DERMA SCIENCES, INC.
Form 10QSB
May 16, 2005

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	March 31, 2005
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: March 31, 2005

Class: Common Stock, par value $.01 per share
Shares Outstanding: 12,284,007

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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. CONDENSED FINANCIAL STATEMENTS

DERMA SCIENCES, INC.

Consolidated Balance Sheets

	March 31, 2005 (Unaudited)	December 3 2004
ASSETS		
Current Assets		
Cash and cash equivalents	$ 76,578	$ 46,50
Accounts receivable, net	2,675,154	2,601,09
Inventories	4,984,889	4,932,23
Prepaid expenses and other current assets	243,059	181,20
Total current assets	7,979,680	7,761,03
Equipment and improvements, net	3,545,261	3,662,55
Goodwill	1,110,967	1,110,96
Other intangible assets, net	362,879	383,91
Other assets, net	333,862	132,46
Total Assets	$ 13,332,649	$ 13,050,93
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit borrowings	$ 3,091,204	$ 2,820,28
Current maturities of long-term debt	256,829	247,30
Accounts payable	1,390,004	1,249,40
Accrued expenses and other current liabilities	408,132	594,43
Total current liabilities	5,146,169	4,911,43
Long-term debt	593,315	867,53
Other long-term liabilities	66,858	53,20
Total Liabilities	5,806,342	5,832,18

Commitments		
Shareholders' Equity		
Convertible preferred stock, $.01 par value; 11,750,000 shares authorized; issued and outstanding: 2,280,407 shares at March 31, 2005 and December 31, 2004 (liquidation preference of $4,210,231 at March 31, 2005 and December 31, 2004)	22,804	22,80
Common stock, $.01 par value, 30,000,000 shares authorized; issued and outstanding: 12,284,007 shares at March 31, 2005 and 11,079,007 shares at December 31, 2004	122,840	110,79
Additional paid-in capital	19,906,973	19,371,22
Accumulated other comprehensive income - cumulative translation adjustments	672,772	699,96
Accumulated deficit	(13,199,082)	(12,986,03
Total Shareholders' Equity	7,526,307	7,218,74
Total Liabilities and Shareholders' Equity	$ 13,332,649	$ 13,050,93

See accompanying consolidated notes.

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DERMA SCIENCES, INC.

Consolidated Statements of Operations (Unaudited)

	Three months ended March 31, 2005	2004
Net sales	$4,893,447	$5,029,42
Cost of sales	3,506,061	3,596,51
Gross Profit	1,387,386	1,432,90
Operating expenses	1,681,055	2,245,05
Interest expense	84,584	46,66
Other (income) expense, net	(165,201)	117,65
Total Expenses	1,600,438	2,409,37
Loss before provision for income taxes	(213,052)	(976,46
Provision for income taxes	-	-
Net Loss	$ (213,052)	$ (976,46
Loss per common share - basic and diluted	($0.02)	($0.1
Shares used in computing loss per common share - basic and diluted	12,011,674	8,809,15

See accompanying consolidated notes.

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DERMA SCIENCES, INC.

Consolidated Statements of Cash Flows (Unaudited)

	Three months ended March 31, 2005	2004
Operating Activities		
Net loss	$(213,052)	$ (976,46
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation of equipment and improvements	121,885	73,91
Amortization of intangible assets	21,032	22,76
Amortization of deferred financing costs	16,869	21,44
Provision for bad debts and rebates	40,221	53,49
Provision for inventory obsolescence	27,519	77,40
Loss on disposal of equipment and improvements	-	94,42
Deferred rent expense	13,651	-
Changes in operating assets and liabilities:		
Restricted cash	-	(1,001,12
Accounts receivable	(141,759)	124,10
Inventories	(87,500)	(822,68
Prepaid expenses and other current assets	(52,817)	(30,87
Other assets	(120,470)	9,43
Accounts payable	145,365	648,36
Accrued expenses and other current liabilities	(193,999)	160,44
Long-term liabilities	-	225,84
Net cash used in operating activities	(423,055)	(1,319,51
Investing Activities		
Purchase of equipment and improvements	(25,480)	(135,88
Cash paid for wound care business	-	(376,51
Net cash used in investing activities	(25,480)	(512,39
Financing Activities		
Net change in bank line of credit	277,161	(292,49
Deferred financing costs	(108,804)	(60,61
Long-term debt repayments	(255,229)	(44,08
Proceeds from issuance of stock, net of issuance costs	565,297	1,979,76
Net cash provided by financing activities	478,425	1,582,56
Effect of exchange rate changes on cash	180	(5,57
Net increase (decrease) in cash and cash equivalents	30,070	(254,91
Cash and cash equivalents		
Beginning of period	46,508	439,83
End of period	$ 76,578	$ 184,91

Supplemental disclosure of non cash investing and financing activities

Note payable for acquisition of Kimberly-Clark wound care assets	-	$ 1,566,00
Equipment obtained with capital lease	-	$ 159,09

See accompanying consolidated notes.

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-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 of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 2005, are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2004, included in Form 10-KSB previously 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 in consolidation.

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.

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.

Concentration of Credit Risk Financial instruments that subject the Company to a concentration of credit risk consist principally of cash and cash equivalents and accounts receivable. The Company maintains cash and cash equivalents with various financial institutions in amounts which at times may exceed federally insured limits. Accounts are guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to $100,000. The Company has not experienced any losses in such accounts. The Company s accounts receivable balance is net of an allowance for doubtful accounts. The Company does not require collateral or other security to support credit sales, but provides an allowance for doubtful accounts based on historical experience and specifically identified risks. Accounts receivable are charged off against the allowance for doubtful accounts when management determines that recovery is unlikely and the Company ceases collection efforts.

DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

Foreign Operations Risk The Company s future operations and earnings will depend to a large extent on the results of its operations in Canada and its ability to continue to maintain a continuous supply of basic wound care products from its own operation and/or its suppliers in China. While the Company does not envision any adverse change to the manner in which operations in Canada and China are presently being conducted, there can be no assurance that the Company will be able to successfully conduct such operations in the future, and a failure to do so may have a material adverse effect on the Company s consolidated financial position, results of operations and cash flows. Also, the success of the Company s operations are subject to numerous contingencies, some of which are beyond management s control. These contingencies include general and regional economic conditions, prices for the Company s products, prices for materials and products purchased from suppliers, competition and changes in regulations.

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.

Equipment and Improvements Equipment and improvements 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 amortized over the lesser of their useful lives or the remaining lease term.

Fair Value of Financial Instruments The carrying value of cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable and accrued expenses reported in the consolidated balance sheets equal or approximate fair value due to their short maturities. The fair value of the Company s long-term debt approximates book value as such notes are at market rates currently available to the Company.

Other Intangible Assets Patents and trademarks and other intangible assets with definite lives are stated on the basis of cost. Patent and trademarks are amortized over 12 to 17 years on a straight-line basis. Other intangible assets consisting of product rights, formulations and specifications, regulatory approvals, customer lists and a non-compete agreement are amortized over 5 years on a straight-line basis.

Long Lived Assets In accordance with Statement of Financial Accounting Standards No. 144 (SFAS 144), Accounting for Impairment or Disposal of Long Lived Assets the Company reviews its long-lived assets with definitive lives whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If the carrying amount of the asset or group of assets exceeds its net realizable value, the asset will be written down to its fair value.

