

DERMA SCIENCES INC
Form 10QSB
August 14, 2002

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

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

For Quarter Ended	June 30, 2002
Commission File	1-31070
Number	

Derma Sciences, Inc.

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

Pennsylvania

(State or other jurisdiction of incorporation or organization)

23-2328753

(I.R.S. Employer Identification No.)

214 Carnegie Center, Suite 100
Princeton, New Jersey 08540
(609) 514-4744

(Address including zip code and telephone
number, of principal executive offices)

Check whether the Issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the Issuer was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No []

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

Date: June 30, 2002

Class: Common Stock, par value \$.01 per share

Shares Outstanding: 4,211,276

DERMA SCIENCES, INC.

FORM 10-QSB

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DERMA SCIENCES, INC.**Consolidated Balance Sheets**

	June 30, 2002 (Unaudited)	December 31, 2001
ASSETS		

Current Assets		
Cash and cash equivalents	\$ 1,139,274	\$ 524,783
Restricted cash	60,000	-
Accounts receivable, net	986,277	914,458
Inventories, net	1,776,220	1,787,247
Prepaid expenses and other current assets	180,732	54,661

Total current assets	4,142,503	3,281,149
Property and equipment, net	180,878	169,708
Goodwill	1,110,967	1,110,967
Patents and trademarks	149,072	157,860
Other assets, net	246,878	-

Total Assets	\$ 5,830,298	\$ 4,719,684

LIABILITIES AND SHAREHOLDERS' EQUITY		

Current Liabilities		
Accounts payable	\$ 852,574	\$ 551,428
Accrued expenses	219,707	392,649
Convertible bonds	-	475,000
Other current liabilities	60,000	-

Total current liabilities	1,132,281	1,419,077

Total Liabilities	1,132,281	1,419,077

Shareholders' Equity		
Common stock, \$.01 par value, 30,000,000 shares authorized; issued and outstanding: 4,211,276 shares in 2002 and 2,407,109 shares in 2001	42,113	24,071
Convertible preferred stock, \$.01 par value; 11,750,000 shares authorized; issued and outstanding: 2,526,242 shares in 2002; 1,960,009 shares in 2001 (liquidation preferences of \$4,460,237 at June 30, 2002)	25,262	19,600
Additional paid-in capital	15,288,986	13,987,882
Accumulated deficit	(10,658,344)	(10,730,946)

Total Shareholders' Equity	4,698,017	3,300,607

Total Liabilities and Shareholders' Equity	\$ 5,830,298	\$ 4,719,684
=====		

See accompanying notes.

DERMA SCIENCES, INC.**Consolidated Statement of Operations (Unaudited)**

	Three months ended June 30,	
	2002	2001
Net sales	\$2,076,724	\$2,381,808
Cost of sales	900,678	1,222,871
Gross Profit	1,176,046	1,158,937
Operating expenses	1,071,692	1,115,501
Interest expense	6,723	44,828
Other (income)/expense, net	89,244	(22,396)
Total Expenses	1,167,659	1,137,933
Income before provision for income taxes	8,387	21,004
Provision for income taxes	-	-
Net Income	\$ 8,387	\$ 21,004
Income per common share - basic	\$ 0.00	\$ 0.01
Income per common share - diluted	\$ 0.00	\$ 0.00
Shares used in computing income per common share - basic	3,854,609	2,407,109
Shares used in computing income per common share - diluted	7,154,322	4,370,451

See accompanying notes.

DERMA SCIENCES, INC.**Consolidated Statement of Operations (Unaudited)**

	Six months ended June 30,	
	2002	2001
Net sales	\$4,191,215	\$4,752,866
Cost of sales	1,850,632	2,504,650
Gross Profit	2,340,583	2,248,216
Operating expenses	2,057,213	2,147,480
Interest expense	131,098	93,850
Other (income)/expense, net	79,670	(23,307)
Total Expenses	2,267,981	2,218,023

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Income before provision for income taxes	72,602	30,193
Provision for income taxes	-	-
Net Income	\$ 72,602	\$ 30,193
Income per common share - basic	\$ 0.02	\$ 0.01
Income per common share - diluted	\$ 0.01	\$ 0.01
Shares used in computing income per common share - basic	3,438,970	2,343,490
Shares used in computing income per common share - diluted	6,814,264	4,361,185

See accompanying notes.

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DERMA SCIENCES, INC.

Consolidated Statement of Cash Flows (Unaudited)

	Six months ended June 30,	
	2002	2001
Operating Activities		
Net income	\$ 72,602	\$ 30,193
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	35,311	40,083
Amortization	28,527	61,836
Non-cash financing costs	120,200	80,000
Provision for bad debts	21,814	56,678
Provision for rebates	(25,000)	(23,644)
Provision for inventory obsolescence	19,297	41,899
Changes in operating assets and liabilities		
Restricted cash	(60,000)	59,545
Accounts receivable	(13,633)	405,064
Inventories	(8,270)	(275,290)
Prepaid expenses and other current assets	(126,071)	(62,624)
Other assets	(3,718)	-
Accounts payable	301,146	(126,237)
Accrued expenses	(52,742)	(123,639)
Other current liabilities	60,000	-
Net cash provided by operating activities	369,463	163,864
Investing Activities		
Purchases of property and equipment	(46,481)	(29,029)
Deferred acquisition costs	(132,602)	-
Net cash used in investing activities	(179,083)	(29,029)
Financing Activities		
Net change in bank line of credit	-	(59,545)
Deferred financing costs	(85,297)	-
Proceeds from issuance of stock, net of issuance costs	509,408	-

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Net cash provided by (used in) financing activities	424,111	(59,545)
Net increase in cash and cash equivalents	614,491	75,290
Cash and cash equivalents		
Beginning of period	524,783	424,165
End of period	\$1,139,274	\$ 499,455
Supplemental cash flow information		
Conversion of bonds payable and accrued interest to preferred stock	\$595,200	-
Common stock and warrants issued for debt conversion/extension	\$120,200	\$160,000
Bond conversion reset provision charge to paid-in capital	\$45,000	-
Stock subscriptions receivable	\$55,000	-

See accompanying notes.

