

DERMA SCIENCES, INC.
Form 10-Q
November 14, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

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 registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction of Incorporation)

23-2328753
(IRS employer identification number)

214 Carnegie Center, Suite 300
Princeton, NJ 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.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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

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

Yes No

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

Date: November 9, 2011 Class: Common Stock, par value \$.01 per share
Shares Outstanding: 10,577,632

PART I – FINANCIAL INFORMATION

DERMA SCIENCES, INC.

FORM 10-Q

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Part I – Financial Information

Item 1. Financial Statements.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets (Unaudited)

	September 30, 2011	December 31, 2010
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 18,063,396	\$ 404,216
Short-term investments	4,481,000	-
Accounts receivable, net	6,165,484	5,441,511
Inventories	10,855,414	12,498,519
Prepaid expenses and other current assets	1,541,823	609,164
Total current assets	41,107,117	18,953,410
Long-term investments	249,000	-
Equipment and improvements, net	3,605,668	3,608,242
Identifiable intangible assets, net	6,726,326	6,971,626
Goodwill	7,119,726	7,119,726
Other assets	128,365	316,859
Total Assets	\$ 58,936,202	\$ 36,969,863
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit borrowings	\$ -	\$ 3,075,555
Current maturities of long-term debt	-	5,851
Accounts payable	3,377,632	3,777,454
Accrued expenses and other current liabilities	1,700,026	2,150,621
Total current liabilities	5,077,658	9,009,481
Long-term liabilities	261,961	211,581
Deferred tax liability	1,132,657	1,068,088
Total Liabilities	6,472,276	10,289,150
Shareholders' Equity		
Convertible preferred stock, \$.01 par value; 1,468,750 shares authorized; issued and outstanding: 73,332 at September 30, 2011 and 284,844 at December 31, 2010 (liquidation preference of \$3,222,368 at September 30, 2011)	733	2,848
Common stock, \$.01 par value; 18,750,000 shares authorized; issued and outstanding: 10,577,632 at September 30, 2011 and 6,563,076 at December 31, 2010	105,776	65,631
Additional paid-in capital	76,708,053	48,803,210
Accumulated other comprehensive income – cumulative translation adjustments	1,332,895	1,604,940
Accumulated deficit	(25,683,531)	(23,795,916)
Total Shareholders' Equity	52,463,926	26,680,713
Total Liabilities and Shareholders' Equity	\$ 58,936,202	\$ 36,969,863

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Operations (Unaudited)

	Three Months ended September 30,	
	2011	2010
Net Sales	\$ 15,845,934	\$ 15,096,134
Cost of sales	11,096,315	10,778,929
Gross Profit	4,749,619	4,317,205
Operating Expenses		
Selling, general and administrative	5,141,548	4,577,329
Research and development	200,541	175,380
Total operating expenses	5,342,089	4,752,709
Operating loss	(592,470)	(435,504)
Other expense, net:		
Interest expense	44,470	119,521
Loss on debt extinguishment	176,101	-
Other expense/(income), net	58,537	(75,530)
Total other expense, net	279,108	43,991
Loss before income taxes	(871,578)	(479,495)
Income tax (benefit)/expense	(82,321)	66,843
Net Loss	\$ (789,257)	\$ (546,338)
Net loss per common share – basic and diluted	\$ (0.08)	\$ (0.08)
Shares used in computing net loss per common share – basic and diluted	10,474,637	6,561,826

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Operations (Unaudited)