Goodwill Goodwill of $1,110,967 represents the excess of the purchase price over the fair value of identifiable net assets acquired in the 1998 acquisition of Sunshine Products. This business combination was accounted for as a purchase. The Company adopted Statement of Financial Accounting Standards No. 142 Goodwill and Other Intangible Assets (SFAS No. 142) on January 1, 2002. Goodwill and certain other intangible assets having indefinite lives are no longer amortized to earnings, but instead are subject to periodic (annual) testing for impairment. The Company tests goodwill for impairment using the two-step process prescribed by SFAS No. 142. The first step tests for potential impairment, while the second step measures the amount of impairment, if any. The Company uses a discounted cash flow analysis to complete the first step in this process. The Company conducted the required annual impairment review in the fourth quarter of 2004 and determined that the goodwill carrying value is not impaired.

Stock Based Compensation SFAS No. 123, Accounting for Stock-Based Compensation , as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure , provides companies with a choice to follow the provisions of SFAS No. 123 in the determination of stock-based employee compensation expense based on the fair values of the options or to continue to use the intrinsic value method pursuant to the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and related interpretations in accounting for stock-compensation plans. The Company has elected to follow the provisions of APB 25. Under APB 25, if the exercise price of the Company s stock options granted to employees equals or exceeds the market price of the underlying common stock on the date of grant, generally no compensation expense is recognized.

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Notes To Consolidated Financial Statements (Unaudited)

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 to employees under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for 2005 and 2004: risk-free interest rate of 4.25% and 4.0%, respectively; dividend yield of 0%; a volatility factor of the expected market price of the Company s Common Stock of 1.376 and 1.463, respectively; and an expected option life of 5 years.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. The Company s stock options have characteristics significantly different from those of traded options. Further, changes in the subjective input assumptions related to the options can materially affect the fair value estimate. Therefore, in management s opinion the existing models do not necessarily provide a reliable single measure of the fair value of the Company s stock options.

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:

	Quarter Ended March 31, 2005	Quarter Ended March 31, 2004
Net loss - as reported	$(213,052)	$ (976,466)
Pro forma compensation expense	(170,226)	(181,906)
Pro forma net loss	$(383,278)	$(1,158,372)
Loss per common share - basic and diluted		
As reported	$(0.02)	$(0.11)
Pro forma	$(0.03)	$(0.13)

As a result of amendments to SFAS No. 123, the Company will be required to expense the fair value of employee stock options beginning with its fiscal quarter ending March 31, 2006.

Income Taxes Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets, including tax loss and credit carryforwards, and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred income tax expense represents the change during the period in the deferred tax assets and deferred tax liabilities. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on their characteristics. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Revenue Recognition The Company operates in three segments: wound care, wound closure and fasteners and skin care. Sales are recorded when product is shipped, title passes to customers and collectability is reasonably assured. Gross sales are adjusted for cash discounts, returns and allowances, Medicaid rebates and trade rebates 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.

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Notes To Consolidated Financial Statements (Unaudited)

Net Income (Loss) per Share Net income (loss) per common share basic is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Net income (loss) per common share diluted reflects the potential dilution of earnings by including potentially issuable shares of common stock (potentially dilutive securities), including those attributable to stock options, warrants and convertible preferred stock in the weighted average number of common shares outstanding for a period, if dilutive. Potential common stock has not been included in the computation of diluted loss per share as the effect would be anti-dilutive.

Total dilutive shares that would have been used to compute income per common share on a fully diluted basis for the three months ended March 31, 2005 and 2004 (assuming profitability) are outlined below:

	March 31, 2005	March 31, 2004
Common shares	12,011,674	8,809,151
Dilutive shares:		
Preferred stock	2,280,407	2,284,162
Warrants	4,578	1,389,496
Stock options	489,559	1,742,943
Sub-total dilutive shares	2,774,544	5,416,601
Total dilutive shares	14,786,218	14,225,752

Reclassifications Certain reclassifications have been made to prior year reported amounts to conform with the 2005 presentation.

2. Acquisition of Kimberly-Clark Corporation s Wound Care Assets

On January 9, 2004, the Company purchased certain wound care assets from Kimberly-Clark Corporation. The primary purpose of the acquisition was to obtain equipment to expand the Company s in-house manufacturing capabilities and to broaden its product line. The assets acquired consist of manufacturing equipment, product rights and other intangibles. The purchase price for the assets was $1,942,797 and was paid as follows: (1) $300,100 at closing; (2) $1,566,000 via a seller financed promissory note due December 31, 2004, without interest; and (3) $76,697 incurred for transaction costs. The acquisition was accounted for as a purchase of a business, effectively January 1, 2004, and the purchase price was allocated to equipment in the amount of $1,600,000 and intangible assets (see Note 6) in the amount of $342,797 based upon the estimated fair values of the assets acquired. The promissory note was paid in full on December 30, 2004.

Kimberly-Clark manufactured wound care products, for the account of the Company, at its facility through April 9, 2004 to meet current customer demand and to build sufficient inventory to cover the period during which production at the Kimberly-Clark facility was discontinued and the equipment was transferred to the Company s facility in Toronto, Canada. Upon cessation of manufacturing at Kimberly-Clark s facility, the Company purchased, in accordance with a pre-determined formula, inventory consisting of raw and packaging materials and up to four months supply of finished goods. The purchase price of this inventory was approximately $550,000. Cash on hand and borrowings against available credit lines were used to pay for this inventory.

The Company completed the transfer, installation and validation of the equipment and commenced manufacturing in Toronto, Canada in August 2004. Through December 31, 2004, the Company expended approximately $680,000 on equipment and manufacturing facility upgrades at its Toronto, Canada location.

DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

3. Accounts Receivable

Accounts receivable include the following:

	March 31, 2005	December 31, 2004
Trade accounts receivable	$2,868,760	$2,774,293
Less: Allowance for doubtful accounts	(67,149)	(57,090)
Allowance for trade rebates	(211,721)	(164,000)
Net trade receivables	2,589,890	2,553,203
Other receivables	85,264	47,889
Total receivables	$2,675,154	$2,601,092

4. Inventories

Inventories include the following:

	March 31, 2005	December 31, 2004
Finished goods	$3,421,385	$3,531,095
Work in process	39,815	71,423
Packaging materials	624,919	461,052
Raw materials	898,770	868,662
Total inventory	$4,984,889	$4,932,232

5. Equipment and Improvements, net

Equipment and improvements include the following:

	March 31, 2005	December 31, 2004
Machinery and equipment	$3,401,114	$3,407,073
Furniture and fixtures	203,499	196,506
Leasehold improvements	718,193	714,992
Gross equipment and improvements	4,322,806	4,318,571
Less: accumulated depreciation	(777,545)	(656,014)

Total equipment and improvements, net	$3,545,261	$3,662,557

Included in equipment and improvements at March 31, 2005 and December 31, 2004 were machinery and equipment with a cost of $228,518 and accumulated amortization of $31,544 and $22,989, respectively, attributable to leased equipment. Amortization of assets under capital leases is included in depreciation expense.

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

6. Other Intangible Assets, net

	March 31, 2005	December 31, 2004
Patents and trademarks	$ 444,067	$ 444,067
Other intangible assets	342,797	342,797
Gross other intangible assets	786,864	786,864
Less: accumulated amortization	(423,985)	(402,953)
Other intangible assets, net	$ 362,879	$ 383,911

Amortization of other intangible assets related to product rights is included in cost of sales.

7. Other Assets, net

Other assets, net include the following:

	March 31, 2005	December 31, 2004
Deferred financing costs, net	$142,564	$ 60,728
Deposits	71,509	71,736
Long-term receivable	119,789	-
Total other assets, net	$333,862	$132,464

Deferred financing costs related to the U.S. credit facility are being amortized over three years. Deferred financing costs related to the Canadian credit facility are being amortized over five years. The long-term receivable relates to amounts due in connection with a distribution agreement upset fee (see Note 15).

