and reporting covenant defaults and amend the existing minimum EBITDA, fixed charge coverage, senior debt leverage and total debt leverage covenants, to be measured on a quarterly basis, to allow the Company to implement its growth strategy. Amendment of the covenants was predicated upon the Company s commitment to raise a minimum of $3,000,000 by May 1, 2008 from the sale of equity and agreement to limit its maximum revolver borrowing to the lesser of (a) the revolver loan commitment ($8,000,000) or (b) the borrowing base (as defined), less $1,500,000. Not less than $3,000,000 of the equity infusion was required to be applied to the outstanding revolver balance which amount is credited as a component of EBITDA for covenant compliance purposes. The Company incurred fees of $250,000 associated with the granting of the covenant amendment, together with related expenses of $10,829 which are included as additions to deferred financing costs. In March 2008, the equity infusion requirement was met (see Note 5).

4. Long-Term Debt

Long-term debt consists of the following:

	September 30, 2009	December 31, 2008
U.S. term loan	$ 3,800,000	$ 4,700,000
Promissory note	500,000	500,000
Capital lease obligations	87,904	163,243
Total debt	4,387,904	5,363,243
Less: current maturities	1,773,401	1,298,207
Long-term debt	$ 2,614,503	$ 4,065,036

U.S. Term Loan

In November 2007, the Company entered into a five-year $6,000,000 term loan agreement with a U.S. lender. On March 31, 2009 the term loan agreement was amended. Under the amended agreement interest on the term loan is payable at the LIBOR three month rate plus 5.75%, (6.03% at September 30, 2009) and on the portion of the term loan secured by restricted cash 3.75% (4.03% at September 30, 2009). Monthly payments of principal in the amount of $100,000 together with interest are due under the amended agreement. The amended agreement is secured by all of the Company s and its subsidiaries existing and after-acquired tangible and intangible assets located in the United States and Canada.

The amended term loan agreement is subject to financial covenants which require maintaining a minimum cumulative EBITDA level and certain ratios of fixed charge coverage, senior debt leverage and total debt leverage as defined in the agreement. Additional covenants governing permitted investments, indebtedness and liens, together with payments of dividends and protection of collateral, are also included in the amended agreement. The amended term loan agreement contains a subjective acceleration provision whereby the lender can declare a default upon a material adverse change in the Company s business operations.

Effective August 13, 2008 and March 28, 2008, the foregoing financial covenants were amended as described in the fourth and fifth paragraphs under the heading Line of Credit Borrowings (see Note 3).

Promissory Note

In connection with the acquisition of Western Medical in April 2006, a portion of the purchase price was paid via a three-year unsecured promissory note issued to the seller. The promissory note originally provided for the payment of simple interest of 12% in 11 quarterly installments of $15,000 and a final payment of accrued interest of $15,000 and the principal balance of $500,000 on April 18, 2009.

On March 31, 2009, the Company entered into a Forbearance Agreement (the Agreement) with Western Medical to postpone payment of its $500,000 promissory note due April 18, 2009. The Company will continue to make interest payments when due and a final payment of the principal plus accrued interest through the date of payment on April 14, 2010. In consideration for the postponement, the Company agreed to grant Western Medical warrants to purchase 50,000 shares of the Company s common stock at the market price on the date of execution of the Agreement. The value of the warrants is being recognized as interest expense over the postponement period.

Capital Lease Obligations

The Company has two capital lease obligations for certain office furniture and distribution equipment totaling $87,904 as of September 30, 2009. The capital lease obligations bear interest at annual rates ranging from 6.8% to 9.6% with the longest lease term expiring in February 2011.