	Nine Months ended September 30,	
	2011	2010
Net Sales	\$ 46,096,813	\$ 41,170,621
Cost of sales	32,291,998	28,950,413
Gross Profit	13,804,815	12,220,208
Operating Expenses		
Selling, general and administrative	14,824,887	13,340,046
Research and development	494,935	415,232
Total operating expenses	15,319,822	13,755,278
Operating loss	(1,515,007)	(1,535,070)
Other expense, net:		
Interest expense	259,899	414,120
Loss on debt extinguishment	176,101	114,072
Other income, net	(56,213)	(253,661)
Total other expense, net	379,787	274,531
Loss before income taxes	(1,894,794)	(1,809,601)
Income tax (benefit)/expense	(7,179)	292,065
Net Loss	\$ (1,887,615)	\$ (2,101,666)
Net loss per common share – basic and diluted	\$ (0.23)	\$ (0.34)
Shares used in computing net loss per common share – basic and diluted	8,175,516	6,259,205

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

	Nine Months Ended September 30,	
	2011	2010
Operating Activities		
Net loss	\$ (1,887,615)	\$ (2,101,666)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation of equipment and improvements	771,646	712,622
Amortization of intangible assets	1,245,300	1,248,525
Amortization of deferred financing costs	77,781	87,501
Non-cash portion of loss on debt extinguishment	112,336	114,072
Provision for bad debts	30,000	22,269
Allowance for sales adjustments	(15,095)	54,446
Provision for inventory obsolescence	441,243	399,355
Loss on disposal of equipment	2,730	-
Deferred rent expense	58,995	(16,425)
Compensation charge for employee stock options	715,180	618,278
Compensation charge for restricted stock	243,124	42,666
Deferred income taxes	78,749	90,247
Changes in operating assets and liabilities:		
Accounts receivable	(742,152)	(2,065,267)
Inventories	1,050,459	(2,405,249)
Prepaid expenses and other current assets	(952,280)	5,556
Other assets	(3,996)	310,505
Accounts payable	(361,097)	814,506
Accrued expenses and other current liabilities	(416,100)	882,080
Long-term liabilities	8,395	(8,862)
Net cash provided by (used in) operating activities	457,603	(1,194,841)
Investing Activities		
Purchase of investments	(4,730,000)	-
Purchase of equipment and improvements	(931,954)	(337,011)
Purchase of intangible assets	(1,000,000)	(2,250,000)
Net cash used in investing activities	(6,661,954)	(2,587,011)
Financing Activities		
Net change in bank line of credit	(3,075,555)	1,352,319
Long-term debt repayments	(5,851)	(4,050,533)
Net change in restricted cash	-	2,032,164
Proceeds from sale of common stock, net of issuance costs	26,984,569	4,491,279
Net cash provided by financing activities	23,903,163	3,825,229
Effect of exchange rate changes on cash and cash equivalents	(39,632)	122,604
Net increase in cash and cash equivalents	17,659,180	165,981
Cash and cash equivalents		
Beginning of period	404,216	243,524
End of period	\$ 18,063,396	\$ 409,505
Supplemental disclosures of cash flow information:		
Purchase of license rights	\$ -	\$ 4,667,126
Issuance of common stock and warrants	-	(2,417,126)

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Cash paid	\$ -	\$ 2,250,000
Issuance of warrants and stock options for payment of offering costs	\$ 490,980	\$ 121,634
Cash paid during the period for:		
Interest	\$ 234,935	\$ 346,443

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiaries (the “Company”) is a medical technology company focused on three segments of the wound care marketplace: pharmaceutical wound care, advanced wound care and traditional wound care products. The Company has one drug candidate that has completed a Phase 2 study and is working towards initiating a Phase 3 study. The Company markets its currently available products principally through direct sales representatives in the United States (“U.S.”), Canada and the United Kingdom (“U.K.”), and through independent distributors within other select international markets. The Company’s U.S. distribution facilities are located in St. Louis, Missouri and Houston, Texas. The Company utilizes third party distributors for distribution in Canada, Europe and the Far East. The Company also has manufacturing facilities in Toronto, Canada and Nantong, China.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. 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 U.S. 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 nine months ended September 30, 2011, are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. Information included in the consolidated balance sheet as of December 31, 2010 has been derived from the consolidated financial statements and footnotes thereto for the year ended December 31, 2010, included in the Annual Report on Form 10-K previously filed with the Securities and Exchange Commission. For further information refer to the Annual Report on Form 10-K.