8. Line of Credit Borrowings

Short-term borrowings include the following:

	March 31, 2005	December 31, 2004
U.S. line of credit	$1,378,677	$1,312,756
Canadian line of credit	1,712,527	1,507,528
Total line of credit borrowings	$3,091,204	$2,820,284

U.S. Line of Credit

On January 31, 2005, the Company entered into a three year revolving credit facility agreement (the New Agreement) with a new U.S. lender for a maximum principal amount of $2,000,000. The New Agreement replaces a $2,000,000 revolving credit facility that expired on January 31, 2005. On January 31, 2005, the Company applied advances of approximately $1,300,000 under the New Agreement in satisfaction of the prior U.S. lender s outstanding obligations. Future advances will be utilized to fund strategic initiatives and general working capital requirements. The Company incurred loan origination and legal fees of approximately $139,600 in connection with the implementation of the New Agreement. These fees have been deferred and are being amortized to interest expense over the three year term of the New Agreement.

The Company may request advances under the New Agreement up to the value of 85% of eligible receivables (as defined) and 55% of eligible inventory (as defined). Interest on outstanding advances is payable monthly in arrears at the prime rate (as defined) plus 2.5%, but not less than 7.5% per annum. At March 31, 2005 the effective interest rate was 8.25%. In addition, the Company pays a monthly collateral management fee at the rate of 1.5% per annum upon the daily average amount of advances outstanding and a monthly unused line fee of 0.5% per annum upon the difference between the daily average amount of advances outstanding and $2,000,000. Outstanding advances are secured by all of the Company s existing and after-acquired tangible and intangible U.S. assets. In addition, the Company has accorded the new U.S. lender its guarantee of payment together with a second lien security interest in the assets of the Company s wholly owned Canadian subsidiary. The new U.S. lender has agreed not to exercise its rights under its second lien security interest and guarantee against the Canadian assets without the Canadian lender s approval.

Over the term of the New 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 based upon its consolidated operating results: a) maintain EBITDA (earnings before interest, taxes, depreciation and amortization) in the range of negative $300,000 (as of January 31, 2005) transitioning to positive $600,000 (post December 31, 2005) and (b) maintain its fixed charge ratio (EBITDA divided by the sum of debt service, capital expenditures, income taxes and dividends) in the range of 1.0 to 1.0 (as of January 31, 2005) to 1.25 to 1.0 (post December 31, 2005). In addition, as it pertains to the Company s U.S. operations, cash collections may not be less than $800,000 for each calendar month through June 30, 2005 and $900,000 for each calendar month thereafter, and at all times the Company s cash on hand (including unused borrowing capacity under the New Agreement) must not be less than $200,000. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the New Agreement.

Based upon consolidated operating results for March 2005, the Company was out of compliance with its EBITDA and fixed charge ratio covenant under the New Agreement at March 31, 2005. The U.S. lender agreed to waive these covenant violations. The Company expects to, but cannot ensure that it will, maintain compliance with all applicable loan covenants in the future.

The Company may terminate the New Agreement at any time after January 31, 2006 by paying all outstanding indebtedness and any other payments due the new U.S. lender and paying the new U.S. lender a yield maintenance based early termination fee equal to the product of: (a) the effective yield on the facility for the six months prior to termination (expressed as an annual percentage rate), (b) $2,000,000, and (c) the quotient of the months remaining in the original term of the New Agreement divided by 12.

On January 13, 2005 in connection with the refinancing of the U.S. line of credit, the Company paid off and cancelled the outstanding irrevocable standby letter of credit issued by the U.S. lender in the amount of $200,000 held by the Company s Canadian lender as additional security for its credit facility. The $200,000 paid to the Canadian lender was applied as a permanent principal reduction against the principal amount due in 2007 associated with the Company s outstanding term loan with the Canadian lender (see Note 10). Subsequently, on January 31, 2005 the Canadian lender agreed as part of refinancing of the U.S. line of credit to retain its second lien security interest and guarantee position against the Company s U.S. assets and not to exercise its rights under its second lien security interest and guarantee against the U.S. assets without the U.S. lender s approval.

On December 30, 2004, the Company paid off the promissory note due Kimberly-Clark Corporation in the amount of $1,566,000 using the restricted cash on deposit with the U.S. lender of $1,000,000 and available line capacity. In addition, the irrevocable standby letter of credit issued on behalf of the Kimberly-Clark Corporation in the amount of $1,566,000 was cancelled. In connection with this transaction, the maximum principal amount of the line was reduced from $4,000,000 to $2,000,000. All other terms of the Agreement remained in full force and effect.

Canadian Line of Credit

In September 2004, the Company finalized the annual renewal of its revolving credit facility (the Canadian Agreement) for a maximum principal amount of $1,820,000 ($2,200,000 Canadian) with its Canadian lender. The Company s wholly owned Canadian subsidiary, Derma Sciences Canada Inc., may request advances under the Canadian Agreement up to the value of 75% of eligible receivables (as defined) plus the lesser of $910,000 ($1,100,000 Canadian) or 40% of eligible inventory (as defined), less priority claims. Interest on outstanding advances is payable monthly in arrears at prime rate (as defined) plus 1.0%, or 5.25% for Canadian dollar advances and 7.25%

for U.S. dollar denominated advances at March 31, 2005. Outstanding advances are secured by all tangible and intangible assets of Derma Sciences Canada Inc. In addition, the Company has accorded the Canadian lender its guarantee of payment together with a second lien security interest in the Company s assets located in the U.S.

Over the term of the Canadian 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. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the Canadian Agreement. In the event of a margin deficiency (as defined) or covenant violation, the Company is required to advance up to an additional $413,000 ($500,000 Canadian) of working capital to Derma Sciences 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.

Losses principally associated with the write-off of obsolete equipment, employee termination costs and a revamping of manufacturing operations in Toronto resulted in Derma Sciences Canada being out of compliance with certain of its income based loan covenants that are measured annually at December 31, 2004. The Canadian lender agreed to waive the covenant violations at December 31, 2004. The Company incurred fees of $12,000 associated with the granting of the waivers in 2004. The Company expects to, but cannot assure that it will, maintain compliance with all applicable loan covenants in the future.

9. Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities include the following:

	March 31, 2005	December 31, 2004
Accrued compensation and related taxes	$116,384	$218,037
Accrued sales, goods and services taxes	42,545	197,984
Accrued administrative fees	134,726	107,916
Other	114,477	70,501
Total accrued expenses and other current liabilities	$408,132	$594,438

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

10. Long-Term Debt

Long-term debt includes the following:

	March 31,	December 31,

	2005	2004
Canadian term loan	$664,534	$ 916,805
Capital lease obligations	185,610	198,040
Total debt	850,144	1,114,845
Less: current maturities	256,829	247,306
Long-term debt	$593,315	$ 867,539

In connection with the acquisition of substantially all the assets of Dumex Medical Inc. in August 2002, 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. Interest on the outstanding principal balance is payable monthly at the bank s prime rate (as defined) plus 1.25%, or 5.5% at March 31, 2005. The term loan is secured by all tangible and intangible assets of Derma Canada and is subject to the same financial covenants applicable to the operating line of credit (see Note 8).

The Company has four capital lease obligations for certain distribution equipment and computer equipment totaling $185,610. The capital leases bear interest at annual rates ranging from 3.9% to 10.2% with the longest lease term expiring in April 2009.