5. Shareholders Equity

Preferred Stock

There are 150,003 shares of series A convertible preferred stock outstanding at September 30, 2009. The series A preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $4.00 per share, votes as a class on matters affecting the series A preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 440,003 shares of series B convertible preferred stock outstanding at September 30, 2009. The series B preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $6.00 per share, votes as a class on matters affecting the series B preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 619,055 shares of series C convertible preferred stock outstanding at September 30, 2009. The series C preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.70 per share, votes as a class on matters affecting the series C preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 1,071,346 shares of series D convertible preferred stock outstanding at September 30, 2009. The series D preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.50 per share, votes as a class on matters affecting the series D preferred stock and maintains voting rights identical to the common stock on all other matters.

Common Stock

Effective May 12, 2009, 175,000 shares of common stock were issued to outside directors upon vesting of compensatory restricted stock granted on May 12, 2006.

In March 2008, the Company raised $5,610,871 (net of $489,129 in commission and other offering expenses) from the private sale of 6,100,000 shares of common stock at a price of $1.00 per share, together with 3,050,000 five-year warrants to purchase one share of common stock at a price of $1.20 per share. In addition, the placement agent for the shares sold received 142,500 five-year warrants to purchase one share of common stock at $1.20 per share. The proceeds were used to meet the minimum equity infusion requirements associated with the

Company s March 28, 2008 amended bank covenants, support the Company s strategic growth initiatives and increase working capital.

In January 2008, the Company issued 210,988 shares of common stock as follows: (a) 100,000 shares in consideration of $105,000 upon exercise of series G warrants, (b) 19,800 shares in consideration of $12,375 upon exercise of 19,800 stock options, and (c) 91,188 shares upon cashless exercise of 178,200 stock options.

Stock Purchase Warrants

At September 30, 2009, the Company had warrants outstanding to purchase 8,795,259 shares of the Company s common stock as outlined below:

Series	Number of Warrants	Exercise Price	Expiration Date
H	2,655,098	$ 1.00	April 30,2011
I	754,806	$ 0.72	April 30, 2011
J	2,142,855	$ 0.77	May 31, 2013
K	3,192,500	$ 1.20	April 1, 2013
L	50,000	$ 0.39	March 31, 2014
Total	8,795,259		

Stock Options

The Company has a stock option plan under which options to purchase a maximum of 10,000,000 shares of common stock may be issued. The plan permits the granting of both incentive stock options and nonqualified stock options to employees and directors of the Company and certain outside consultants and advisors to the Company. The option exercise price may not be less than the fair market value of the stock on the date of the grant of the option. The duration of each option may not exceed 10 years from the date of grant. Under the plan, options to purchase 1,662,500 and 360,000 shares of common stock were granted to officers, directors, agents and employees for the nine months ended September 30, 2009 and 2008, respectively, with exercise prices ranging from $0.36 to $1.11 per share. For the nine months ended September 30, 2009 and 2008, 15,000 and 10,000 respectively of plan options were forfeited and for the nine months ended September 30, 2008, 198,000 plan options were exercised. As of September 30, 2009, options to purchase 7,777,125 shares of the Company s common stock were issued and outstanding under the plan.

The Company has previously granted nonqualified stock options to officers, directors, agents and employees outside of the stock option plan (non-plan options). All non-plan options were granted at the fair market value at the date of grant. During the nine months ended September 30, 2009 and 2008, 237,000 and 44,000 non-plan options expired, respectively. As of September 30, 2009, non-plan options to purchase 1,656,000 shares of the Company s common stock were issued and outstanding.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

A summary of the Company s stock option activity and related information for the nine months ended September 30, 2009 and 2008 follows:

	2009		2008	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding January 1	8,022,625	$ 0.69	8,223,480	$ 0.78
Granted	1,662,500	$ 0.38	360,000	$ 0.92
Forfeited	(15,000)	$ 0.70	(10,000)	$ 1.22
Expired	(237,000)	$ 1.11	(44,000)	$ 3.22
Exercised	-	$ -	(198,000)	$ 0.63
Outstanding September 30	9,433,125	$ 0.63	8,331,480	$ 0.78
Exercisable at September 30	6,791,250	$ 0.67	6,358,980	$ 0.81