Principles of Consolidation – The consolidated financial statements include the accounts of Derma Sciences, Inc. and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates – The preparation of consolidated 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. Estimates and assumptions are required in the determination of sales deductions for trade rebates, sales incentives, discounts and allowances. Significant estimates and assumptions are also required in determining the appropriateness of amortization periods for identifiable intangible assets, the potential impairment of goodwill and the valuation of inventory.

Revenue Recognition – Sales are recorded when product is shipped or title passes to customers and collectability is reasonably assured. Gross sales are adjusted for cash discounts, returns and allowances, trade rebates, distribution fees (in Canada) and other sales deductions in the same period that the related sales are recorded. Freight costs billed to and reimbursed by customers are recorded as a component of revenue. Freight costs to ship product to customers are recorded as a component of cost of sales.

Net Loss per Share – Net loss per common share – basic is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Net 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 three and nine months ended September 30, 2011 and 2010 as the effect would be anti-dilutive.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

	Three and Nine Months Ended September 30,	
	2011	2010
Dilutive shares:		
Convertible preferred stock	73,332	284,844
Restricted common stock	50,500	20,000
Warrants	3,065,702	1,734,531
Stock options	1,393,223	1,265,600
Total dilutive shares	4,582,757	3,304,975

Reclassification – Amortization of the world-wide licensing rights for Medihoney have been reclassified from an operating expense to cost of sales for 2010 in the accompanying statement of operations.

2. Adjustment of Prior Year Financial Statement Amounts

During the three months ended December 31, 2010, the Company determined that certain immaterial corrections were required to be made to previously issued financial statements. Specifically, the Company determined that its valuation allowance for deferred tax assets was understated and as a result income tax expense was also understated. This error was caused by improperly considering as a source of future taxable income the reversal of taxable temporary differences associated with goodwill that have an indefinite reversal period. Accordingly, an increase in the valuation allowance is required for deferred tax assets.

The following table summarizes the effects of the corrections to the Company's consolidated balance sheet and consolidated statement of operations as of and for the three and nine months ended September 30, 2010.

	As Adjusted	As Previously Reported
As of September 30, 2010		
Consolidated Balance Sheet:		
Deferred tax liability	\$ 992,636	\$ 321,323
Total liabilities	11,280,905	10,609,592
Shareholders' equity	\$ 26,653,710	\$ 27,325,023
For the three months ended September 30, 2010		
Consolidated Statement of Operations:		
Income taxes	\$ 66,843	\$ 23,057
Net loss	(546,338)	(502,552)
Net loss per common share	\$ (0.08)	\$ (0.08)
For the nine months ended September 30, 2010		

Consolidated Statement of Operations:

Income taxes	\$ 292,065	\$ 160,709
Net loss	(2,101,666)	(1,970,310)
Net loss per common share	\$ (0.34)	\$ (0.31)

The adjustment does not impact the previously reported total amounts of consolidated cash flows from operating, investing and financing activities.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

3. Cash and Cash Equivalents and Investments

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. The Company considers highly liquid investments purchased with an original maturity greater than three months as investments.

Cash and cash equivalents and investments at September 30, 2011 and December 31, 2010 consisted of the following:

	September 30, 2011	December 31, 2010
Cash	\$ 3,944,859	\$ 404,216
Money market accounts	2,709,449	-
Mutual funds	11,409,088	-
Cash and cash equivalents	18,063,396	404,216
Investments	4,730,000	-
Total cash and cash equivalents and investments	\$ 22,793,396	\$ 404,216

The Company maintains cash with various domestic and foreign financial institutions within the ordinary course of business, which at times may exceed jurisdictional insurance limits. The money market accounts are deposited in various U.S. financial institutions and are fully insured by the Federal Deposit Insurance Corporation. Cash equivalents consist of funds deposited into mutual funds investing in U.S. government obligations that are fully secured by the U.S. government. Investments consist of certificates of deposits in various U.S. financial institutions and are fully insured by the Federal Deposit Insurance Corporation. The Company intends to hold its investments to maturity and accordingly these investments are carried at amortized costs.