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiary (the Company) is a full line provider of advanced wound care, wound closure-fasteners 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 and select international markets.

Basis of Presentation

Certain amounts in the prior years' financial statements have been reclassified to conform to the current year presentation.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-QSB and Item 310(b) of Regulation S-B. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2002, are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. For further information, refer to the financial statements and footnotes thereto for the year ended December 31, 2001, included in Form 10-KSB filed with the Securities and Exchange Commission.

Summary of Significant Accounting Policies

Principles of Consolidation The consolidated financial statements include the accounts of Derma Sciences, Inc. and its wholly owned subsidiary Sunshine Products, Inc. All significant intercompany accounts and transactions

have been eliminated.

Use of Estimates In conformity with accounting principles generally accepted in the United States, the preparation of financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Although these estimates are based on knowledge of current events and actions which may be undertaken in the future, actual results may ultimately differ from these estimates.

Cash and Cash Equivalents The Company considers cash and cash equivalents as amounts on hand, on deposit in financial institutions and highly liquid investments purchased with an original maturity of three months or less.

Net Income per Share Net income per common share basic is computed by dividing net income by the weighted average number of common shares outstanding for the period. Net income per common share diluted reflects the potential dilution of earnings by including other common stock equivalents, including stock options, warrants, convertible preferred stock and convertible bonds in the weighted average number of common shares outstanding for a period, if dilutive.

Inventories Inventories consist primarily of raw materials, packaging materials and finished goods valued at the lower of cost or market. Cost is determined on the basis of the first-in, first-out method.

Property and Equipment Property and equipment are stated at cost and are depreciated principally by the straight-line method over the estimated useful lives of the assets ranging from three to ten years.

Patents and Trademarks Patents and trademarks are stated on the basis of cost and are amortized over 12 to 17 years on a straight-line basis.

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

Goodwill and Other Intangible Assets On January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142 ("SFAS No. 142"), "Goodwill and Other Intangible Assets." SFAS No. 142 requires that goodwill and intangible assets deemed to have indefinite lives no longer be amortized but be subject to an annual impairment test. Other intangible assets will continue to be amortized over their useful lives.

Revenue Recognition The Company operates in three segments, wound care, wound closure-fasteners and skin care. Sales are recorded when product is shipped and title passes to customers. Gross sales are adjusted for cash discounts, Medicaid rebates and trade rebates to derive net sales. Freight costs to ship product to customers are recorded as a component of cost of sales.

Advertising and Promotion Costs Advertising and promotion costs are expensed in the year incurred.

2. Accounts Receivable

Accounts Receivable comprise the following:

June 30,	December 31,
2002	2001

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Trade accounts receivable	\$1,029,712	\$1,051,283
Less: Allowance for doubtful accounts	(40,000)	(50,000)
Allowance for trade rebates	(75,000)	(100,000)
Net trade receivables	914,712	901,283
Equity subscriptions receivable	55,000	-
Other receivables	16,565	13,175
Total receivables	\$ 986,277	\$ 914,458

3. Inventories

Inventories comprise the following:

	June 30, 2002	December 31, 2001
Finished goods	\$1,547,355	\$1,617,449
Packaging materials	257,322	268,001
Raw materials	86,543	96,797
Gross inventory	1,891,220	1,982,247
Reserve for obsolescence	(115,000)	(195,000)
Net inventory	\$1,776,220	\$1,787,247

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

4. Property and Equipment

Property and equipment comprise the following:

	June 30, 2002	December 31, 2001
Machinery and equipment	\$ 390,245	\$ 360,188
Furniture and fixtures	684,760	668,336
Gross property and equipment	1,075,005	1,028,524
Less: Accumulated depreciation	(894,127)	(858,816)
Net property and equipment	\$ 180,878	\$ 169,708

5. Goodwill

Goodwill relates to the acquisition of Sunshine Products, Inc. in 1998. Effective January 1, 2002, in accordance with SFAS No. 142, the Company discontinued the amortization of goodwill and conducted the first of the required annual tests of goodwill impairment. An impairment charge would be recognized if the fair value of Sunshine Products, Inc.'s goodwill is less than its carrying value.

The results of the initial test indicates that the goodwill carrying value is not impaired. Application of the non-amortization provisions of SFAS No. 142 for the three months and six months ended June 30, 2001 would have resulted in an increase in net income of \$26,500 and \$53,000, respectively.

6. Patents and Trademarks

Patents and trademarks comprise the following:

	June 30, 2002	December 31, 2001
	-----	-----
Patents and trademarks	\$ 451,417	\$ 451,417
Less: Accumulated amortization	(302,345)	(293,557)
	-----	-----
Net patents and trademarks	\$ 149,072 =====	\$ 157,860 =====

7. Other Assets

Other assets comprise the following:

	June 30, 2002

Deferred financing costs	\$110,558
Deferred acquisition costs	132,602
Other	3,718

Total other assets	\$246,878 =====

Deferred financing costs consists of \$30,000 related to the imputed value of the eighteen months reset provision granted to bondholders in connection with the conversion of the Series C and D convertible bonds in January 2002 and \$80,558 related to deferred lender and legal costs associated with the thirty-six month revolving credit facility agreement entered into in April 2002. Both amounts are being amortized monthly to interest expense

DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

over the foregoing eighteen month and thirty-six month terms. Deferred acquisition costs relate to a potential acquisition in progress (see Note 13). These costs will be expensed if the acquisition is not completed.

In the second quarter 2002, \$94,928 of deferred acquisition costs related to a discontinued initiative were expensed.

8. Bank Line of Credit

On April 30, 2002, the Company entered into a three-year revolving credit facility agreement (the Agreement) for a maximum principal amount of \$2,500,000. Through June 30, 2002, no advances had been drawn against the facility. At June 30, 2002, maximum potential advances under the Agreement were \$1,450,000. Advances will be utilized to fund strategic initiatives and general working capital requirements. Lender and legal fees of \$85,297 incident to the revolving credit facility were deferred and are being amortized to interest expense over the three-year term of the Agreement.