During the nine months ended September 30, 2009 and 2008 the fair value of each service and performance based option award was estimated at the date of grant using the Black-Scholes option pricing model. The weighted-average assumptions used during the three and nine months ended September 30, 2009 and 2008 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Risk-free interest rate	2.88%	3.30%	2.31%	3.08%
Volatility factor	83.73%	107.5%	92.16%	118.07%
Dividend yield	0%	0%	0%	0%
Expected option life (years)	6.25	6.25	6.25	6.25
Contractual life (years)	10	10	10	10

In both 2009 and 2008, the risk-free rate utilized represents the U.S. Treasury yield curve rate which approximates the risk-free rate for the expected option life at the time of grant. In 2009 and 2008, the volatility factor was calculated based on the seventy-five month-end closing prices of the Company s common stock preceding the month of stock option grant. The Company uses a seventy-five month volatility period to coincide with the expected stock option life. Based on guidance from Staff Accounting Bulletin 107 and 110, a stock option life of 6.25 years was utilized under the simplified method. The dividend yield is 0% since the Company does not anticipate paying dividends in the near future. Based on the Company s historical experience of options that expire or are cancelled before becoming fully vested, the Company assumed an annualized forfeiture rate of 1.0% for all options. The Company will record additional expense if the actual forfeiture rate is lower than estimated, and will record a recovery of prior expense if the actual forfeiture rate is higher than estimated.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

The weighted average fair value per share of options granted during the nine months ended September 30, 2009 and 2008 was $0.29 and $0.80, respectively. During the nine months ended September 30, 2009 and 2008, stock option compensation expense was recorded using the fair value method under SFAS 123R as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Cost of sales	$ 23,327	$ 16,158	$ 73,764	$ 42,170
Selling, general and administrative expenses	169,461	170,318	594,894	551,276
Total stock option compensation expense	$192,788	$186,476	$668,658	$593,446

As of September 30, 2009, there was $582,257 of unrecognized compensation cost related to nonvested service based awards, $39,375 nonvested performance based awards and $52,941 nonvested market based awards granted under the plan. That cost is expected to be recognized over the options remaining weighted average vesting period of 1.47 years for service and performance based options and 0.15 years for market based options.

For the nine months ended September 30, 2009 and 2008, no income tax benefit was recognized related to stock option activity.

Restricted Common Stock

On May 11, 2006, the Company adopted a restricted common stock plan and reserved 2,500,000 shares of common stock for issuance.

On May 12, 2006, 175,000 shares of restricted common stock were granted to non-employee members of the Company s board of directors and vested three years from the date of the grant. The fair market value at the date of grant, determined by the quoted market price, was $145,250 or $0.83 per share. The fair market value of the grant was recognized as compensation expense over the three-year service period. For the nine months ended September 30, 2009 and 2008, $18,148 and $36,315 was recorded in operating expense respectively for these grants. On May 12, 2009 all of the outstanding restricted common stock became fully vested.

Shares Reserved for Future Issuance

At September 30, 2009, the Company had reserved the following shares of common stock for future issuance:

Convertible preferred shares (series A - D)	2,280,407
Common stock options available for grant	2,222,875
Common stock options outstanding	9,433,125
Common stock warrants outstanding (series H - L)	8,795,259
Restricted common stock available for grant	2,325,000
Total common stock shares reserved	25,056,666

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

6. Comprehensive Income (Loss)

The Company s comprehensive income (loss) was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Net income (loss) as reported	$ 139,603	$ (701,619)	$ (1,178,978)	$ (3,381,895)
Other comprehensive income (loss):				
Foreign currency translation adjustment	363,948	(267,176)	610,150	(454,698)
Comprehensive income (loss)	$ 503,551	$ (968,795)	$ (568,828)	$ (3,836,553)

7. Operating Segments

The Company consists of three operating segments: wound care, wound closure specialty securement devices and skin care. Products in the wound care segment consist of basic and advanced dressings, adhesive strips, ointments and sprays. Wound closure and specialty securement device products include wound closure strips, nasal tube fasteners and a variety of catheter fasteners. The skin care segment consists of antibacterial skin cleansers, hair and body soaps, lotions and moisturizers.