The following table provides fair value information as of September 30, 2011:

	Total carrying value as of September 30, 2011	Fair Value Measurements, Using Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash and cash equivalents	\$ 18,063,396	\$ 18,063,339	\$ -	\$ -
Investments	4,730,000	4,710,181	-	-
Total	\$ 22,793,396	\$ 22,773,520	\$ -	\$ -

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets. Level 2 inputs are quoted prices for similar assets in active markets or inputs that are observable for the asset, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on management's own assumptions used to measure assets at fair value. A financial asset's classification

is determined based on the lowest level input that is significant to the fair value measurement.

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

4. Inventories

Inventories are valued at the lower of cost or market determined based on the first in first out method and include the following:

	September 30, 2011	December 31, 2010
Finished goods	\$ 7,526,103	\$ 8,727,822
Work in process	884,380	598,486
Packaging materials	913,684	778,900
Raw materials	1,531,247	2,393,311
Total inventory	\$ 10,855,414	\$ 12,498,519

5. Line of Credit Borrowings

On September 30, 2011 the Company terminated its five-year revolving credit agreement with its lender. In connection with the termination the Company recorded a loss on debt extinguishment of \$176,101 representing the then unamortized portion of deferred financing costs of \$112,336 and related fees of \$63,765.

6. Shareholders' Equity

Common Stock

In June 2011, the Company received net proceeds of \$26,366,450 (after \$2,708,498 in commission and other cash basis offering expenses) from the sale of 3,524,239 shares of common stock at \$8.25 per share, together with 1,762,118 five-year series R warrants to purchase common stock at \$9.90 per share. Additionally, the placement agents received 70,484 five-year warrants to purchase common stock at \$9.90 per share.

During 2011, the Company received \$618,119 (net of \$68,204 in expenses) and issued 278,805 shares of common stock upon the exercise of stock purchase warrants and options. In addition, during 2011 the Company issued 211,512 shares of common stock upon the conversion of series B, C and D preferred stock.

In February 2010, the Company received net proceeds of \$4,478,801 (after \$1,110,199 in commission and other cash basis offering expenses) from the sale of 1,117,800 shares of common stock at a price of \$5.00 per share, together with 372,600 five-year warrants to purchase common stock at \$5.50 per share. In addition, the placement agent received 29,160 five-year warrants to purchase common stock at \$6.25 per share.

In February 2010, the Company issued 400,000 shares of its common stock together with 133,333 warrants to purchase its common stock at an exercise price of \$5.50 per share and 100,000 warrants to purchase its common stock at an exercise price of \$6.25 per share in connection with the purchase of the world-wide Medihoney license rights.

During 2010, the Company received \$12,478 and issued 3,751 common stock shares upon the exercise of stock options. In addition, during 2010 the Company issued 220 shares of common stock upon the conversion of series A and B preferred stock.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

Stock Purchase Warrants

At September 30, 2011, the Company had warrants outstanding to purchase 3,065,702 shares of the Company's common stock consisting of the following:

Series	Number of Warrants	Exercise Price	Expiration Date
J	267,858	\$ 6.16	May 31, 2013
K	389,064	\$ 9.60	April 1, 2013
L	6,250	\$ 3.12	March 31, 2014
N	100,000	\$ 6.25	February 22, 2015
O	331,900	\$ 5.50	February 22, 2015
P	4,695	\$ 6.25	February 16, 2015
Q	133,333	\$ 5.50	February 22, 2015
R	1,832,602	\$ 9.90	June 22, 2016
Total	3,065,702		

In 2011, 224,063 series H, 94,351 series I, 10,000 series K, 40,700 series O and 24,465 series P warrants were exercised either on a for cash or cashless basis. Also in 2011, 107,852 series H warrants expired and 1,832,602 series R warrants were issued in connection with the June 2011 stock sale.