11. Shareholders Equity

Preferred Stock

There are 150,003 shares of series A convertible preferred stock outstanding at March 31, 2005. The series A preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $4.00 per share, votes as a class on matters affecting the series A preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 440,003 shares of series B convertible preferred stock outstanding at March 31, 2005. 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. During the year ended December 31, 2004, 4,167 series B preferred shares were converted into common stock.

There are 619,055 shares of series C convertible preferred stock outstanding at March 31, 2005. The series C preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.70 per share, votes as a class on matters affecting the series C preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 1,071,346 shares of series D convertible preferred stock outstanding at March 31, 2005. The series D preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.50 per share, votes as a class on matters affecting the series D preferred stock and maintains voting rights identical to the common stock on all other matters.

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DERMA SCIENCES, INC.

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Common Stock

On February 8, 2005, the Company closed a private offering of 2,760,000 units at $0.50 per unit, each unit consisting of one share of the Company s common stock and one four-year series G warrant to purchase one share of common stock at a price of $1.05. Total offering proceeds of $1,246,656, net of $133,344 in offering expenses, were used for working capital. The offering commenced prior to December 31, 2004. During 2005, the Company sold 1,205,000 units at $0.50 per unit and received total offering proceeds of $565,297, net of $54,703 in offering expenses. As of December 31, 2004, the Company had sold 1,555,000 units at $0.50 per unit and received total offering proceeds of $681,359, net of $78,641 in offering expenses.

Stock Options

During the three months ended March 31, 2005, the Company issued 1,021,000 stock options that are exercisable at $0.50 per share.

Stock Purchase Warrants

During the three months ended March 31, 2005, the Company issued 1,205,000 series G warrants in conjunction with the private offering discussed above. There were no other changes in outstanding warrants during the period.

At March 31, 2005, the Company had warrants outstanding to purchase 5,939,448 shares of 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
G	2,760,000	$1.05	December 31, 2008

Shares Reserved for Future Issuance

At March 31, 2005, the Company had reserved the following shares of common stock for future issuance:

Convertible preferred shares (series A - D)	2,280,407
Common stock options outstanding	5,485,655
Common stock options available for grant	751,000
Common stock warrants (series E - G)	5,939,448
Total common stock shares reserved	14,456,510

12. Comprehensive Loss

The Company s comprehensive loss was as follows:

	Quarter Ended March 31, 2005	Quarter Ended March 31, 2004
Net loss as reported	$(213,052)	$ (976,466)
Other comprehensive loss:		
Foreign currency translation adjustment	(27,188)	(27,241)
Comprehensive loss	$(240,240)	$(1,003,707)

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DERMA SCIENCES, INC.

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13. 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.

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 ended March 31, 2005 and 2004 are as follows:

	Three Months Ended March 31, 2005				
	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company
Net sales	$3,871,130	$628,298	$ 394,019	-	$ 4,893,447
Gross profit	1,069,385	312,739	5,262	-	1,387,386
Total expenses	-	-	-	$(1,600,438)	(1,600,438)

Net loss					$ (213,052)
Net long-lived assets	$3,417,330	-	$1,341,458	$ 260,319	$ 5,019,107

Three Months Ended March 31, 2004

	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company
Net sales	$3,609,348	$958,269	$ 461,805	-	$ 5,029,422
Gross profit	866,140	467,383	99,383	-	1,432,906
Total expenses	-	-	-	$(2,409,372)	(2,409,372)
Net loss					$ (976,466)
Net long-lived assets	$2,818,342	-	$1,338,848	$ 226,650	$ 4,383,840

Long-lived assets consist of property and equipment, patents and trademarks, other intangible assets and goodwill. Wound care long-lived assets consist principally of Derma Sciences Canada Inc., equipment and improvements and other intangible assets acquired in the January 2004 Kimberly-Clark wound care asset acquisition and patents and trademarks. Wound closure-fasteners are for the most part outsourced and accordingly are not supported by long-lived assets. Skin care long-lived assets consist of goodwill associated with the acquisition of Sunshine Products, Inc. and equipment and improvements associated therewith. Corporate headquarters and the Company s U.S. distribution center equipment and improvements are included in the other costs column since they service all three business segments.

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DERMA SCIENCES, INC.

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The following table presents net sales by geographic region.

	Three Months Ended March 31, 2005	2004
United States	49%	56%
Canada	47%	40%
Other	4%	4%

The following table presents net long-lived assets by geographic region.

	March 31, 2005	March 31, 2004
United States	$1,979,013	$3,620,210
Canada	3,020,109	722,915
Other	19,985	40,715
	$5,019,107	$4,383,840

14. Income Taxes

No provision for income taxes has been made in the first quarter 2005 and 2004 given the Company s net operating losses. No benefit has been recorded as the realization of the net operating losses is not assured.

At December 31, 2004, the Company has net operating loss carryforwards of approximately $8,130,000 for federal income tax purposes that begin to expire in years 2012 through 2024. For state income tax purposes, the Company has net operating loss carryforwards in a number of jurisdictions in varying amounts and with varying expiration dates. The most significant net operating loss is in New Jersey, site of the Company s domicile. This state presently has a moratorium on the use of net operating losses. As of December 31, 2004, the Company has foreign net operating loss carryforwards of approximately $1,065,000 which begin to expire in 2009. The timing in which the Company can utilize its net operating loss carryforwards in any year or in total may be limited under the Internal Revenue Code section 382 regarding changes in ownership of corporations. Due to uncertainties surrounding the Company s ability to use its net operating loss carryforwards, a valuation allowance has been provided as of March 31, 2005.

15. Distribution Agreement Upset Fee

In August 2004, the Company s exclusive distribution agreement for certain catheter fasteners expired and was not renewed by the manufacturer. Sales and gross profit of these catheter fasteners for the three months ended March 31, 2005 and 2004 were as follows:

	Three Months Ended March 31,	
	2005	2004
Sales	$38,000	$311,000
Gross profit	$17,000	$141,000

In accordance with the Company s distribution agreement with a major customer for these catheter fasteners, if the customer subsequently entered into an agreement with the manufacturer to distribute these products, then the customer shall pay the Company an upset fee of $200,000 payable in forty-eight monthly installments of $4,167. As of January 2005, the customer advised the Company that it had entered into an agreement with the manufacturer to distribute the catheter fasteners and that it was liable for payment of the upset fee. In January 2005, the Company discounted the future cash flow stream associated with the payment of the upset fee and recognized a gain of $164,300 in other income. The current portion of the receivable has been recorded in accounts receivable and the long-term portion in other assets in the balance sheet.

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16. Employee Termination Costs

On March 9, 2004 the Company terminated the employment of its Executive Vice President and President of its Derma Sciences Canada Inc. subsidiary. The Company recorded an estimated charge of $450,000 representing severance, benefits and other costs associated with this termination. The charge was recorded against general administrative expense in the statement of operations. The liability was recorded to the extent of $225,000 in other current liabilities and to the extent of $225,000 in other long-term liabilities in the balance sheet.

On September 24, 2004 the Company settled the foregoing litigation. In accordance with the settlement, the Company extended the expiration date of previously granted options to purchase 500,000 shares of the Company s common stock at $0.50 per share from May 9, 2004 to September 30, 2006. The settlement costs and other costs associated with the termination totaling $301,600 were recorded in general and administrative expense in the 2004 consolidated statement of operations.