The Company may request advances under the Agreement up to the value of eighty-five percent (85%) of eligible receivables (as defined) and fifty percent (50%) of eligible finished goods inventory (as defined). Interest on outstanding advances is payable monthly in arrears at the rate of prime plus 2.5% per annum, but not less than 7.5% per annum. The Company will pay a monthly collateral management fee at the rate of 1.5% per annum upon the daily average amount of advances outstanding each month. In addition, the Company will pay a monthly unused line fee at the rate of 0.6% per annum upon the difference between the daily average amount of advances outstanding and \$2,500,000. Outstanding advances are secured by all existing and after-acquired tangible and intangible assets of the Company.

Over the term of the Agreement, the Company has agreed to comply with the following covenants as measured at the end of each month for the average of the three most recent calendar months: (a) the Company will maintain a positive EBITDA (earnings before interest, taxes, depreciation and amortization), and (b) the fixed charge ratio (EBITDA divided by the sum of debt service, capital expenditures, income taxes and dividends) may not be less than 1.2:1.0. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the Agreement.

The Company may terminate the Agreement at any time by paying off all outstanding indebtedness and any other payments due to the lender. Early termination fees of \$50,000 or \$25,000 are payable if termination occurs before April 30, 2003 or April 30, 2004, respectively. There is no fee for termination of the Agreement after April 30, 2004.

The Company previously had a \$1,000,000 bank line of credit facility fully secured with cash deposited with the bank. On November 5, 2001, the Company paid off its outstanding loan balance and did not renew the line of credit facility. At June 30, 2001, \$580,455 of the line of credit facility was outstanding.

9. Convertible Bonds

Effective January 7, 2002, bondholders of all the Company's issued and outstanding Series C and D convertible bonds converted the entirety of the \$475,000 principal and \$120,200 accrued interest into units at a rate of one unit for each \$0.50 of principal and interest converted. Each unit consists of one share of Series C or Series D Preferred Stock and one and one tenth warrants to purchase one share of common stock at a per share exercise price of \$0.57 (Series F Warrants). Each share of preferred stock is convertible into common stock on a one-for-one basis. Principal and accrued interest under the bonds totaling \$595,200 were converted into 1,190,400 shares of convertible preferred stock and 1,309,441 warrants.

If prior to July, 2003, the Company offers for sale its common stock at a price per share below \$0.50 or its warrants at a per share exercise price of less than \$0.57, then the Company has agreed to: (1) issue to the bondholders such additional shares of preferred stock and warrants as, when added to the preferred stock and

DERMA SCIENCES, INC.**Notes To Consolidated Financial Statements**

warrants previously issued, equal the shares of preferred stock and warrants that would have been issued using the lower common stock price as the conversion rate, and (2) lower the per share exercise price of the Series F Warrants to the lower per share exercise price.

In connection with the conversion, the Company recognized an imputed non-cash interest charge of \$165,200. A charge of \$45,000 was taken to account for the value of the reset concession granted to the bondholders. This charge is being amortized over the eighteen-month term of the reset concession. A charge of \$120,200 was taken immediately to account for the conversion terms associated with the accrued interest.

As of January 5, 2001, bondholders owning an aggregate of \$475,000 of the Company's Series C and Series D Convertible Bonds extended the maturity date of their bonds from January 7, 2001 to January 7, 2002. In consideration for this maturity postponement, the Company accorded the bondholders the following: (1) 57,000 shares of the Company's Common Stock with registration rights, (2) reduction in the per unit conversion rate of the Series C and Series D Convertible Bonds remaining outstanding from \$0.75 to \$0.50, (3) increase in the ratio of preferred stock to warrants comprising the units from one share of preferred stock and one warrant to one share of preferred stock and one and one tenth warrants, and (4) reduction of the exercise price of the warrants from \$0.85 per share to \$0.57 per share. The \$160,000 value of the foregoing was recorded as bond discount and amortized to interest expense over the one-year bond maturity extension.

10. Shareholders Equity**Preferred Stock**

There are 150,003 shares of Series A Convertible Preferred Stock (Series A Preferred) outstanding. The Series A Preferred 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 and maintains voting rights identical to the Common Stock on all other matters.

There are 452,504 shares of Series B Convertible Preferred Stock (Series B Preferred) outstanding. The Series B Preferred 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 and maintains voting rights identical to the Common Stock on all other matters.

There are 719,055 shares of Series C Convertible Preferred Stock (Series C Preferred) outstanding. The Series C Preferred is convertible into Common Stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging \$0.72 per share, votes as a class on matters affecting the Series C Preferred and maintains voting rights identical to the Common Stock on all other matters.

There are 1,204,680 shares of Series D Convertible Preferred Stock (Series D Preferred) outstanding. The Series D Preferred is convertible into Common Stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging \$0.53 per share, votes as a class on matters affecting the Series D Preferred and maintains voting rights identical to the Common Stock on all other matters.

Stock Purchase Warrants

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At June 30, 2002, the Company had warrants outstanding to purchase the Company's common stock as outlined below:

Series	Number of Warrants	Exercise Price	Expiration Date
E	2,200,009	\$0.85	July 18, 2005
F	1,309,441	\$0.57	January 6, 2007

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

Other Equity Transactions

The Company initiated in January 2002 a private offering of 2,000,000 shares of its common stock at a price of \$0.50 per share (the Offering). Offering proceeds will be used to fund an acquisition or other strategic initiatives of the Company approved by the purchasers. In the event the proceeds are not so utilized by July 31, 2002, each purchaser has the option to rescind his/its purchase of common stock and receive all consideration paid therefor. This right of rescission must be exercised, if at all, prior to August 1, 2002.