Stock Options

The Company has a stock option plan under which options to purchase a maximum of 2,500,000 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. As of September 30, 2011, options to purchase 1,287,848 shares of the Company's common stock were issued and outstanding under the plan and 1,181,151 shares were available for future grant.

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. As of September 30, 2011, non-plan options to purchase 105,375 shares of the Company's common stock were issued and outstanding.

For the three and nine months ended September 30, 2011 and 2010, the fair value of each option award was estimated at the date of grant using the Black-Scholes option pricing model. The weighted-average assumptions used were as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
Risk-free interest rate	1.29 %	1.78 %	2.07 %	2.54 %

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Volatility factor	76.6	%	107.5	%	75.6	%	79.97	%
Dividend yield	0	%	0	%	0	%	0	%
Expected option life (years)	6.25		6.25		6.25		6.25	

The risk-free rate utilized represents the U.S. treasury yield curve rate for the expected option life at the time of grant. The volatility factor was calculated based on the Company's historical stock price volatility equal to the expected life of the option at the grant date. 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 were forfeited before becoming fully vested, the Company has 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 Consolidated Financial Statements (Unaudited)

A summary of the Company's stock option activity and related information for the nine months ended September 30, 2011 follows:

	Options	Weighted Average Exercise Price
Outstanding – January 1, 2011	1,203,600	\$ 5.07
Granted	272,500	6.85
Exercised	(78,501)	3.21
Expired	(4,376)	4.23
Outstanding – September 30, 2011	1,393,223	\$ 5.53
Expected to vest – September 30, 2011	1,379,291	\$ 5.53
Exercisable at September 30, 2011	1,071,918	\$ 5.32

During 2011, service based options of 130,000 and performance based options of 142,500 were granted to Company officers, directors, and employees. The weighted average fair value per share of options granted during the nine months ended September 30, 2011 was \$5.30.

During the three and nine months ended September 30, 2011 and 2010, stock option compensation expense was recorded as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Cost of sales	\$ 22,863	\$ 18,885	\$ 58,533	\$ 58,383
Selling, general and administrative expenses	199,889	182,262	656,647	559,895
Total stock option compensation expense	\$ 222,752	\$ 201,147	\$ 715,180	\$ 618,278

As of September 30, 2011, there was \$714,111 of unrecognized compensation cost related to nonvested service based awards and \$293,241 nonvested performance based awards granted under the plan. These costs are expected to be recognized over the options' remaining weighted average vesting period of 1.33 years for the service and 0.65 years for the performance based awards.

Restricted Common Stock

The Company has a restricted common stock plan under which 312,500 shares of common stock are reserved for issuance. There are 219,125 shares available for issuance under the plan as of September 30, 2011.

In May 2011, 21,000 shares of restricted common stock were granted under the plan to non-employee members of the Company's board of directors; 20,000 shares will vest one year from date of grant, and 1,000 shares vested immediately. The fair market value at the date of grant determined by the quoted market price was \$215,460, or \$10.26 per share. For the nine months ended September 30, 2011, \$95,760 of compensation expense was recorded for these grants.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

In January 2011, 30,500 shares of restricted common stock were granted under the plan to Company employees on a performance basis which vest one year from date of grant if the performance conditions are met. The fair market value at the date of grant determined by the quoted market price was \$150,975, or \$4.95 per share. For the nine months ended September 30, 2011, \$113,232 was recorded in operating expense for these grants.

