DERMA SCIENCES INC
Form 10QSB
November 14, 2003

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	September 30, 2003
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 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 [ ]

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

Date: September 30, 2003	Class: Common Stock, par value $.01 per share Shares Outstanding: 7,462,695

DERMA SCIENCES, INC.

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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.

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Part I - Financial Information

Item 1. FINANCIAL STATEMENTS

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DERMA SCIENCES, INC.

Consolidated Balance Sheets

	September 30, 2003 (Unaudited)	December 2002
ASSETS		
Current Assets		
Cash and cash equivalents	$ 1,114,880	$ 1,496,3
Accounts receivable, net	2,184,374	1,975,9
Inventories	3,769,448	2,875,7
Prepaid expenses and other current assets	337,162	281,0
Total current assets	7,405,864	6,629,1
Property and equipment, net	1,099,201	987,8
Goodwill	1,110,967	1,110,9
Patents and trademarks, net	127,784	140,3
Other assets, net	186,574	220,1
Total Assets	$ 9,930,390	$ 9,088,5
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit	$ 1,162,136	$ 1,962,6
Current maturities of long-term debt	172,635	173,4
Accounts payable	1,133,080	692,2
Accrued expenses and other current liabilities	266,758	445,7
Total current liabilities	2,734,609	3,274,1
Long-term debt	858,582	845,4

Total Liabilities	3,593,191	4,119,6
Shareholders' Equity		
Common stock, $.01 par value, 30,000,000 shares authorized; issued and outstanding: 7,462,695 shares at September 30, 2003 and 4,631,276 shares at December 31, 2002	74,627	46,3
Convertible preferred stock, $.01 par value; 11,750,000 shares authorized; issued and outstanding: 2,284,574 shares at September 30, 2003 (liquidation preference of $4,235,233) and 2,526,242 shares at December 31, 2002 (liquidation preference of $4,460,237)	22,846	25,2
Additional paid-in capital	16,691,598	15,588,6
Accumulated other comprehensive income (loss)	224,006	(21,7
Accumulated deficit	(10,675,878)	(10,669,5
Total Shareholders' Equity	6,337,199	4,968,9
Total Liabilities and Shareholders' Equity	$ 9,930,390	$ 9,088,5

See accompanying notes.

DERMA SCIENCES, INC.

Consolidated Statement of Operations (Unaudited)

	Three months ended September 30, 2003	2002
Net sales	$4,212,619	$3,159,598
Cost of sales	2,812,161	1,745,272
Gross Profit	1,400,458	1,414,326
Operating expenses	1,469,362	1,168,931
Interest expense, net	44,750	35,488
Other (income)/expense, net	(17,917)	22,459
Total Expenses	1,496,195	1,226,878
(Loss) income before provision for income taxes	(95,737)	187,448
Provision for income taxes	-	-
Net (Loss) Income	$ (95,737)	$ 187,448
(Loss) income per common share - basic	$ (0.01)	$ 0.04
(Loss) income per common share - diluted	$ (0.01)	$ 0.03
Shares used in computing (loss) income per common share - basic	7,338,682	4,331,276
Shares used in computing (loss) income per common share - diluted	7,338,682	7,043,889

See accompanying notes.

DERMA SCIENCES, INC.

Consolidated Statement of Operations (Unaudited)

	Nine months ended September 30, 2003	2002
Net sales	$13,065,047	$7,402,26
Cost of sales	8,451,050	3,647,35
Gross Profit	4,613,997	3,754,90
Operating expenses	4,470,354	3,226,14
Interest expense, net	215,236	166,58
Other (income)/expense, net	(65,293)	102,13
Total Expenses	4,620,297	3,494,85
(Loss) income before provision for income taxes	(6,300)	260,05
Provision for income taxes	-	-
Net (Loss) Income	$ (6,300)	$ 260,05
(Loss) income per common share - basic	$ 0.00	$ 0.0
(Loss) income per common share - diluted	$ 0.00	$ 0.0
Shares used in computing (loss) income per common share - basic	5,656,822	3,736,40
Shares used in computing (loss) income per common share - diluted	5,656,822	6,890,80

See accompanying notes.

DERMA SCIENCES, INC.