As of June 30, 2002 the Company had concluded subscription agreements with its president, together with 15 other individual and institutional investors, for the sale of 1,300,000 shares of common stock for a total investment of \$650,000 under the Offering. At June 30, 2002, subscriptions totaling \$595,000 had been funded. The balance of \$55,000 has been recorded as Subscriptions Receivable on the balance sheet as of June 30, 2002. Proceeds totaling \$650,000 have been received as of August 14, 2002. With the exception of subscriptions totaling \$60,000, with respect to which rescission rights were temporarily extended, the rescission rights discussed above have expired or been waived. Accordingly, at June 30, 2002, \$590,000 of the Offering proceeds and related 1,180,000 shares of Common Stock have been recorded as equity and shares outstanding. The balance of the Offering proceeds of \$60,000 has been recorded as Restricted Cash and Other Current Liabilities on the balance sheet as of June 30, 2002 and will be so recorded until the rescission rights relative to investment are exercised or waived. The corresponding 120,000 shares of Common Stock issued subject to the right of rescission have not been reported as outstanding or considered in the earnings per share calculation as they are deemed to be temporary equity.

As of March 31, 2002, Offering subscriptions totaling \$565,000 had been funded. This \$565,000 was recorded as Restricted Cash and Other Current Liabilities on the balance sheet given the above discussed rights of rescission. As of March 31, 2002 shares subject to the rights of rescission were considered to be temporary equity and were not reported as outstanding or considered in the earnings per share calculation.

In May 2002, a total of 624,167 shares of Series A, B and C Preferred Stock were converted into 624,167 shares of Common Stock. In February 2001, a total of 229,169 shares of Series B, C and D Preferred Stock were converted into 229,169 shares of Common Stock. In January 2001, 57,000 shares of Common Stock were issued as consideration for extending the maturity date of the Series C and D convertible bonds.

11. Income Taxes

No provision for income taxes has been made in the second quarter or the six months ended June 30, 2002, given the Company's available net operating loss carry forwards.

At December 31, 2001, the Company has net operating loss carryforwards of approximately \$6,800,000 for federal income tax purposes that begin to expire in years 2012 through 2020. For state income tax purposes, the Company has net operating loss carryforwards of \$6,800,000 that expire in years 2004 through 2010. During 1998 the Company had a change in control as defined by the Internal Revenue Code Section 382. Consequently, certain limitations may apply to the timing and amount of the utilization of such net operating loss carryforwards.

12. Operating Segments

The Company consists of three operating segments, wound care, wound closure-fasteners and skin care. Products in the wound care segment consist of dressings, ointments and sprays designed to treat chronic wounds. Wound closure-fasteners products include wound closure strips, nasal tube fasteners, a variety of catheter fasteners and net dressings. The skin care segment consists of bath sponges, antibacterial skin cleansers, hair and body soaps, lotions and moisturizers designed to enable customers to implement and maintain successful skin care / hygiene programs.

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Notes To Consolidated Financial Statements

Products in all three operating segments are marketed to long-term care facilities, hospitals, physicians, clinics, home health care agencies and other healthcare institutions. The manufacture of wound care and wound closure-fastener products is primarily outsourced. Skin care products are manufactured in-house with the exception of the bath sponge line. Internally, the segments are managed at the gross profit level. The aggregation or allocation of other costs by segment is not practical.

Segment sales and gross profit for the six months ended June 30, 2002 and 2001 are as follows:

	Six Months Ended June 30, 2002				
	Wound Care	Wound Closure- Fasteners	Skin Care	Other Costs	Total Company
	-----	-----	-----	-----	-----
Net sales	\$1,534,324	\$1,424,997	\$1,231,894	---	\$4,191,215
	-----	-----	-----	-----	-----
Gross profit	1,188,292	717,567	434,724	---	2,340,583
Total expenses	---	---	---	(\$2,267,981)	(2,267,981)

Net income					\$ 72,602
					=====

	Six Months Ended June 30, 2001				
	Wound Care	Wound Closure- Fasteners	Skin Care	Other Costs	Total Company
	-----	-----	-----	-----	-----

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Net sales	\$1,411,439	\$1,605,952	\$1,735,475	---	\$4,752,866
	-----	-----	-----	-----	-----
Gross profit	1,088,272	798,369	361,575	---	2,248,216
Total expenses	---	---	---	(\$2,218,023)	(2,218,023)

Net income					\$ 30,193
					=====

With the exception of goodwill associated with the acquisition of Sunshine Products, Inc. (attributable to the skin care operations segment), the Company's property, equipment and intangible assets support each of the Company's operating segments in approximately equal measure. Accordingly, the Company does not classify its assets by operating segments.

International sales were \$328,500 in 2002 and \$322,500 in 2001. Wound closure-fastener sales represent the majority of international sales.

13. Subsequent Events

On July 19, 2002 the Company's offer to purchase the assets and business operations of privately held Dumex Medical Inc., Toronto, Ontario, Canada was approved by the Ontario Superior Court of Justice Commercial List in accordance the Bankruptcy and Insolvency Act of Canada. Dumex is a leading manufacturer and distributor of wound care products and medical devices primarily to the Canadian market. Dumex's 2001 sales were \$9.1 million of which 76% and 24% were to Canadian and United States customers, respectively. Synergies

DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

expected to be realized from this acquisition include growth of Dumex's product line in the United States and utilization of Dumex's manufacturing capabilities by the Company. On or about August 19, 2002 Dumex's assets are expected to be transferred to a new wholly owned subsidiary of the Company free of claims and entitlements of Dumex's unsecured creditors and shareholders.

The assets to be transferred to the Company's wholly owned subsidiary consist primarily of accounts receivable, inventory and fixed assets. The fair market value of these assets at closing is expected to approximate the purchase price of \$3.76 million. The purchase price will be financed by assumption of Dumex indebtedness, cash-on-hand and draws from the Company's credit line. Upon closing of the acquisition, the Company will contribute approximately \$450,000 to its Canadian subsidiary to provide working capital. The Company has entered into an employment agreement with the founder of Dumex who will serve as the Canadian subsidiary's Chief Executive Officer. The Company also plans to employ certain other of Dumex's key employees.