Products in all three operating segments are marketed to long-term care facilities, hospitals, physicians, clinics, home health care agencies and other healthcare institutions. Basic and advanced wound care products are manufactured both internally and outsourced, while the manufacture of skin care products is completely outsourced. Wound closure-specialty securement devices are significantly manufactured in-house. Internally, the segments are managed at the gross profit level. The aggregation or allocation of other costs by segment is not practical.

Segment sales, gross profit and other related information for 2009 and 2008 are as follows:

Three Months Ended September 30, 2009

Wound Care	Wound Closure-Specialty Securement Devices	Skin Care	Other Costs	Total Company

Net sales	$ 12,289,311	$ 409,565	$183,549	-	$ 12,882,425
Gross profit	3,765,137	231,070	48,064	-	4,044,271
Total expenses	-	-	-	$(3,904,668)	(3,904,668)
Net income					$ 139,603

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

Three Months Ended September 30, 2008

Net sales	$ 12,237,599	$ 388,024	$206,951	-	$ 12,832,574
Gross profit	3,559,460	206,085	61,008	-	3,826,553
Total expenses	-	-	-	$(4,528,172)	(4,528,172)
Net loss					$ (701,619)

Nine Months Ended September 30, 2009

	Wound Care	Wound Closure-Specialty Securement Devices	Skin Care	Other Costs	Total Company
Net sales	$ 33,023,590	$1,307,327	$546,741	-	$ 34,877,658
Gross profit	9,969,307	714,272	142,095	-	10,825,674
Total expenses	-	-	-	$(12,004,652)	(12,004,652)
Net loss					$(1,178,978)

Nine Months Ended September 30, 2008

Net sales	$ 35,696,657	$1,357,431	$587,274	-	$ 37,641,362
Gross profit	9,591,468	742,020	166,246	-	10,499,734
Total expenses	-	-	-	$(13,881,629)	(13,881,629)
Net loss					$(3,381,895)

The following table presents net sales by geographic region.

Three Months Ended September 30,		Nine Months Ended September 30,	
2009	2008	2009	2008

United States	72%	72%	72%	70%
Canada	23%	24%	22%	25%
Other	5%	4%	6%	5%

For the nine months ended September 30, 2009, the Company has a major U.S. customer comprising 14% of U.S. sales and 5% of U.S. operations trade accounts receivable at September 30, 2009. The Company s wholly owned Canadian subsidiary sells to one customer who serves as its exclusive third party distributor and comprises 100% of Canada operations trade accounts receivable at September 30, 2009.

8. Income Taxes

The Company recorded a $47,151 and $3,540 foreign income tax benefit for the nine months ended September 30, 2009 and 2008 respectively, based on the operating results of the Company s wholly owned Canadian subsidiary. The 2009 benefit was comprised of $25,788 current foreign tax benefit and $21,363 deferred

Index

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

foreign tax benefit while the 2008 benefit was all deferred. No benefit was realized for the Company s net loss from U.S. operations in the nine months ended September 30, 2009 and 2008 due to uncertainties surrounding the Company s ability to utilize its net operating loss carry forwards.

Due to uncertainties surrounding the Company s ability to use its U.S. net operating loss carry forwards and net deferred assets, a full valuation allowance has been provided. The Company s wholly owned Canadian subsidiary, based on recent operating profitability and the prospect of future profitable operations, realized its net operating loss carry forward and deferred tax assets and liabilities.