Consolidated Statement of Cash Flows (Unaudited)

	Nine months ended September 30, 2003	200
Operating Activities		
Net (loss) income	$ (6,300)	$ 260
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:		

Depreciation	115,532	58
Amortization	116,979	48
Amortization of deferred financing costs	15,000	120
Provision for doubtful accounts and trade rebates	6,871	12
Provision for inventory obsolescence	16,072	37
Loss on disposal of property and equipment	2,132	
Changes in operating assets and liabilities:		
Accounts receivable	(21,815)	(165
Inventories	(576,674)	267
Prepaid expenses and other current assets	(32,916)	(137
Other assets	10,138	(9
Accounts payable	408,370	53
Accrued expenses and other current liabilities	(212,291)	30
Net cash (used in) provided by operating activities	(158,902)	575
Investing Activities		
Purchase of inventory and product rights	(114,691)	
Purchases of property and equipment	(98,885)	(69
Acquisition of business assets, net of cash acquired	-	(1,016
Net cash used in investing activities	(213,576)	(1,086
Financing Activities		
Net change in bank line of credit	(964,930)	725
Deferred financing costs	(29,423)	(85
Long-term debt repayments	(150,734)	(8
Proceeds from issuance of stock, net of issuance costs	1,128,798	618
Net cash (used in) provided by financing activities	(16,289)	1,251
Effect of exchange rate changes on cash	7,290	
Net (decrease) increase in cash and cash equivalents	(381,477)	740
Cash and cash equivalents		
Beginning of period	1,496,357	524
End of period	$1,114,880	$ 1,265
Supplemental cash flow information		
Conversion of bonds payable and accrued interest to preferred stock	$ -	$595
Common stock and warrants issued for debt conversion/extension	$ -	$120
Bond conversion reset provision charge to paid-in capital	$ -	$45
Stock options granted in connection with acquisition	$ -	$115

See accompanying notes.

DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiaries (the Company) are full line providers of 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, Canada and other select international markets. The Company s principal manufacturing and distribution facilities are located in St. Louis, Missouri and Toronto, Canada. The Company also has a manufacturing facility in Nantong, China.

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 adjustments) considered necessary for a fair presentation have been included. Operating results for the nine month period ended September 30, 2003, are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2002, 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 subsidiaries. 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.

Foreign Currency Translation Assets and liabilities are translated using the exchange rates in effect at the balance sheet date, while income and expenses are translated using average rates. Translation adjustments are reported as a component of shareholders equity in accumulated other comprehensive income (loss).

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.

Allowance for Doubtful Accounts The Company provides an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make required payments. The allowance is determined by analyzing historical data and trends. Past due or delinquency status is based on contractual terms. Charges for doubtful accounts are recorded in operating expenses.

Inventories Inventories consist primarily of raw materials, packaging materials, work in process 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. Leasehold improvements are depreciated over the lesser of their useful lives or the remaining lease term.

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.

Goodwill On January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142 (SFAS No. 142), Goodwill and Other Intangible Assets. In accordance with SFAS No. 142, goodwill is deemed to have an indefinite life and is no longer amortized but is subject to an annual impairment test.

Stock Based Compensation The Company grants stock options to employees with an exercise price equal to the fair value of the shares on the date of grant. The Company accounts for stock option grants in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees , and, accordingly recognizes no compensation expense for the stock option grants.

Pro forma information regarding net income (loss) and earnings (loss) per share is required by SFAS No. 123, which also requires that the information be determined as if the Company has accounted for its stock options granted under the fair value method of that Statement. For purposes of pro forma disclosures, the estimated fair value of stock options is amortized to expense over the options vesting period. Therefore, future pro forma compensation expense may be greater as additional options are granted. The Company s pro forma information follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Net (loss) income - as reported	$ (95,737)	$187,448	$ (6,300)	$260,05
Pro forma compensation expense	(185,879)	(50,015)	(587,461)	(99,55
Pro forma net (loss) income	$(281,616)	$137,433	$(593,761)	$160,49
(Loss) income per common share - basic				
As reported	$(0.01)	$0.04	$0.00	$0.07
Pro forma	$(0.04)	$0.03	$(0.10)	$0.04
(Loss) income per common share - diluted				
As reported	$(0.01)	$0.03	$0.00	$0.04
Pro forma	$(0.04)	$0.02	$(0.10)	$0.02

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. Freight costs billed to and reimbursed by customers are recorded as a component of net sales.

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

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

2. Dumex Medical Inc. Acquisition

On August 26, 2002, the Company acquired substantially all the assets of Dumex Medical Inc., a leading manufacturer and distributor of wound care and related medical devices to the Canadian market. The acquisition was effected by the Company s wholly owned Canadian subsidiary, Dumex Medical Canada Inc. The results of operations of Dumex Medical Canada Inc. have been included in the Company s consolidated financial statements since the acquisition date.