17. Subsequent Events

Distribution Agreement for Silver Plated Wound Dressings

On April 15, 2005 the Company entered into a one and one-half year agreement with a new manufacturer to serve as the exclusive distributor for certain silver plated wound dressings to the U.S. military through the Defense Supply Center Philadelphia (DSCP). The agreement further grants the Company the right to market and sell the dressings on a non-exclusive basis within the United States and Canada. This agreement positions the Company to expand its sales base for silver plated wound dressings. During the initial term of the agreement the Company is required to meet minimum U.S. military sales failing which the manufacturer, at its option, may terminate the exclusive nature of the agreement. The agreement will automatically renew for successive one-year periods unless, not less than ninety days prior to expiration of the then current term, either party notifies the other of its intent not to renew. In connection with entering into this agreement, the Company terminated its existing relationship with another manufacturer of silver plated wound dressings.

Appointment of Canadian Distributor

On May 9, 2005 the Company entered into a five-year agreement with a Canadian company to serve as the exclusive distributor of its products in Canada. The agreement also appoints the distributor as the Company s servicing agent to fulfill contracts held directly by the Company and to perform normal logistics functions associated with the maintenance and warehousing of inventory, order processing and product delivery. The agreement requires the distributor to meet minimum purchase and growth targets failing which the Company may cancel the agreement upon 180 days notice. The Company believes that this agreement will allow it to better service its customers throughout Canada and provide greater opportunity for growth in sales of basic and advanced wound care products.

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

QUARTER ENDED MARCH 31, 2005 COMPARED TO QUARTER ENDED MARCH 31, 2004.

Results of Operations

Overview

The first quarter 2005 and 2004 operating results include Derma Sciences, Inc. and its subsidiaries. Unless otherwise indicated by the context, the term Canadian operations is used throughout this discussion in reference to the operations of Derma Sciences Canada Inc. and the term U.S. operations is used throughout this discussion in reference to the Company s U.S. operations.

The Company engages in the manufacture, marketing and sale of three dermatological product lines consisting of wound care, wound closure and fasteners and skin care. The wound care line is composed of basic and advanced wound care products. Basic wound care consists of gauze dressings, abdominal pads, laparotomy sponges, burn dressings and bandages. Advanced wound care products consist of ointments, packing strips, hydrogel dressings, hydrocolloid dressings, foam dressings and impregnated gauze dressings. The wound closure and fastener line consists of wound closure strips and a variety of catheter fasteners. The skin care line consists of bath sponges, skin cleansers, soaps, hair and body washes and moisturizers.

The following table highlights the quarters ended March 31, 2005 versus March 31, 2004 operating results:

	Quarter Ended March 31, 2005	Quarter Ended March 31, 2004	Variance	
Gross Sales	$5,260,630	$5,303,477	$ (42,847)	(0.1%)
Adjustments	(367,183)	(274,055)	93,128	34.0%
Net sales	4,893,447	5,029,422	(135,975)	(2.7%)
Cost of sales	3,506,061	3,596,516	(90,455)	(2.5%)
Gross profit	1,387,386	1,432,906	(45,520)	(3.2%)
Gross profit percentage	28.4%	28.5%		
Operating expenses	1,681,055	2,245,055	(564,000)	(25.1%)
Interest expense, net	84,584	46,667	37,917	81.3%
Other (income) expense, net	(165,201)	117,650	(282,851)	-
Total expenses	1,600,438	2,409,372	(808,934)	(33.6%)
Loss before income taxes	(213,052)	(976,466)	763,414	78.2%
Provision for income taxes	-	-	-	-
Net loss	$ (213,052)	$ (976,466)	$ 763,414	78.2%

Sales and Gross Profit

Gross sales are adjusted for trade rebates, Medicaid rebates, returns and allowances and cash discounts to derive net sales. The rebates are accrued monthly based upon an analysis of sales subject to rebate and actual rebates received. Trends are monitored and accruals are adjusted as appropriate. Medicaid rebates are accrued monthly based upon recent historical activity and reconciled quarterly based upon receipt of rebate reports from participating state agencies. Returns and allowances and cash discounts have historically been accounted for on a cash basis which approximates accrual based accounting given the month to month consistency of these charges.

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Gross to net sales adjustments comprise the following:

	Quarter Ended March 31,	
	2005	2004
Gross Sales	$5,260,630	$5,303,477
Trade rebates	(273,184)	(187,917)
Medicaid rebates	(7,420)	(14,400)
Returns and allowances	(55,175)	(24,229)
Cash discounts	(31,404)	(47,509)
Total adjustments	(367,183)	(274,055)
Net sales	$4,893,447	$5,029,422

Trade rebates increased in the first quarter 2005 versus 2004 due to new rebate intensive private label sales and an increase in the level of sales subject to rebate (contract business) in other areas of the Company s business. A continuing trend towards lower levels of Medicaid reimbursed sales is responsible for the lower level of Medicaid rebates. The increase in returns and allowances generally reflects an increase in the level of shipping errors and damaged products associated with opening of the new U.S. distribution center in March 2004, a significant increase in the number of new product stock keeping units introduced after the first quarter 2004 in connection with the acquisition of the Kimberly-Clark wound care products and the launch of a large number of new private label products. The decrease in cash discounts reflects the Company s efforts to tighten its overall discount terms started in 2004 and the loss of a significant customer in late 2004 that historically took its cash discount.

A roll forward of the trade rebate accruals at March 31, 2005 and 2004 is outlined below:

	Quarter Ended March 31,	
	2005	2004
Beginning balance - January 1	$ 235,200	$ 212,000
Rebates paid	(202,684)	(204,917)
Rebates accrued	273,184	187,917

Ending balance - March 31	$ 305,700	$ 195,000

The $70,500 increase in the first quarter 2005 trade rebate reserve reflects the quarter-to-quarter changes discussed above coupled with lower rebates paid due to extended payment terms with two large customers. With the exception of these two customers, there has been no discernable change in the nature of the Company s business as it relates to the accrual and subsequent payment of rebates. The $17,000 decrease in the first quarter 2004 trade rebate reserve reflects the work down (via payment of rebates without a corresponding amount of accruals) of a higher than normal beginning balance due to significant sales of product subject to rebate in December 2003.

The following table highlights the March 31, 2005 versus March 31, 2004 product line net sales and gross profit:

	Quarter Ended March 31,			
	2005	2004	Variance	
Product Line Net Sales				
Wound care	$3,871,130	$3,609,348	$ 261,782	7.3%
Wound closure and fasteners	628,298	958,269	(329,971)	(34.4%)
Skin care	394,019	461,805	(67,786)	(14.7%)
Totals	$4,893,447	$5,029,422	$(135,975)	(2.7%)
Product Line Gross Profit				
Wound care	$1,069,385	$ 866,141	$203,244	23.5%
Wound closure and fasteners	312,739	467,382	(154,643)	(33.1%)
Skin care	5,262	99,383	(94,121)	(94.7%)
Totals	$1,387,386	$1,432,906	$ (45,520)	(3.2%)

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Wound care sales increased $261,782, or 7.3%, to $3,871,130 in 2005 from $3,609,348 in 2004. The increase is attributable to a basic wound care increase of $364,746, or 15.1%. This increase was driven by continued growth in the U.S. of $73,871, or 17.7%, and Canada of $290,875, or 14.6% (comprised of 7.1% real growth and 7.5% related to a 7.0% strengthening of the Canadian dollar). Advanced wound care sales decreased $102,964, or 8.6%, to $1,092,831 in 2005 from $1,195,795 in 2004. This decrease was driven by a reduction in former Kimberly-Clark Corporation branded and private label business that was higher in 2004 due to customer buy-ins in the first quarter prior to discontinuation of production at the Kimberly-Clark facility and transfer of the equipment to the Company s facility in Canada and a significant reduction in 2005 of silver product sales versus a very strong 2004 first quarter as customer demand for these products remains soft. These decreases were partially offset by continued growth of the Company s private label sales to U.S. distributors. Dermagran sales were essentially flat quarter to quarter curtailing a trend of decreasing quarterly sales of this product line in 2004.