9. Reverse Stock Split

On September 24, 2009 the Board of Directors unanimously adopted a resolution approving and recommending to shareholders for their approval a proposal to grant discretionary authority to the Board of Directors to amend the Company s certificate of incorporation in order to: (i) effect a reverse split of the Company s common and preferred shares (the Reverse Split) at any time within one year after the date of shareholder approval, at any whole number ratio between 1 for 5 and 1 for 10, with the exact exchange ratio and timing of the Reverse Split to be determined by the Board of Directors, and (ii) effect a reduction of the Company s authorized common and preferred shares by a factor corresponding to the Reverse Split exchange ratio (the Proposal). On or about October 6, 2009, a Notice of Special Meeting of Shareholders (Proxy Statement) was sent to shareholders of record as of October 1, 2009, notifying them of the Proposal and the Special Meeting of Shareholders on November 23, 2009.

With the exception of a minimum share price, the Company believes it meets the criteria for listing on one of the national market exchanges. The Reverse Split is designed to enable the Company to meet the minimum share price requirement. If and when the Proposal is approved, the Company plans to seek a listing for its common stock on a national market. The Company believes the Reverse Split could enhance the appeal of its common stock to the financial community. The Company believes that a number of individual and institutional investors are reluctant or unable to invest in OTC Bulletin Board companies or companies with relatively low per share values. The reduction in the number of issued and outstanding shares of common stock effected by the Reverse Split, together with the anticipated increased stock price resulting from the Reverse Split, could promote a broader market for the Company s common stock than that which currently exists.

Index

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

Quarter Ended September 30, 2009 Compared to Quarter Ended September 30, 2008

Overview of Consolidated Operating Results

The 2009 and 2008 operating results include Derma Sciences, Inc. and our subsidiaries. Unless otherwise indicated by the context, the terms U.S. operations and Canadian operations are used throughout this discussion in reference to the U.S. operations and the operations of Derma Sciences Canada Inc., respectively.

The following table highlights the quarter ended September 30, 2009 versus 2008 operating results:

	Quarter Ended September 30,			
	2009	2008	Variance	
Gross Sales	$ 15,356,917	$ 15,468,607	$(111,690)	(0.7%)
Sales adjustments	(2,474,492)	(2,636,033)	(161,541)	(6.1%)
Net sales	12,882,425	12,832,574	49,851	0.4%
Cost of sales	8,838,154	9,006,021	(167,867)	(1.9%)
Gross profit	4,044,271	3,826,553	217,718	5.7%
Selling, general and administrative expense	3,677,182	4,115,154	(437,972)	(10.6%)
Research and development expense	70,412	84,891	(14,479)	(17.1%)
Interest expense	220,839	251,256	(30,417)	(12.1%)
Other income, net	(69,002)	(1,419)	(67,583)	
Total expenses	3,899,431	4,449,882	(550,451)	(12.4%)
Income/(loss) before income taxes	144,840	(623,329)	768,169	
Provision for income taxes	5,237	78,290	(73,053)	
Net income/(loss)	$ 139,603	$ (701,619)	$ 841,222	

Gross to Net Sales Adjustments

Gross sales are adjusted for trade rebates, distributor fees (in Canada), sales incentives, returns and allowances and cash discounts to derive net sales. Trade rebates are trued-up monthly based upon an analysis of historical sales subject to rebate and actual rebates received from distributors. Non-exclusive distributors generally carry one month s inventory. Our exclusive distributor in Canada normally carries two and one-half to three and one-half months inventory. As distributor inventory is depleted via sales, it is replenished via purchases from us. Rebates are processed and submitted for credit on a timely basis consistent with distributor sales. To minimize their cash outflow invested in rebates, distributors generally strive to optimize the rebate credit submission process.

Historical trends of sales subject to rebate and rebates received are evaluated monthly, by distributor, on a three month, six month and twelve month rolling basis to update the continued reasonableness of the assumptions used to quantify the trade rebate accrual balance. Deviations in the trends resulting, among other causes, from distributors not submitting their rebates on a timely basis are analyzed and factored in determining the required accrual balance.