DERMA SCIENCES, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

QUARTER ENDED JUNE 30, 2002 COMPARED TO QUARTER ENDED JUNE 30, 2001.**Results of Operations**

Net sales decreased \$305,084, or 12.8%, to \$2,076,724 in the second quarter 2002 from \$2,381,808 in the second quarter 2001. Gross profit increased \$17,109, or 1.5%, to \$1,176,046 in the second quarter 2002 from \$1,158,937 in the second quarter 2001. Gross Profit margins increased to 56.6% in the second quarter 2002 from 48.7% in the second quarter 2001. Operating expenses decreased \$43,809, or 3.9%, in the second quarter 2002 to \$1,071,692 from \$1,115,501 in the second quarter 2001. Interest expense decreased \$38,105 in the second quarter 2002 to \$6,723 from \$44,828 in the second quarter 2001. Other expense increased \$111,640 to expense of \$89,244 in the second quarter 2002 versus income of \$22,396 in the second quarter 2001. Net income of \$8,387 was generated in the second quarter of 2002 versus net income of \$21,004 in the second quarter of 2001.

Sales Overview

The Company's sales are derived from its wound care, wound closure-fasteners and skin care product lines. Wound care sales consist mainly of Dermagran ointment and spray and hydrophilic wound dressings. Wound closure-fasteners sales consist primarily of wound closure strips and catheter fasteners. Skin care sales consist of bath sponges, body washes, shampoos, incontinent care products, skin conditioners, disinfectants and deodorizers.

Gross sales are adjusted for trade rebates, cash discounts and Medicaid rebates to derive net sales. Gross to net sales adjustments comprise the following:

	Quarter Ended June 30,	
	2002	2001
	-----	-----
Gross Sales	\$2,328,700	\$2,674,250
Trade rebates	(188,540)	(222,345)
Cash discounts	(44,686)	(51,347)
Medicaid rebates	(18,750)	(18,750)
	-----	-----
Net Sales	\$2,076,724	\$2,381,808
	=====	=====

Gross sales were down \$345,550, or 12.9%, quarter to quarter reflecting lower skin care sales associated with the loss of the Beverly supply agreement and lower wound closure fasteners sales due to softening demand for Suture Strips and fasteners and Percu-Stay backorders. Trade rebates are down due to the reduction in rebate intensive Beverly skin care sales and discontinuation of a wound care related incentive rebate agreement in November 2001. Cash discounts are down due to the lower sales base and efforts undertaken to improve adherence to terms.

The following table presents net sales by product line expressed in dollars and percentage change:

	Quarter Ended June 30,		
	2002	2001	Variance
	-----	-----	-----
Product Line			

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Wound care	\$ 784,245	\$ 735,653	\$ 48,592	6.6%
Wound closure-fasteners	657,227	839,627	(182,400)	(21.7%)
Skin care	635,252	806,528	(171,276)	(21.2%)
	-----	-----	-----	
Total	\$2,076,724	\$2,381,808	(\$305,084)	(12.8%)
	=====	=====	=====	

Skin care sales decreased principally due to the loss of the Beverly supply agreement effective May 31, 2001. Competitive market pressure also contributed. Sales of the Company's new bath sponge included in this product line were \$24,924. Wound closure fasteners sales were adversely affected by continued Percu-Stay supply interruptions resulting in significant customer backorders at quarter end. Suture Strip and catheter fasteners sales were down significantly due to competitive pressure despite continued growth from the Suture Strip private label agreement entered into in late 2001. Wound care sales increased slightly due to continued growth of the line's mainstay ointment and cream products partially offset by increasing competitive price pressure. In addition, second quarter wound care sales benefited from discontinuation of an incentive rebate agreement with a major customer in November 2001.

Net Sales, Cost of Sales and Gross Profit

The Company's net sales, cost of sales, gross profit and gross profit margins for the second quarter of 2002 and 2001 are outlined in the table below:

	Quarter Ended June 30,				Variance	
	2002		2001			
	-----	-----	-----	-----	-----	-----
Net sales	\$2,076,724	100.0%	\$2,381,808	100.0%	(\$305,084)	(12.8%)
Cost of sales	900,678	43.4%	1,222,871	51.3%	(322,193)	(26.3%)
	-----	-----	-----	-----	-----	-----
Gross profit	\$1,176,046	56.6%	\$1,158,937	48.7%	\$ 17,109	1.5%
	=====	=====	=====	=====	=====	=====

Gross profit and profit margins increased in the second quarter 2002 versus the second quarter 2001 due principally to favorable sales mix. Higher margined wound care sales increased to 38% of quarterly sales in 2002 versus 31% in 2001. Conversely, lower margined skin care sales decreased to 31% of quarterly sales in 2002 from 34% in 2001. Skin care line margins have improved in 2002 due to cost reduction initiatives implemented in response to the loss of the Beverly business in 2001 and the reclassification to operating expense in 2002 of certain overhead costs previously charged to cost of sales. Holding contract manufactured costs essentially flat in 2002 versus 2001 also contributed.

Operating Expenses

A summary of selling, marketing and general administrative expenses for the second quarter 2002 and 2001 are outlined in the table below.

	Quarter Ended June 30,		Variance
	2002	2001	
	----	----	-----

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Selling	\$ 314,426	\$ 363,949	(\$49,523)	(13.6%)
Marketing	157,351	131,166	26,185	20.0%
General administrative	599,915	620,386	(20,471)	(3.3%)
	-----	-----	-----	
Total	\$1,071,692	\$1,115,501	(\$43,809)	(3.9%)
	=====	=====	=====	

Selling expenses are down quarter to quarter due to lower commission expense associated with a reduction of the independent manufacturers representatives network in January 2002 and again in June 2002 in response to an ongoing evaluation of the cost-benefit of employing this method of sales representation. Lower travel and entertainment and administrative costs associated with the Company's ongoing cost reduction efforts also contributed. The increase in marketing expense reflects the costs of several market studies conducted by outside consultants in the second quarter 2002 and increased compensation and operating expenses associated with a marketing support associate hired in May 2001. Promotion efforts were comparable quarter to quarter while clinical support activities were significantly reduced. The reduction in General Administrative expense reflects the discontinuation of goodwill amortization of \$26,500 coupled with lower other general administrative spending due to cost containment initiatives which were partially offset by higher compensation and benefit costs for existing personnel.