3. Accounts Receivable

Accounts receivable include the following:

	September 30, 2003	December 31, 2002
Trade accounts receivable	$2,296,691	$1,943,674
Less: Allowance for doubtful accounts	(27,871)	(40,000)
Allowance for trade rebates	(115,000)	(96,000)
Net trade receivables	2,153,820	1,807,674
Other receivables	30,554	168,319
Total receivables	$2,184,374	$1,975,993

4. Inventories

Inventories include the following:

	September 30, 2003	December 31, 2002
Finished goods	$2,706,928	$2,111,546
Work in process	132,852	91,788
Packaging materials	350,426	287,903
Raw materials	579,242	384,518
Total inventory	$3,769,448	$2,875,755

5. Property and Equipment

Property and equipment include the following:

	September 30, 2003	December 31, 2002
Machinery and equipment	$1,256,854	$1,043,383
Furniture and fixtures	181,267	165,858
Leasehold improvements	47,581	40,714
Gross property and equipment	1,485,702	1,249,955
Less: Accumulated depreciation	(386,501)	(262,064)
Net property and equipment	$1,099,201	$ 987,891

6. Goodwill

Goodwill of $1,110,967 relates to the 1998 acquisition of Sunshine Products, Inc. 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 and subsequent tests which the Company completed in the fourth quarter, 2002 indicate that the goodwill carrying value is not impaired.

7. Patents and Trademarks

Patents and trademarks include the following:

	September 30, 2003	December 31, 2002
Patents and trademarks	$ 444,067	$ 444,067
Less: Accumulated amortization	(316,283)	(303,689)
Net patents and trademarks	$ 127,784	$ 140,378

8. Other Assets

Other assets include the following:

	September 30, 2003	December 31, 2002
Deferred financing costs, net	$ 79,422	$162,314
Deposits	67,827	57,863
Intangible assets-product rights, net	38,313	-
Other	1,012	-

Total other assets	$186,574	$220,177
	=======	=======

9. Short Term Borrowings

Short term borrowings include the following:

	September 30, 2003	December 31, 2002
Canadian line of credit	$1,162,136	$ 962,627
U.S. line of credit	-	1,000,000
	---------	---------
Total short term borrowings	$1,162,136	$1,962,627
	=========	=========

Canadian Line of Credit

Effective August 26, 2002, in connection with the acquisition of Dumex Medical Inc., the Company entered into a sixteen month revolving credit facility agreement (the Dumex Agreement) for a maximum principal amount of $1,630,000 with a Canadian bank. The Company s wholly owned Canadian subsidiary, Dumex Medical Canada Inc., may request advances under the Dumex Agreement up to the value of seventy-five percent (75%) of its eligible receivables (as defined) and fifty percent (50%) of its eligible inventory (as defined) up to a maximum of $704,000. Interest on outstanding advances is payable monthly at the Canadian prime rate (as defined) plus 1.0%, or 5.5% for advances outstanding at September 30, 2003. Outstanding advances are secured by all tangible and intangible assets of Dumex Medical Canada Inc. In addition, the Canadian bank has a second lien security interest in the assets of the Company s U.S. operations. The Company has also guaranteed payment of amounts due under the Dumex Agreement.

Over the term of the Dumex Agreement, the Company has agreed to comply with a number of financial covenants governing minimum working capital, current ratios, tangible net worth, interest coverage, total indebtedness to tangible net worth and total indebtedness to adjusted pre-tax earnings. These covenants are measured at the end of each month. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the Dumex Agreement. In the event of a margin deficiency (as defined) or covenant violation, the Company is required to advance up to an additional $370,000 of working capital to Dumex Medical Canada Inc. in order to correct the deficiency. This additional working capital may be repaid to the Company 45 days after the margin deficiency or covenant violation has been cured upon the condition that such repayment not result in a margin deficiency, covenant violation or any other event of default.

U.S. Line of Credit

In March, 2003 the Company entered into a new one year line of credit agreement (subject to annual renewal) with a U.S. lender (the Agreement) for a maximum principal amount of $2,000,000. No funds have been drawn against the line to date. Estimated maximum potential advances under the Agreement at September 30, 2003 were $1,680,000, less any outstanding standby letters of credit. Advances will be utilized to fund strategic initiatives and for general working capital purposes. The Company terminated its prior U.S. line of credit on February 28, 2003 by repaying the $1,000,000 outstanding indebtedness and paying a $50,000 early termination fee. In addition, the Company charged $66,342 to interest expense for deferred financing costs associated with the prior U.S. line of credit.