Wound care gross profit increased $203,244, or 23.5%, to $1,069,385 in 2005 from $866,141 in 2004. Gross profit margins increased to 27.6% in 2005 from 24.0% in 2004. The improved gross profit dollars and margins are due to the flow through of lower basic wound care costs negotiated in 2004, lower advanced wound care costs associated with manufacturing the former Kimberly-Clark products in-house versus the acquisition related negotiated costing used in 2004 and the non-recurrence of a one-time $59,400 inventory write-off incurred in 2004.

Wound closure and fastener sales decreased $329,971, or 34.4%, to $628,298 in 2005 from $958,269 in 2004. A reduction of approximately $250,000 in sales of certain catheter fasteners in 2005 versus 2004 associated with the loss of the Company s exclusive distribution agreement for the sale of these products in August 2004 is primarily responsible for the decrease. A $60,000 suture strip backorder in the first quarter 2005 due to a delay in product receipt from a supplier and slightly softer demand for the Company s other catheter securement devices also contributed.

Wound closure-fastener gross profit decreased $154,643, or 33.1%, to $312,739 in 2005 from $467,382 in 2004. Gross profit margins improved slightly to 49.8% in 2005 from 48.8% in 2004. The decrease in margin dollars is consistent with the sales shortfall. The margin improvement reflects the benefit of the loss of the exclusive catheter fastener business which was slightly lower margined than the average for the line, partially offset by slightly higher overall product costs for the balance of the products in the line in 2005 versus 2004 due to supplier price increases.

Skin care sales decreased $67,786, or 14.7%, to $394,019 in 2005 from $461,805 in 2004 due to continuing competitive pressure and the loss of several customers (distributors) who initiated their own private label skin care lines using other suppliers. Skin care gross profit decreased $94,121, or 94.7%, to $5,262 in 2005 from $99,383 in 2004. The decrease is driven by lower pricing to retain or secure business in a highly competitive marketplace, the adverse impact of lower production volumes on overhead absorption and higher material and freight costs associated with increasing energy prices.

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Operating Expense

The following table highlights March 31, 2005 versus March 31, 2004 operating expenses by type:

	Quarter Ended March 31, 2005	2004	Variance	
Distribution	$ 244,667	$ 306,925	$ (62,258)	(20.3%)
Marketing	96,795	87,896	8,899	10.1%
Sales	455,214	456,673	(1,459)	(0.3%)
General administrative	884,379	1,393,561	(509,182)	(36.5%)
Total	$1,681,055	$2,245,055	$(564,000)	(25.1%)

Operating expense decreased $564,000, or 25.1%, to $1,681,055 in 2005 from $2,245,055 in 2004, net of a $71,727, or 6.0% increase related to the impact of a 7.0% strengthening of the Canadian dollar on the Canadian operations.

Distribution expense decreased $62,258, or 20.3%, in 2005 versus 2004. The decrease was due principally to the non recurrence of one-time costs of $50,000 accrued in the first quarter 2004 to close one of the Company s existing distribution centers as part of its U.S. distribution consolidation program and other one-time costs associated with opening the new U.S. distribution center in March 2004.

Marketing expense increased $8,899, or 10.1%, to $96,795 in 2005 from $87,896 in 2004 as a result of hiring a marketing director in February 2004, together with higher literature and promotion expense in support of the Company s growth initiatives partially offset by a reduction in recruiting expense associated with the director s hiring in 2004.

Sales expense decreased $1,459, or 0.3%, to $455,214 in 2005 from $456,673 in 2004. This essentially flat change was driven by a decrease in the U.S. sales operation due to lower operating expenses offset by an increase in the level of sales support in Canada in the form of additional sales resources and operating expense in an effort to strengthen sales representation in eastern and western provinces.

General administrative expense decreased $509,182, or 36.5%, to $884,379 in 2005 from $1,393,561 in 2004. The primary drivers for the decrease were the non-recurrence in 2005 of a $450,000 charge for employee termination costs and a $42,600 bad debt write-off taken in the first quarter of 2004. The balance of the decrease reflects the impact of various cost reduction initiatives partially offset by higher compensation, benefits, accounting and board of directors expenses.

Interest Expense

Interest expense increased $37,917, or 81.3%, to $84,584 in 2005 from $46,667 in 2004. The increase is due to higher interest and related fees associated with the U.S. operations moving into a net borrowing position in the second half of 2004 versus no borrowing in the first quarter 2004. Canadian interest expense in the first quarter 2005 was comparable to the first quarter 2004.

Other Income/Expense

Other income/expense increased $282,851 to $165,201 income in 2005 from $117,650 expense in 2004. The increase is primarily driven by $164,300 in income relative to a distribution agreement upset fee recorded in 2005 and the non-recurrence in 2005 of $94,428 in obsolete equipment write-off incurred in the first quarter of 2004. A lower level of miscellaneous expenses in 2005 versus 2004 also contributed.

Income Taxes

The Company did not record any tax expense in the first quarter of 2005 or 2004 given its net operating losses and available net operating loss carryforwards.

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Net Loss

The Company incurred a $213,052 loss, or $0.02 loss per share (basic and diluted), in 2005 compared to a $976,466 loss, or $0.11 loss per share (basic and diluted) in 2004.

Liquidity and Capital Resources

Operational Overview

In the first quarter 2005, the Company continued to operate at a loss as the ramp up of its key sales growth initiatives continue to move slower than planned. As expected, in the first quarter 2005 the Company began to realize the benefit of its major manufacturing initiatives that were completed in late 2004. Excluding one-time costs of $542,600 incurred in 2004, operating expenses were essentially flat quarter-to-quarter reflecting an effort to restrain expenses to the extent possible without adversely affecting the underlying infrastructure previously put in place to support planned growth. Excluding a one-time gain of $164,300 related to a distribution agreement upset fee, the net loss in the first quarter was $377,352. This performance continued to put pressure on the Company s overall liquidity. In response, the Company is taking steps to accelerate sales growth and properly align operating expenses with expected revenues in 2005 while closely monitoring its liquidity.

On January 9, 2004, the Company purchased the Kimberly-Clark Corporation wound care business for total consideration of $1,942,797. The consideration consisted of cash of $376,797 and a seller financed, non-interest bearing promissory note due on or before December 31, 2004 of $1,566,000. The cash outlay consisted of $300,100 paid at closing and $76,697 for acquisition related costs. The equipment purchased was installed in a newly renovated area in the Company s manufacturing facility in Toronto, Canada that was completed in August 2004. The cost to transfer, install and validate the equipment was approximately $680,000. The promissory note was paid in full on December 30, 2004 using restricted cash on deposit with the U.S. lender and available line capacity.

On February 25, 2004, the Company closed a private offering of 2,057,145 shares of its common stock at a price of $1.05 per share. Offering proceeds were used to fund the acquisition of the Kimberly-Clark Corporation wound care business and for general working capital purposes. Offering proceeds of $1,961,797 , net of offering expenses of $198,203, were received.

On September 24, 2004, the Company settled litigation brought against it and its wholly owned Canadian subsidiary by a former executive relative to the executive s termination of employment. Pursuant to the settlement, the Company will pay the sum of $269,500 over a period of seven months and extend the expiration date of previously granted options to purchase 500,000 shares of the Company s common stock at $0.50 per share from May 9, 2004 to September 30, 2006. The settlement costs, together with estimated other costs associated with the termination aggregating $301,600, were charged against the reserve established in March 2004 to cover the estimated cost of the litigation. The balance due the former employee at March 31, 2005 was $16,534.