Interest Expense, net

Interest expense, net decreased \$38,105 to \$6,723 in the second quarter 2002 from \$44,828 in the second quarter 2001. The decrease is attributable to the non-recurrence of \$40,000 of non-cash interest expense associated with amortizing the consideration granted in January 2001 to extend the maturity date of the Series C and D convertible bonds and elimination of convertible bond interest due to the conversion of the bonds in January 2002, partially offset by incremental 2002 expense associated with amortization of deferred financing costs associated with the Series C and D bond conversion reset provision, and deferred lender and legal costs associated with securing a new line of credit agreement.

Other Income and Expense

Other expense increased \$111,640 to \$89,244 expense in the second quarter 2002 from \$22,396 income in the second quarter 2001. The increase is primarily attributable to a \$94,928 write-off of acquisition costs associated with a cancelled initiative together with the non-recurrence of a \$12,500 Medicaid adjustment received in 2001.

Provision for Income Taxes

No provision for income taxes has been provided in the second quarter of 2002 and 2001 given available net operating loss carry forwards.

Net Income

The Company generated net income of \$8,387 in the second quarter 2002 compared to net income of \$21,004 in the second quarter 2001. Second quarter 2002 net income includes a \$94,928 charge to Other Expense relating to a cancelled acquisition initiative. Non-cash imputed interest costs of \$7,500 and \$40,000 were included in second quarter 2002 and 2001 net income, respectively. In addition, second quarter 2001 net income includes

\$26,500 of goodwill amortization expense. Adjusting for these items, net income would have been \$110,815 and \$87,504 in the second quarter 2002 and 2001, respectively.

SIX MONTHS ENDED JUNE 30, 2002 COMPARED TO SIX MONTHS ENDED JUNE 30, 2001.**Results of Operations**

Net sales decreased \$561,651, or 11.8%, to \$4,191,215 in the six months ended June 2002 from \$4,752,866 in the six months ended June 2001. Gross profit increased \$92,367, or 4.1%, to \$2,340,583 from \$2,248,216. Gross profit margins increased to 55.8% from 47.3%. Operating expenses decreased \$90,267, or 4.2%, to \$2,057,213 from \$2,147,480. Interest expense increased \$37,248 to \$131,098 from \$93,850. Other expense increased \$102,977 to \$79,670 expense from \$23,307 income. Net income of \$72,602 was generated in the six months ended June 2002 versus net income of \$30,193 in 2001.

Sales Overview

Gross sales are adjusted for trade rebates, cash discounts and Medicaid rebates to derive net sales. Gross to net sales adjustments comprise the following:

	Six Months Ended June 30,	
	2002	2001
	-----	-----
Gross Sales	\$4,629,601	\$5,357,897
Trade rebates	(312,912)	(462,256)
Cash discounts	(88,099)	(105,275)
Medicaid rebates	(37,375)	(37,500)
	-----	-----
Net Sales	\$4,191,215	\$4,752,866
	=====	=====

Gross sales were down \$728,296, or 13.6%, period to period principally reflecting lower skin care sales associated with the loss of the Beverly supply agreement. Lower Percu-Stay sales due to backorders from the supplier also contributed. Trade rebates were down due to the reduction in rebate intensive Beverly skin care sales and discontinuation of a wound care related incentive rebate agreement in November 2001. Cash discounts were down due to the lower sales base and efforts undertaken to improve adherence to terms.

The following table presents net sales by product line expressed in dollars and percentage change:

	Six Months Ended June 30,			
	2002	2001		Variance
	-----	-----		-----
Product Line				
Wound care	\$1,534,324	\$1,411,439	\$ 122,885	8.7%
Wound closure-fasteners	1,424,997	1,605,952	(180,955)	(11.3%)
Skin care	1,231,894	1,735,475	(503,581)	(29.0%)
	-----	-----	-----	
Total	\$4,191,215	\$4,752,866	(\$561,651)	(11.8%)
	=====	=====	=====	

Skin care sales decreased principally due to the loss of the Beverly supply agreement effective May 31, 2001. Competitive market pressure also contributed. As expected, the sales loss in the second quarter 2002 was significantly less than in the first quarter 2002. Sales of the Company's new bath sponge included in this product line were \$38,247.

Wound closure fastener sales were adversely impacted by Percu-Stay backorders. After a strong first quarter, Suture Strip and catheter fastener sales were down due to softening demand despite continued growth from the private label Suture Strip agreement initiated in late 2001. Wound care sales increased slightly due to

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continued growth of the line's mainstay ointment and cream products in an increasing price-competitive market place. In addition, wound care sales benefited from discontinuation of an incentive rebate agreement with a major customer in November 2001.

Net Sales, Cost of Sales and Gross Profit

The Company's net sales, cost of sales, gross profit and gross profit margins for the six months ended 2002 and 2001 are outlined in the table below:

	Six Months Ended June 30,				Variance	
	2002		2001			
Net sales	\$4,191,215	100.0%	\$4,752,866	100.0%	(\$561,651)	(11.8%)
Cost of sales	1,850,632	44.2%	2,504,650	52.7%	(654,018)	(26.1%)
Gross profit	\$2,340,583	55.8%	\$2,248,216	47.3%	\$ 92,367	4.1%

Gross profit and profit margins increased in the first six months of 2002 versus 2001 due principally to favorable sales mix. Higher margined wound care sales increased to 37% of sales in the first six months of 2002 versus 30% in 2001. Conversely, lower margined skin care sales decreased to 29% of sales in 2002 versus 36% in 2001. Significantly lower sales of lower margined Percu-Stay in 2002 versus 2001 also contributed. Skin care line margins have improved in 2002 versus 2001 due to cost reduction initiatives implemented in response to the loss of the Beverly business in 2001 and the reclassification to operating expense in 2002 of certain overhead costs previously charged to cost of sales. The company has also been successful in holding the line on contract manufactured product cost increases in 2002.