The Company may request advances under the Agreement up to the value of 80% of eligible U.S. receivables (as defined) and 50% of eligible U.S. inventory (as defined), excluding work-in-process inventory. Interest on outstanding advances is payable monthly in arrears at the one month LIBOR rate (as published in The Wall Street Journal), plus 3.0%, or 4.1% on September 30, 2003. In addition, the Company will pay an annual line fee of $20,000. This line fee and any one-time lender or legal costs associated with securing the line of credit will be deferred and amortized to interest expense over the line term of one year.

Outstanding advances are secured by all tangible and intangible assets of the Company s U.S. operations. Over the term of the Agreement, the Company has agreed to maintain its fixed charge ratio (as defined) at not less than 1.25:1.0 as measured quarterly on a twelve month trailing basis. Additional covenants governing permitted indebtedness, changes in entity status, purchase of securities and protection of collateral are included in the Agreement.

As security for indebtedness of the Company s subsidiary, Dumex Medical Canada Inc., the Company has accorded a Canadian bank its guarantee of payment together with a second lien security interest in the Company s assets located in the U.S. In connection with the Agreement and in return for a standby letter of credit in the amount of $200,000 against the new line of credit, the Canadian bank has agreed not to exercise its rights under its second lien security interest and guarantee against the Company s U.S. assets without the U.S. lender s approval. The standby letter of credit serves to reduce the Company s potential borrowing capacity under the Agreement by $200,000.

10. 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 series F warrants.

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 was amortized over the eighteen-month term of the reset concession. A charge of $120,200 was recorded to account for the conversion terms associated with the accrued interest.

11. Long-Term Debt

Long-term debt includes the following:

	September 30, 2003	December 31, 2002
Canadian term loan	$1,027,483	$ 987,576
Capital lease obligations	3,734	31,372
Total debt	1,031,217	1,018,948

Less: current maturities	172,635	173,493
Long-term debt	$ 858,582	$ 845,455

Effective August 26, 2002, in connection with the acquisition of substantially all the assets of Dumex Medical Inc., the Company entered into a five-year term loan agreement with a Canadian Bank. The loan is repayable in monthly payments consisting of principal and interest commencing October 1, 2002. Interest on the outstanding principal balance is payable monthly at the bank s prime rate (as defined) plus 1.25%, or 5.75% at September 30, 2003. The term loan is secured by all tangible and intangible assets of Dumex Medical Canada Inc. and is subject to the same financial covenants applicable to the operating line of credit (Note 9).

12. Shareholders Equity

Preferred Stock

There are 150,003 shares of series A convertible preferred stock outstanding. 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 444,170 shares of series B convertible preferred stock outstanding. 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. 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. The series D preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $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.

Stock Purchase Warrants

At September 30, 2003, the Company had warrants outstanding to purchase the Company s common stock as outlined below:

Series	Number of Warrants	Exercise Price	Expiration Date
E	1,870,007	$0.85	July 18, 2005
F	1,309,441	$0.57	January 6, 2007

The Company s 666,673 series B warrants with an exercise price of $6.75 per share expired on June 15, 2002. In connection with the conversion of the Company series C and D convertible bonds on January 7, 2002 as described in Note 10, 1,309,441 series F warrants were issued.

Other Equity Transactions

In June 2003, the Company closed a private offering of 4,000,000 shares of its common stock at a price of $0.50 per share initiated in January 2002. Offering proceeds are being used to fund strategic initiatives and for general working capital purposes. From January 2002 through September 30, 2003, 4,000,000 shares of common stock were issued pursuant to the offering and offering proceeds of $1,882,118, net of $117,882 in offering expenses, have been received.

In July 2003, a total of 241,668 shares of Series B, C and D preferred stock were converted into 241,668 shares of common stock. In addition, in July 2003 there was a cashless exercise of 330,002 Series E warrants into 189,751 shares of common stock.

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.

13. Comprehensive Income

The Company s total comprehensive income was as follows:

	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2002
Net (loss) income - as reported	$ (6,300)	$260,050
Other comprehensive income (loss):		
Foreign currency translation adjustment	245,742	(32,349)
Comprehensive income	$239,442	$227,701

14. Promissory Note

On January 9, 2003 the Company loaned $50,000 to a supplier pursuant to a secured promissory note. The stated maturity date of the note is December 31, 2003. The note may be prepaid without penalty, bears interest at the annual rate of 5% and is secured by the tangible and intangible property of the supplier. The funds advanced are to be used by the supplier for general working capital purposes in the ordinary course of business. The promissory note, together with accrued interest of $1,838, is included in prepaid expenses and other current assets.

15. Income taxes

No provision for income taxes has been provided for in the three or the nine months ended September 30, 2003 or 2002 given the Company s available net operating loss carryforwards.