In 2004, the Company entered into operating and capital leases totaling approximately $4,222,000 in commitments through 2012, with terms ranging from three to five years, relative to the following: extension of the Canada manufacturing facility lease in the amount of $1,902,000, lease for the new U.S. distribution center in the amount of $1,118,000, Canada distribution and U.S. manufacturing facility extensions in the amount of $903,000 and U.S. distribution center equipment and upgrades to the Company-wide telecommunications and information technology equipment in the amount of $299,000. No further significant lease obligations are anticipated in the foreseeable future.

On February 8, 2005, the Company closed a private offering of 2,760,000 units at $0.50 per unit, each unit consisting of one share of the Company s common stock and one four-year series G warrant to purchase one share of common stock at a price of $1.05. Total offering proceeds of $1,246,656, net of $133,344 in offering expenses, were used for working capital. The offering was initiated in December 2004. In 2004, the Company sold 1,555,000 units and received offering proceeds of $681,359, net of $78,641 in offering expenses. In 2005, the Company sold 1,205,000 units and received offering proceeds of $565,297, net of $54,703 in offering expenses.

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In 2004, the Company s exclusive distribution agreement for certain catheter fasteners expired and was not renewed by the manufacturer. In accordance with the Company s distribution agreement with a major customer for the fasteners, if the customer subsequently enters into an agreement with the manufacturer to distribute these products, then the customer shall pay the Company an upset fee of $200,000 in forty-eight monthly installments of $4,167.

As of January 2005, the customer advised the Company that it had entered into an agreement with the manufacturer to distribute the catheter fasteners and that it was liable for payment of the upset fee. In January 2005, the Company discounted the future cash flow stream associated with the payment of the upset fee and recognized a gain of $164,300.

Cash Flow

At March 31, 2005 and December 31, 2004, the Company had cash and cash equivalents on hand of $76,578 and $46,508, respectively. The $30,070 increase represents a timing difference that results from net cash provided by investing activities of $478,425 partially offset by net cash used in operating activities of $423,055 and net cash used in investing activities of $25,480.

Net cash used in operating activities stems from cash used in ongoing operations of $127,710 (net loss less non cash items) offset by cash used from the net change of $295,345 in operating assets and liabilities. Increases in receivables and other assets related to the $164,300 distribution upset fee receivable recorded in the first quarter 2005 and payable monthly over four years and the payment of scheduled employee termination and annual Canadian sales tax liabilities were primarily responsible for the decrease in accrued expenses and other current liabilities. Trade receivables were up slightly due to higher March 2005 sales representing a use of cash. The increase in accounts payable exceeded that of inventory representing a net source of cash due to close monitoring in an effort to improve the Company s cash flow in these areas.

Net cash used in investing activities of $25,480 reflects the Company s plan to limit capital expenditures to that necessary to continue running the business until operational performance improves.

Net cash provided by financing activities of $478,425 consisted of net proceeds of $565,297 from the sale of common stock in the first quarter 2005 coupled with additional line of credit borrowings of $277,161, partially offset by deferred financing costs of $108,804 related to refinancing the U.S. line of credit in January 2005 and debt repayment of $255,229. Aside from regularly scheduled debt payments, $200,000 of the debt repayment related to the payoff of the outstanding standby letter of credit issued by the U.S. lender in favor of the Company s Canadian lender as additional security for the Company s credit facility in January 2005. The payment was applied as a permanent principal reduction against the principal amount due in 2007 associated with the Company s outstanding term loan with the Canadian lender.

Working Capital

Working capital decreased $16,085 at March 31,2005 to $2,833,511 from $2,849,596 at December 31, 2004. The modest change principally reflects the infusion of cash associated with the securities private placement in the first quarter 2005 and additional line of credit borrowing offset by the net change in operating assets and liabilities, debt repayment and deferred financing costs. Cash used in operations of $127,710 (net loss less non cash items) during the quarter also contributed.

Financing Arrangements United States

On January 31, 2005 the Company entered into a three year revolving credit facility agreement (the new agreement) with a new U.S. lender for a maximum principal amount of $2,000,000. The new agreement replaces a $2,000,000 revolving credit facility that expired on January 31, 2005 with the previous U.S. lender. At January 31, 2005 maximum potential advances under the new agreement were approximately $1,700,000. On January 31, 2005, the Company applied advances of approximately $1,300,000 under the new agreement in satisfaction of the prior U.S. lender s outstanding obligations. Future advances will be utilized to fund strategic initiatives and general working capital requirements. The Company incurred loan origination and legal fees of approximately $139,600 in connection with the implementation of the new agreement. These fees have been deferred and are being amortized to interest expense over the three year term of the new agreement.

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The Company may request advances under the new agreement up to the value of 85% of eligible receivables (as defined) and 55% of eligible inventory (as defined). Interest on outstanding advances is payable monthly in arrears at the prime rate (as defined) plus 2.5%, but not less than 7.5% per annum. At March 31, 2005 the effective interest rate was 8.25%. In addition, the Company pays a monthly collateral management fee at the rate of 1.5% per annum upon the daily average amount of advances outstanding and a monthly unused line fee of 0.5% per annum upon the difference between the daily average amount of advances outstanding and $2,000,000. Outstanding advances are secured by all of the Company s existing and after-acquired tangible and intangible U.S. assets. In addition, the Company has accorded the new U.S. lender its guarantee of payment together with a second lien security interest in the assets of the Company s wholly owned Canadian subsidiary. The new U.S. lender has agreed not to exercise its rights under its second lien security interest and guarantee against the Canadian assets without the Canadian lender s approval.

Maximum potential advances under the new agreement at March 31, 2005 were $1,795,466. Advances outstanding against the line were $1,378,677 at March 31, 2005, leaving an additional $416,789 available for borrowing.

Over the term of the new 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 based upon its consolidated operating results: a) maintain EBITDA (earnings before interest, taxes, depreciation and amortization) in the range of negative $300,000 (as of January 31, 2005) transitioning to positive $600,000 (post December 31, 2005) and (b) maintain its fixed charge ratio (EBITDA divided by the sum of debt service, capital expenditures, income taxes and dividends) in the range of 1.0 to 1.0 (as of January 31, 2005) to 1.25 to 1.0 (post December 31, 2005). In addition, as it pertains to the Company s U.S. operations, cash collections may not be less than $800,000 for each calendar month through June 30, 2005 and $900,000 for each calendar month thereafter, and at all times the Company s cash on hand (including unused borrowing capacity under the new agreement) must not be less than $200,000. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the new agreement.

Based upon consolidated operating results for March 2005, the Company was out of compliance with its EBITDA and fixed charge ratio covenant under the new agreement at March 31, 2005. The U.S. lender agreed to waive these covenant violations. The Company expects to, but cannot assure that it will, maintain compliance with all applicable loan covenants in the future.

The Company may terminate the new agreement at any time after January 31, 2006 by paying all outstanding indebtedness and any other payments due the U.S. lender and paying the U.S. lender a yield maintenance based early termination fee equal to the product of: (a) the effective yield on the facility for the six months prior to termination (expressed as an annual percentage rate), (b) $2,000,000, and (c) the quotient of the months remaining in the original term of the new agreement divided by 12.

On January 13, 2005, in connection with the refinancing of the U.S. line of credit, the Company paid off and cancelled the outstanding irrevocable standby letter of credit issued by the U.S. lender in the amount of $200,000 held by the Company s Canadian lender as additional security for its credit facility. The $200,000 paid to the Canadian lender was applied as a permanent principal reduction against the principal amount due in 2007 associated with the Company s outstanding term loan with the Canadian lender. Subsequently, on January 31, 2005 the Canadian lender agreed as part of refinancing of the U.S. line of credit to retain its second lien security interest and guarantee position against the Company s U.S. assets and not to exercise its rights under its second lien security interest and guarantee against the U.S. assets without the new U.S. lender s approval.