Operating Expenses

A summary of selling, marketing and general administrative expenses for the first six months of 2002 and 2001 are outlined in the table below:

	Six Months Ended June 30,			Variance
	2002	2001		
Selling	\$ 663,129	\$ 744,594	(\$81,465)	(10.9%)
Marketing	221,925	194,960	26,965	13.8%
General administrative	1,172,159	1,207,926	(35,767)	(3.0%)
Total	\$2,057,213	\$2,147,480	(\$90,267)	(4.2%)

Selling expenses were down in the first six months of 2002 versus 2001 principally due to lower commission expense associated with a restructuring of the Company's independent manufacturers' representatives network. Lower travel and entertainment and administrative costs associated with the Company's ongoing cost reduction initiative also contributed. The increase in marketing expense is attributable to several marketing studies conducted by outside consultants in the second quarter 2002, a higher level of promotion activity and increased operating costs associated with a marketing support associate hired in May 2001. These cost increases were partially mitigated by a significant reduction in clinical support activity in 2002 versus 2001. The reduction in General Administrative expense reflects the discontinuation of goodwill amortization of \$53,000 coupled with other general administrative spending which were partially offset by higher compensation and benefit costs for existing employees.

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Interest Expense, net

Interest expense, net increased \$37,248 to \$131,098 in the first six months of 2002 from \$93,850 in 2001. The increase is attributable to an imputed non-cash interest charge of \$135,200 associated with the conversion of the Company's Series C and D bonds in January 2002, together with an interest charge commencing in May 2002 relative to the amortization of deferred lender and legal costs associated with securing a new line of credit agreement. This increase was partially offset by the non-recurrence of \$80,000 of non-cash interest expense associated with amortizing the consideration granted in January 2001 to extend the maturity date of the outstanding Series C and D convertible bonds and elimination of convertible bond interest coincident with the conversion of all outstanding bonds in January 2002.

Other Income and Expense

Other expense increased \$102,977 to \$79,670 expense in the first six months of 2002 from \$23,307 income in 2001. The increase is primarily attributable to a \$94,928 write-off of acquisition costs associated with a cancelled initiative together with the non-recurrence of a \$12,500 Medicaid adjustment received in 2001.

Provision for Income Taxes

No provision for income taxes has been provided in the first six months of 2002 and 2001 given available net operating loss carry forwards.

Net Income

The Company generated net income of \$72,602, or \$0.02 per share (basic) and \$0.01 per share (diluted), in the first six months of 2002 compared to net income of \$30,193, or \$0.01 per share (basic) or \$0.01 per share (diluted) in 2001. Six months 2002 net income includes a \$94,928 charge for expenses associated with a cancelled acquisition initiative. Non-cash imputed interest costs of \$135,200 and \$80,000 were included 2002 and 2001 net income, respectively. In addition, six months 2001 net income includes \$53,000 of goodwill amortization expense. Adjusting for these items, net income would have been \$302,730 and \$163,193 in the first half of 2002 and 2001, respectively.

Liquidity and Capital Resources

Operating results for the second quarter and six months ended June 2002 versus the corresponding periods last year are positive. Sales, while softer than expected, are comparable with the last three quarters. Operating expenses remain in line with revenues and cash flow continues to be positive.

At June 30, 2002 and December 31, 2001, the Company had unrestricted cash and cash equivalents of \$1,139,274 and \$524,783, respectively. The \$614,491 increase in cash was provided by \$509,408 raised from the

issuance of stock and \$369,463 of positive cash flow from operations, less capital expenditures of \$46,481, deferred financing costs of \$85,297 and deferred acquisition costs of \$132,602. Working capital improved \$1,148,150 at June 30, 2002 to \$3,010,222 from \$1,862,072 at December 31, 2001. The improvement in working capital is principally attributable to the \$595,200 conversion of the Company's Series C and D bonds inclusive of accrued interest, together with the net increase in cash.

During the three months ended June 30, 2002, the Company deferred charges of \$132,602 relating to a potential acquisition. These costs are included in Other Assets on the balance sheet. These deferred costs will be expensed if the transaction is not completed as planned.

On April 30, 2002, the Company entered into a three-year revolving credit facility agreement (the Agreement) for a maximum principal amount of \$2,500,000. Through June 30, 2002, no advances had been drawn against the facility. At June 30, 2002, maximum potential advances under the Agreement were \$1,450,000. Fees of \$85,297 incident to the revolving credit facility were deferred and are being amortized to interest expense over the three-year term of the Agreement.

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The Company initiated in January 2002 a private offering of 2,000,000 shares of its common stock at a price of \$0.50 per share (the Offering). Offering proceeds will be used to fund an acquisition or other strategic initiatives of the Company approved by the purchasers. In the event the proceeds are not so utilized by July 31, 2002, each purchaser has the option to rescind his/its purchase of common stock and receive all consideration paid therefor. This right of rescission must be exercised, if at all, prior to August 1, 2002.

As of June 30, 2002 the Company had concluded subscription agreements with its president, together with 15 other individuals and institutional investors, for the sale of 1,300,000 shares of common stock for a total investment of \$650,000 under the Offering. At June 30, 2002, subscriptions totaling \$595,000 had been funded. The balance of \$55,000 has been recorded as Subscriptions Receivable on the balance sheet as of June 30, 2002. Proceeds totaling \$650,000 have been received as of August 14, 2002. With the exception of subscriptions totaling \$60,000, with respect to which rescission rights were temporarily extended, the rescission rights discussed above have expired or been waived. Accordingly, at June 30, 2002, \$590,000 of the Offering proceeds and related 1,180,000 shares of Common Stock have been recorded as equity and shares outstanding. The balance of the Offering proceeds of \$60,000 has been recorded as Restricted Cash and Other Current Liabilities on the balance sheet as of June 30, 2002 and will be so recorded until the rescission rights relative to investment are exercised or waived. The corresponding 120,000 shares of Common Stock issued subject to the right of rescission have not been reported as outstanding or considered in the earnings per share calculation as they are deemed to be temporary equity.