At December 31, 2002, the Company had net operating loss carryforwards of approximately $6,855,000 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 approximately $6,855,000 that expire in years 2004 through 2010. As of December 31, 2002, the Company has foreign net operating loss carryforwards of approximately $182,000 which begin to expire in 2009.

16. 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 basic and advanced dressings, ointments and sprays designed to treat 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. As of August 26, 2002, Dumex Medical Canada Inc. s operating results have been included in the wound care segment.

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 advanced wound care and wound closure-fastener products is primarily outsourced. Basic wound care and 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 three months and nine months ended September 30, 2003 and 2002 are as follows:

	Three Months Ended September 30, 2003				
	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	T Co
Net sales	$3,059,851	$651,924	$500,844	-	$ 4,
Gross profit	941,038	326,826	132,594	-	1,
Total expenses	-	-	-	$(1,496,195)	(1,
Net loss					$
Net long-lived assets	$1,017,710	-	$1,327,829	$30,726	$ 2,

Three Months Ended September 30, 2002

	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	T Co
Net sales	$1,586,916	$908,480	$664,202	-	$3,
Gross profit	746,361	444,527	223,438	-	1,
Total expenses	-	-	-	$(1,226,878)	(1,
Net income					$
Net long-lived assets	$1,000,392	$132	$1,245,861	$46,320	$2,

Nine Months Ended September 30, 2003

	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	T Co
Net sales	$9,266,229	$2,220,288	$1,578,530	-	$13,
Gross profit	3,093,372	1,075,701	444,924	-	4,
Total expenses	-	-	-	$(4,620,297)	(4,
Net loss					$
Net long-lived assets	$1,017,710	-	$1,327,829	$30,726	$ 2,

Nine Months Ended September 30, 2002

	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	T Co
Net sales	$3,123,812	$2,340,372	$1,938,078	-	$7,
Gross profit	1,934,220	1,161,663	659,026	-	3,
Total expenses	-	-	-	$(3,494,859)	(3,
Net income					$
Net long-lived assets	$1,000,392	$132	$1,245,861	$46,320	$2,

Long-lived assets consist of property and equipment, patents and trademarks and goodwill. Wound care long-lived assets consist principally of Dumex Medical Canada Inc. property and equipment in the three and nine months ended September 30, 2003 and 2002. Wound closure-fastener products are for the most part outsourced, and accordingly, are not appreciably supported internally by long-lived assets. Skin care long-lived assets consist of goodwill associated with the acquisition of Sunshine Products, Inc. and associated property and equipment.

International sales (excluding Canada) were $582,087 and $482,619 in 2003 and 2002, respectively. Wound closure-fasteners sales represent the majority of international sales.

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17. Product Rights Purchase

On August 5, 2003, the Company purchased for cash all right, title and interest to Genesis Ointment for $114,691 from Gericare Providers, Inc. Genesis Ointment is a vitamin enriched moisture barrier and skin protectant that both competes with and complements the Company s existing wound care product line.

The asset purchase agreement consisted of inventory and intangible assets related to the product and further provides that Gericare Providers, Inc. not enter into any business that competes in any way with Genesis Ointment or Derma Sciences Dermagran line of wound care products for a period of five years from the date of the agreement.

The purchase price of $114,691, including transaction related costs, has been recorded as inventory at estimated fair market value less selling costs of $74,124 and intangible assets of $40,567. The intangible assets are being amortized to operating expense over three years.

18. New Lease Agreement

On August 22, 2003, as part of the rationalization of its U.S. distribution network the Company entered into a five year lease for a 42,400 square foot facility in Fenton, Missouri. The facility will serve as the primary U.S. distribution center for the Company s products. Lease payments will commence on or about December 15, 2003. First year lease payments are $143,417, increasing to $270,710 in year five. Minimum lease payments over the term of the lease are $1,035,000.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Quarter Ended September 30, 2003 Compared to Quarter Ended September 30, 2002.