In May 2010, 20,000 shares of restricted common stock were granted under the plan to non-employee members of the Company's board of directors that will vest one year from date of grant. The fair market value at the date of grant determined by the quoted market price was \$102,400, or \$5.12 per share. For the nine months ended September 30, 2011 and 2010, \$34,133 and \$42,666 was recorded in operating expense for these grants, respectively.

Shares Reserved for Future Issuance

At September 30, 2011, the Company had reserved the following shares of common stock for future issuance:

Convertible preferred shares (series A – B)	73,332
Common stock options outstanding	1,393,223
Common stock options available for grant	1,181,151
Common stock warrants outstanding	3,065,702
Restricted common stock grants	50,500
Restricted common stock available for grant	219,125
Total common stock shares reserved	5,983,033

7. Comprehensive Loss

The Company's comprehensive loss was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net loss as reported	\$ (789,257)	\$ (546,338)	\$ (1,887,615)	\$ (2,101,666)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(431,383)	181,751	(272,045)	110,084
Comprehensive loss	\$ (1,220,640)	\$ (364,587)	\$ (2,159,660)	\$ (1,991,582)

8. Operating Segments

During the quarter ended September 30, 2011, the Company changed its segment reporting to reflect the current and foreseeable nature of its business operations. The former wound care, wound closure and specialty securement devices and skin care segments no longer reflect how the Company operates its business. The previously reported wound care segment reflected the combined operating activities of the advanced and traditional wound care products. Under the new reporting format they are separately identified and form the basis for two new reporting segments. The previously

reported wound closure and specialty securement devices and skin care operating segments are now combined into the traditional wound care segment. A new segment was created to reflect the Company's significant investment in pharmaceutical products. All prior periods have been restated to conform to the new segment reporting.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

The Company currently operates in three segments: advanced wound care, traditional wound care and pharmaceutical wound care products. They are and will be managed separately because each segment requires different technology, marketing and sales strategies. Advanced wound care products principally consist of both novel and otherwise differentiated dressings, bandages and ointments designed to promote wound healing and/or prevent infection. Traditional wound care products principally consist of commodity related dressings, ointments, gauze bandages, adhesive bandages, wound closer strips, catheter fasteners and skin care products. Pharmaceutical wound care products consist of DSC127, a novel product for the treatment of diabetic foot ulcers which is presently under development having recently completed its Phase 2 trial.

Advanced and traditional wound care products are marketed globally to acute care, extended care, home health care, wound and burn care clinics and physician offices. The Company utilizes a broad network of well-established distributors to deploy its products to end users. Only a small portion of the Company's sales are sold directly to end users. The advanced and traditional wound care products are both manufactured internally and sourced from third party suppliers. The majority of marketing expenses are deployed in support of advanced wound care products with traditional wound care products requiring limited support. The Company utilizes direct sales representatives, distributor relationships and contractual relationships with buying groups and wound care service providers to sell its products. Direct sales representatives are used solely in support of advanced wound care sales.

The pharmaceutical wound care segment is presently limited to the development of DSC127. All expenses associated with this activity are being recorded as research and development expense.

Each operating segment is managed at the segment contribution level consisting of gross profit minus direct expense consisting of distribution, marketing, sales and research and development expenses. Expenses are allocated directly by segment to the extent possible. Expenses common to all three operating segments are allocated consistently using activity based assumptions. The aggregation or allocation of indirect expenses by segment is not practical.

Operating segment sales, gross profit, segment contribution and other related information for 2011 and 2010 are as follows:

Three Months Ended September 30, 2011

	Advanced Wound Care	Traditional Wound Care	Pharmaceutical Wound Care	Other	Total Company
Net sales	\$ 4,077,575	\$ 11,768,359	\$ -	\$-	\$ 15,845,934
Gross profit	1,882,756	2,866,863	-	-	4,749,619
Direct expenses	(2,133,792)	(871,540)	(200,541)	-	(3,205,873)
Segment contribution	\$ (251,036)	\$ 1,995,323	\$ (200,541)	-	1,543,746
Indirect expenses					