Effective January 7, 2002, bondholders of all the Company's issued and outstanding Series C and D convertible bonds converted the entirety of the \$475,000 principal and \$120,200 accrued interest into units at a rate of one unit for each \$0.50 of principal and interest converted. Each unit consists of one share of Series C or Series D Preferred Stock and one and one tenth warrants to purchase one share of common stock at a per share exercise price of \$0.57 (Series F Warrants). Each share of preferred stock is convertible into common stock on a one-for-one basis. Principal and accrued interest under the bonds totaling \$595,200 were converted into 1,190,400 shares of convertible preferred stock and 1,309,441 warrants.

If prior to July, 2003 the Company offers for sale its common stock at a price per share below \$0.50 or its warrants with a per share exercise price of less than \$0.57, then the Company has agreed to: (1) issue to the bondholders such additional shares of preferred stock and warrants as, when added to the preferred stock and warrants previously issued, equal the shares of preferred stock and warrants that would have been issued using the lower common stock price as the conversion rate, and (2) lower the per share exercise price of the Series F Warrants to the lower per share exercise price.

In connection with the conversion, the Company recognized imputed non-cash interest charges of \$165,200. A charge of \$45,000 was taken to account for the value of the reset concession granted the bondholders. This charge is being amortized over the eighteen-month term of the reset provision. A charge of \$120,200 was taken immediately to account for the beneficial reduction in conversion terms associated with the accrued interest.

On July 19, 2002 the Company's offer to purchase the assets and business operations of privately held Dumex Medical Inc., Toronto, Ontario, Canada was approved by the Ontario Superior Court of Justice Commercial List in accordance the Bankruptcy and Insolvency Act of Canada. Dumex is a leading manufacturer and distributor of wound care products and medical devices primarily to the Canadian market. Dumex's 2001 sales were \$9.1 million of which 76% and 24% were to Canadian and United States customers, respectively. Synergies expected to be realized from this acquisition include growth of Dumex's product line in the United States and utilization of Dumex's manufacturing capabilities by the Company. On or about August 19, 2002 Dumex's assets are expected to be transferred to a new wholly owned subsidiary of the Company free of claims and entitlements of Dumex's unsecured creditors and shareholders.

The assets to be transferred to the Company's wholly owned subsidiary consist primarily of accounts receivable, inventory and fixed assets. The fair market value of these assets at closing is expected to approximate the purchase price of \$3.76 million. The purchase price will be financed by assumption of Dumex indebtedness, cash-on-hand and draws from the Company's credit line. Upon closing of the acquisition, the Company will

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contribute approximately \$450,000 to its Canadian subsidiary to provide working capital. The Company has entered into an employment agreement with the founder of Dumex who will serve as the Canadian subsidiary's Chief Executive Officer. The Company also plans to employ certain other of Dumex's key employees.

The Common Stock of the Company is traded on the OTC Bulletin Board under the symbol DSCI.OB. The Common Stock is also traded on the Boston and Pacific Stock Exchanges under the symbol DMS. The Company has paid no cash dividends in respect of its Common Stock and does not intend to pay cash dividends in the near future.

Prospectively, the Company expects to build on the momentum created in 2001 in a competitive market place. Modest sales and profitability growth are projected in 2002. Sales are projected to grow based upon identified new customers, new products and expanded sales and marketing efforts. Steps are planned to better control product costs and minimize year-to-year cost increases. Operating expenses will continue to be properly balanced with revenues. Cash flow is projected to improve in concert with the Company's operating performance.

Strategically, the Company's plan is to stay focused on its base business while considering external opportunities to leverage its core capabilities and grow the business.

Forward Looking Statements

Statements that are not historical facts, including statements about the Company's confidence, strategies, expectations about new or existing products, technologies, opportunities, market demand or acceptance of new or existing products are forward-looking statements that involve risks and uncertainties. These uncertainties include, but are not limited to, product demand and market acceptance risk, impact of competitive products and prices, product development, commercialization or technological delays or difficulties, and trade, legal, social, financial and economic risks.

Critical Accounting Policies

The preparation of the financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts in the financial statements and the accompanying notes. Actual results could differ from those estimates. We believe the following accounting policies are the most critical to the Company.

Revenue Recognition and Allowance for Trade Rebates

Revenue is recognized when product is shipped and title passes to the customer. Sales are adjusted for cash discounts, Medicaid rebates and trade rebates to derive net sales. The Company establishes an allowance for trade and Medicaid rebates based on past experience. If the estimate of trade and Medicaid rebates is not sufficient to cover actual rebates, additional allowances may be required.

Reserve for Obsolete Inventory

The Company establishes a reserve for obsolete inventory based on quantities of the inventory on hand, expected future sales and inventory expiration dates. If the estimated reserve for obsolete inventory is not sufficient to cover actual obsolete inventory, additions to the reserve may be required.

Part II - Other Information

Item 1. Legal Proceedings

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits. All exhibits required by Item 601 of Regulation S-B and required hereunder, as filed with the Securities and Exchange Commission in Form 10-KSB on April 1, 2002, are incorporated herein by reference.

Pursuant to Section 1350, Chapter 63 of Title 18, United States Code, the Registrant furnishes herewith the following certifications of its Principal Executive Officer and Principal Financial Officer:

<u>Exhibit</u>	<u>Description</u>
99.1	Certification of Principal Executive Officer pursuant to U.S.C. Section 1350 regarding Form 10-QSB for the quarter ended June 30, 2002
99.2	Certification of Principal Financial Officer pursuant to U.S.C. Section 1350 regarding Form 10-QSB for the quarter ended June, 2002

(b) Reports on Form 8-K. Form 8-K was filed on May 22, 2002 relative to the Registrant's securing a revolving credit facility. Form 8-K/A-1 was filed on June 6, 2002 relative to the Registrant's private placement of common stock.

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

DERMA SCIENCES, INC.

Dated: August 14, 2002

By: /s/ John E. Yetter
John E. Yetter, CPA
Chief Financial Officer