Results of Operations

The following table highlights the third quarter of 2003 and 2002 operating results:

	Three Months Ended September 30,		
	2003	2002	Variance
Net sales	$4,212,619	$3,159,598	$1,053,021

Gross profit	1,400,458	1,414,326	(13,868)	(
Operating expenses	1,469,362	1,168,931	300,431	
Interest expense, net	44,750	35,488	9,262	
Other (income) expense, net	(17,917)	22,459	(40,376)	
Total expenses	1,496,195	1,226,878	269,317	
(Loss) income before income taxes	(95,737)	187,448	(283,185)	
Provision for income taxes	-	-	-	
Net (loss) income	$ (95,737)	$ 187,448	$ (283,185)	

Net sales increased $1,053,021, or 33%, to $4,212,619 in the third quarter 2003 from $3,159,598 in the third quarter 2002. The increase is due to inclusion of the Dumex Business for the entire three month period ended September 2003 versus the shorter period in the same quarter of the prior year from the August 26, 2002 acquisition date to the end of September 2002. Dumex sales for the quarter ended September 2003 were slightly below expectation due to a significant shortfall in private label sales. Institutional sales were in line with expectations. Dumex sales in the U.S. were off slightly in the quarter due to temporary product supply issues associated with the integration of the U.S. distribution network. Derma sales were 18% lower versus the third quarter 2002. This decrease is principally attributable to competitive pressures in the wound-closure fasteners and skin care businesses. Higher sales of a wound-closure product in 2002 due to an inventory adjustment by a customer, coupled with the return to a normal ordering pattern in 2003, also contributed. Sales of Derma wound care products increased slightly in the third quarter 2003 versus 2002.

Gross profit decreased $13,868, or 1%, to $1,400,458 in the third quarter 2003 from $1,414,326 in the third quarter 2002. Despite a significant sales increase, gross profit dollars declined compared to the third quarter 2002 due to an adverse sales mix towards a higher concentration of lower margin Dumex sales as a percentage of total sales, coupled with gross profit erosion due to pricing and product cost pressures. The gross profit percentages for the third quarter 2003 and 2002 were 33% and 45%, respectively. Dumex margins deteriorated in 2003 as a result of lower sales prices due to competitive pressure, higher raw material (cotton) costs for traditional wound care products and unfavorable fixed overhead absorption attributable to outsourcing of a portion of Dumex s production to China. Derma s margins in the third quarter of 2003 compared to 2002 were lower in the wound care and wound-closure fasteners lines due to pricing pressures. Skin care margins were significantly lower compared with the prior year because of lower sales volumes and its adverse impact on operational efficiency and fixed overhead absorption.

Operating expenses increased $300,431, or 26%, to $1,469,362 in the third quarter 2003 from $1,168,931 in the third quarter 2002. The increase is primarily attributable to the inclusion of Dumex expenses for the entire third quarter 2003 versus five weeks of the third quarter 2002. Dumex operating expenses met expectations on a local currency basis but were adversely impacted by the strengthening Canadian dollar. Derma expenses in the third quarter 2003 increased 6% over the third quarter 2002. Derma selling expenses increased as a result of the reorganization, expansion and upgrade of the sales force at the beginning of 2003 which was partially offset by lower marketing expenses and integration savings in the regulatory area.

Interest expense, net increased $9,262 to $44,750 in the third quarter 2003 from $35,488 in the third quarter of 2002. Interest expense, net in the third quarter 2003 is comprised of Dumex interest expense of $37,648 related to its line of credit and long-term indebtedness and $10,945 related to financing costs associated with the new U.S. line of credit, partially offset by interest income of $3,879. Prior year interest expense, net of $35,488 primarily consisted of the Dumex interest expense of $12,894 related to its line of credit and long-term indebtedness for a five week period and $19,816 for interest and amortization of deferred financing costs related to its U.S. line of credit, partially offset by interest income.

Other income increased $40,376 to $17,917 income in the third quarter 2003 from $22,459 expense in the third quarter 2002. The increase is primarily attributable to the sale and/or conversion of previously reserved, discontinued and slow moving inventory of $28,000, together with the non-recurrence of $22,300 in acquisition related costs in 2002, partially offset by storage and demurrage costs of $8,500.

No provision for income taxes has been provided for in the third quarter of 2003 and 2002 due to the availability of net operating loss carry forwards.

The Company generated a net loss of $95,737, or $(0.01) per share (basic and diluted), in the third quarter of 2003 compared to net income of $187,448, or $0.04 per share (basic) and $0.03 per share (diluted), in the third quarter 2002.

Nine Months Ended September 30, 2003 Compared to Nine Months Ended September 30, 2002.