We currently pay our exclusive Canadian distributor a fixed fee of 10% on net sales subject to the fee (as defined) for distribution services in Canada. The distributor fee is accrued each month based on net sales to the distributor times the ratio of estimated percentage of distributor fee expense to net sales based on past history. The percentage of distributor fee expense to net sales is re-evaluated quarterly for reasonableness.

Index

Sales incentives are credits granted to specific customers based upon attainment of pre-determined sales objectives. The agreements are generally for a period of one year.

Returns and allowances and cash discounts are accrued monthly based on recent historical activity.

Gross to net sales adjustments comprise the following:

	Quarter Ended September 30, 2009	Quarter Ended September 30, 2008
Gross Sales	$ 15,356,917	$ 15,468,607
Trade rebates	(1,820,697)	(1,920,398)
Distributor fees	(266,783)	(291,178)
Sales incentives	(164,711)	(173,980)
Returns and allowances	(118,355)	(128,459)
Cash discounts	(103,946)	(122,018)
Total adjustments	(2,474,492)	(2,636,033)
Net sales	$ 12,882,425	$ 12,832,574

Trade rebates decreased in 2009 versus 2008 due principally to lower Canadian sales subject to rebate which, in turn, resulted from lower demand as a result of the exclusive Canadian distributor reducing its inventory, unfavorable exchange and a slight increase in sales not subject to rebate. U.S. rebates increased slightly due to an increase in regular and private label sales subject to rebate, coupled with an increase in the percentage of rebates to sales due to list price increases (without a commensurate increase in contract pricing). The decrease in distribution fee expense is commensurate with the change in Canadian net sales upon which it is based, coupled with a small increase in the amount of sales not subject to the fee. The decrease in sales incentive expense relates principally to lower incentive related traditional wound care sales. The sales returns and allowances decrease is principally due to the non-recurrence of higher FAD integration related returns and allowances in 2008. The decrease in cash discounts principally reflects lower U.S. sales subject to cash discount.

Rebate Reserve Roll Forward

A three month roll forward of the trade rebate accruals at September 30, 2009 and 2008 are outlined below:

	Quarter Ended September 30, 2009	Quarter Ended September 30, 2008
Beginning balance June 30	$ 2,309,304	$ 3,050,302
Rebates paid	(1,759,195)	(2,096,119)
Rebates accrued	1,820,697	1,920,398
Ending balance September 30	$ 2,370,806	$ 2,874,581

The $61,502 increase in the trade rebate reserve balance for the three months ended September 30, 2009 principally reflects a higher level of sales subject to rebate during the quarter and a slight delay in the submission of rebates for payment. There has been no other discernable change in the nature of our business as it relates to the accrual and subsequent payment of rebates.

Index

Net Sales and Gross Margin

The following table highlights the September 30, 2009 versus 2008 product line net sales and gross profit:

	Quarter Ended September 30, 2009	2008	Variance	
Net Sales	$ 12,882,425	$ 12,832,574	$ 49,851	0.4%
Cost of sales	8,838,154	9,006,021	(167,867)	(1.9%)
Gross Profit	$ 4,044,271	$ 3,826,553	$ 217,718	5.7%
Gross Profit %	31.4%	29.8%		

Consolidated net sales increased $49,851, or 0.4% (1.5% adjusted for exchange), in 2009 versus 2008. Canadian net sales decreased $184,310, or 6.0%, to $2,893,529 in 2009 from $3,077,839 in 2008. This decrease was driven by unfavorable exchange of $147,865 associated with a 5.4% weakening of the Canadian dollar and lower sales of $36,445. Inventory rationalization on the part of our exclusive Canadian distributor is principally responsible for the lower sales. Real growth as measured by sales of our products reported by our exclusive distributor, unadjusted for foreign exchange, approximated 3.0%. U.S. net sales increased $234,161, or 2.4%, to $9,988,896 in 2009 from $9,754,735 in 2008. The increase was driven by higher advanced wound care sales of $942,859 and private label sales of $407,382 partially offset by lower FAD sales of $1,069,599 and traditional wound care sales of $51,333. Sales of the