Results of Operations

The following table highlights the first nine months of 2003 and 2002 operating results:

	Nine Months Ended September 30,		
	2003	2002	Variance
Net sales	$13,065,047	$7,402,262	$5,662,785
Gross profit	4,613,997	3,754,909	859,088
Operating expenses	4,470,354	3,226,144	1,244,210
Interest expense, net	215,236	166,585	48,651
Other (income) expense, net	(65,293)	102,130	(167,423)
Total expenses	4,620,297	3,494,859	1,125,438
(Loss) income before income taxes	(6,300)	260,050	(266,350)
Provision for income taxes	-	-	-
Net (loss) income	$ (6,300)	$ 260,050	$ (266,350)

Net sales increased $5,662,785, or 77%, to $13,065,047 in the nine months ended September 30, 2003 from $7,402,262 in the nine months ended September 2002. The increase is attributable to the inclusion of Dumex sales since the acquisition date of August 26, 2003. Dumex institutional sales in Canada are growing in line with expectations on a local currency basis and have benefited from a stronger Canadian dollar. Dumex was successful in renewing and expanding its business with two large buying groups in 2003. Dumex s private label business is down significantly versus historical levels due to the loss of several customers. Dumex sales in the United States are growing modestly in response to a focused sales effort. Derma sales are down 9% versus the prior year. This softer than expected performance is due to competitive pressure across the entire Derma product line coupled with the Company s decision to focus a significant portion of its sales and marketing resources on expanding the U.S. Dumex business.

Gross profit increased $859,088, or 23% in the first nine months of 2003 to $4,613,997 from $3,754,909 in the first nine months of 2002 due to inclusion of the incremental Dumex sales. Overall, gross margin percentages have decreased from 51% to 35%. This significant decrease is attributable to the increasingly higher percentage of lower margin Dumex sales as a percentage of total sales coupled with pricing and product cost pressures in certain segments of the business. Dumex margins have deteriorated in 2003 due principally to aggressive competitive pricing and higher raw material (cotton) costs for traditional wound care products. Lower fixed overhead absorption associated with outsourcing products to China versus in-house manufacture also contributed. Derma s margins are lower in the wound care and wound-closure fastener line due to pricing pressures. Skin care line margins are down significantly due to the adverse impact of lower sales volumes on operational efficiency and fixed overhead absorption.

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Operating expenses increased $1,244,210, or 39%, in the first nine months of 2003 to $4,470,354 from $3,226,144 in the first nine months of 2002 due principally to the inclusion of incremental Dumex expenses. On a local currency basis, Dumex operating expenses are slightly higher than expected due to higher insurance, accounting, health benefit and travel costs. A planned increase in sales resources also contributed. In addition, Dumex operating expenses were adversely impacted by the strengthening Canadian dollar. Derma operating expenses increased 2% over the prior year. Marketing expense decreased significantly due to a lower level of promotion activities as the focus was shifted to the sales force and building the Dumex business. Sales expense has increased 10% consistent with the plan initiated in January 2003 to reorganize and upgrade the sales team. General administrative expenses are up 5% over the prior period. The increase is due to higher occupancy, public relations, accounting, insurance and travel costs coupled with increased costs associated with upgrading the finance and information technology resources in response to the Dumex acquisition in August 2002. These increases have been partially offset by integration savings in the regulatory area and lower bad debt, legal, consulting and recruiting costs.

Interest expense, net increased $48,651 to $215,236 in the first nine months of 2003 from $166,585 in the first nine months of 2002. Interest expense, net in the first nine months of 2003 is principally comprised of Dumex interest expense of $112,898 related to its line of credit and long-term indebtedness, the February 28, 2003 termination of the Company s previous U.S. line of credit facility resulting in the write-off of $66,342 of deferred financing costs, $19,662 interest incurred on the U.S. line of credit prior to termination, non-cash interest charges of $15,000 and $21,426 related to financing costs associated with the new U.S. line of credit, partially offset by interest income of $18,003. Prior year interest expense, net of $166,585 consisted of non-cash interest charges of $142,700 associated with the conversion of the Company s Series C and D bonds and accrued interest outstanding in January 2002 and five weeks worth of Dumex and U.S. line of credit interest from the acquisition date.

Other expense, net increased $167,423 to $65,293 income in the first nine months of 2003 from $102,130 expense in 2002. Other income in 2003 is principally comprised of $88,000 resulting from the favorable settlement of an Internal Revenue Service claim and the sale and/or conversion of previously reserved, discontinued and slow-moving inventory of $115,100, partially offset by the payment of a $50,000 fee associated with the early termination of the Company s previous U.S. line of credit, exchange losses of $23,100, storage and demurrage for containers of $33,500 and one-time ISO consulting and audit expenses of $18,100. Other expense, net in the first nine months of 2002 relates to the write-off of deferred costs related to a cancelled acquisition initiative of $94,900.

No provision for income taxes has been provided in the first nine months of 2003 and 2002 given available net operating loss carry forwards.

The Company generated a net loss of $6,300, or $0.00 per share (basic and diluted), in the first nine months of 2003 compared to net income of $260,050, or $0.07 per share (basic) and $0.04 per share (diluted), in 2002.

Liquidity and Capital Resources

At September 30, 2003 and December 31, 2002 the Company had cash and cash equivalents of $1,114,880 and $1,496,357, respectively. The decrease in cash and cash equivalents is attributable to cash used in operating activities of $158,902, cash used to purchase product rights of $114,691, cash used for the purchase of equipment of $98,885 and cash used in financing activities of $16,289. Cash used in operating activities was driven principally by increases in inventory in support of existing and planned sales growth and the pay down of accrued liabilities, partially offset by an increase in accounts payable.

The purchase of equipment reflects an orderly plan to upgrade the Company s manufacturing and information technology equipment. Cash used in financing activities relates to net proceeds of $1,128,798 from the sale of common stock and an increase in the borrowings on Dumex s line of credit of $35,070, offset by repayment of Derma s previous U.S. line of credit of $1,000,000 in February 2003 and scheduled long-term debt repayments. Working capital increased $1,316,254 to $4,671,255 at September 30, 2003 from $3,355,001 at December 31, 2002.

In connection with the Dumex acquisition, the Company entered into a sixteen month $1,630,000 revolving credit facility expiring December 31, 2003 to fund day-to-day operations. Maximum potential advances under the agreement at September 30, 2003 were $1,365,000. Advances outstanding against the credit facility were $1,162,136 at September 30, 2003, leaving an additional $202,864 available for borrowing.

In March 2003 the Company entered into a new one year line of credit agreement (subject to annual renewal) with a U.S. lender (the Agreement) for a maximum principal amount of $2,000,000. No funds have been drawn against the line to date. Estimated maximum potential advances under the Agreement at September 30, 2003 were $1,680,000, less any outstanding standby letters of credit. Advances will be utilized to fund strategic initiatives and for general working capital purposes.

As security for indebtedness of the Company s subsidiary, Dumex Medical Canada Inc., the Company has accorded a Canadian bank its guarantee of payment together with a second lien security interest in the Company s assets located in the U.S. In connection with the Agreement and in return for a standby letter of credit in the amount of $200,000 against the new line of credit, the Canadian bank has agreed not to exercise its rights under its second lien security interest and guarantee against the Company s U.S. assets without the U.S. lender s approval. The standby letter of credit serves to reduce the Company s potential borrowing capacity under the Agreement by $200,000.

Prospectively, the Company seeks to increase sales and profits by, among other initiatives, focusing on growing Dumex product line sales in the U.S., driving organic growth of its core product lines both in the U.S. and Canada and integrating the Dumex business more fully into Derma. Steps are planned to improve overall supply chain efficiency and cost effectiveness. Plans are also in place to invest in upgrading sales and marketing resources. Operating expenses will continue to be properly balanced with revenues.

Among the potential sources of capital the Company expects to utilize to finance its growth plans are anticipated improved profitability and prudent utilization of available lines of credit.

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

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.

Critical Accounting Policies

The preparation of the consolidated 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.

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Inventory

The Company writes down the value of inventory by the estimate of the difference between the cost of the inventory and its net realizable value. The estimate takes into account projected sales of the inventory on hand and the age of the inventory in stock. If actual future demand or market conditions are less favorable than those projected by management, additional inventory write-downs may be required. The provision for the write-down of inventory is recorded in cost of sales.

Goodwill Impairment

At September 30, 2003, the Company s skin care segment had $1,110,967 of goodwill. The Company tests goodwill for impairment in the forth quarter of each year or when impairment indicators are present. The process of evaluating the potential impairment of goodwill is highly subjective and requires significant judgments at many points during the analysis. In estimating the fair value of the skin care segment with recognized goodwill, the Company makes estimates and judgments about the future cash flows of this segment. The Company s cash flow forecasts are based on assumptions that are consistent with the plans and estimates used to manage the underlying business. In addition, the Company makes certain judgments about allocating shared assets to the balance sheet for this segment. Changes in these estimates would cause the skin care segment to be valued differently in the future.

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Item 3. CONTROLS AND PROCEDURES

The Company s management, including the Chief Executive Officer and Chief Financial Officer, have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14 as of the end of the period covered by this report. Based on the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this quarterly report has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation.

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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 March 31, 2003, are incorporated herein by reference.

Exhibit	Description
31.1	Certification of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer pursuant to U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Principal Financial Officer pursuant to U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K. Forms 8-K were filed on August 19, 2003 relative to the Registrant s financial results for the three months and six months ended June 30, 2003 and on August 29, 2003 relative to the Registrant s purchase of the rights to a skin care product.

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.

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

Dated: November 13, 2003