On December 30, 2004, the Company paid off the promissory note due Kimberly-Clark Corporation in the amount of $1,566,000 using the restricted cash on deposit with the U.S. lender of $1,000,000 and available line capacity. In addition, the irrevocable standby letter of credit issued on behalf of the Kimberly-Clark Corporation in the amount of $1,566,000 was cancelled. In connection with this transaction, the maximum principal amount of the line was reduced from $4,000,000 to $2,000,000. All other terms of the prior agreement remained in full force and effect.

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On January 30, 2004 the Company entered into a modified one year line of credit agreement with its previous U.S. lender (the prior agreement). The maximum principal amount of the line increased to $4,000,000 from $3,000,000. In connection with entering into this line of credit agreement, the Company deposited $1,000,000 of cash in a restricted account with the U.S. lender and the U.S. lender issued an irrevocable standby letter of credit on the Company s behalf for the benefit of Kimberly-Clark Corporation in the amount of $1,566,000. Advances were used to fund strategic initiatives and for general working capital purposes. Estimated maximum potential advances under the prior agreement were equal to the lesser of (A) $4,000,000 or (B) the sum of (i) 80% of eligible receivables (as defined), (ii) 50% of eligible inventory (as defined), (iii) an amount equal to the immediate liquidation value of funds deposited with the U.S. lender in a restricted account as security for any letters of credit extended by the lender on the Company s behalf up to $1,000,000, less the aggregate amount of any outstanding letters of credit issued by the U.S. lender.

Outstanding advances were secured by all tangible and intangible assets of the Company s U.S. operations. Over the term of the Agreement, the Company 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, purchases of securities and protection of collateral were included in the Agreement. Ongoing operating losses resulted in the Company being out of compliance with certain of its U.S. line of credit covenants at March 31, June 30 and September 30, 2004. In return for a commitment to secure alternative financing for its U.S. obligations prior to the January 31, 2005 maturity date of the prior agreement, the U.S. lender agreed to waive the Company s prior covenant violations and to maintain the line of credit until maturity thereof. The Company has incurred waiver fees of $7,500 and agreed to an increase in the rate of interest payable under the line. All other terms of the prior agreement were maintained in full force and effect.

Financing Arrangements Canada

In September 2004, the Company finalized the annual renewal of its revolving credit facility (the Canadian Agreement) for a maximum principal amount of $1,820,000 ($2,200,000 Canadian) with its Canadian lender. The

Company s wholly owned Canadian subsidiary, Derma Sciences Canada Inc., may request advances under the Canadian Agreement up to the value of 75% of eligible receivables (as defined) plus the lesser of $910,000 ($1,100,000 Canadian) or 40% of eligible inventory (as defined), less priority claims. Interest on outstanding advances is payable monthly in arrears at prime rate (as defined) plus 1.0%, or 5.25% for Canadian dollar advances and 7.25% for U.S. dollar denominated advances at March 31, 2005. Outstanding advances are secured by all tangible and intangible assets of Derma Sciences Canada Inc. In addition, the Company has accorded the Canadian lender its guarantee of payment together with a second lien security interest in the Company s assets located in the U.S. Maximum potential advances under the Canadian agreement at March 31, 2005 were $1,820,000. Advances outstanding against the Canadian agreement were $1,712,527 at March 31, 2005, leaving an additional $107,473 available for borrowing.

Over the term of the Canadian 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. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the Canadian Agreement. In the event of a margin deficiency (as defined) or covenant violation, the Company is required to advance up to an additional $413,000 ($500,000 Canadian) of working capital to Derma Sciences 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.

Losses principally associated with the write-off of obsolete equipment, employee termination costs and a revamping of manufacturing operations in Toronto resulted in Derma Sciences Canada being out of compliance with certain of its income based loan covenants that are measured annually at December 31, 2004. The Canadian lender agreed to waive the covenant violations at December 31, 2004. The Company incurred fees of $12,000 associated with the granting of the waivers in 2004. The Company expects to, but cannot assure that it will, maintain compliance with all applicable loan covenants in the future.

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Prospective Assessment

The Company seeks to increase sales and gross margins and return to profitability by increasing sales of contracted private label products and focusing on organic growth of its core product lines in the U.S. and Canada. In the first quarter 2005, the Company began to realize the benefit of lower basic wound care product costs negotiated in mid-2004 and lower advanced wound care costs associated with the commencement in late 2004 of in-house manufacture of a wide range of products using the equipment purchased from Kimberly-Clark Corporation. Further, over the balance of 2005, the Company expects to benefit from the non-recurrence of the one-time costs incurred in the last three quarters of 2004 associated with bringing the manufacture of private label advanced wound care and Kimberly-Clark products on line. Steps have been taken to reduce operating expenses wherever possible and to limit incremental spending in this area to that necessary to support existing operations. Operational expenditures will continue to be closely monitored and adjusted as necessary to ensure alignment with expected sales and margin growth.

Capital spending has and will continue to be limited to that necessary to maintain current operations until the Company s financial performance improves. The Company will continue to closely monitor inventory levels with the objective of reducing its investment in inventory wherever possible.

The Company believes that available funds from expected improving operations and available lines of credit will be sufficient to satisfy the Company s liquidity requirements for the foreseeable future. If need be, the Company expects that it can secure additional equity funding to improve liquidity. In addition, the Company will continue to evaluate 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 foreseeable future.

Additional Financial Information

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

Estimates and assumptions are required in the determination of sales deductions for trade rebates, 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. Some of these judgments can be subjective and complex, and, consequently, actual results may differ from these estimates. For any individual estimate or assumption made by us, there may also be other reasonable estimates or assumptions. We believe, however, that given current facts and circumstances, it is unlikely that applying any such other reasonable judgment would cause a material adverse effect on our consolidated results of operations, financial position or cash flows for the periods represented in this section. Our most critical accounting policies are described below:

Revenue Recognition and Adjustments to Revenue

Revenue is recognized when product is shipped and title passes to the customer and collectability is reasonably assured. When we recognize revenue from the sale of our products, we simultaneously adjust revenue for estimated trade rebates. A trade rebate represents the difference between our invoice price to the wholesaler and the indirect customer s contract price. These rebates are estimated based on historical experience, estimated future trends, estimated customer inventory levels, current contract sales terms with our wholesale and indirect customers and other competitive factors. If the assumptions we used to calculate these rebates do not appropriately reflect future activity, our financial position, results of operations and cash flows could be impacted. We continually monitor the factors that influence these rebates and make adjustments as necessary.

Goodwill

At March 31, 2005, the Company s skin care segment had $1,110,967 of goodwill. The Company tests goodwill for impairment in the fourth 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 and assumptions in estimating future cash flows to determine the fair value of the reporting unit. These assumptions include future growth rates, discount factors, future tax rates and other factors. 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. If the expected cash flows are not realized, impairment losses may be recorded in the future.

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.

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Item 3. CONTROLS AND PROCEDURES

The Company s management, with the participation of the Company s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company s disclosure controls and procedures as of March 31, 2005. Based on this evaluation, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective for gathering, analyzing and disclosing the information the Company is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC s rules and forms.

During the three months ended March 31, 2005, there was no change in the Company s internal controls over financial reporting that materially affected, or is reasonably likely to materially affect, the Company s internal controls over financial reporting.

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Part II Other Information

Item 1. Legal Proceedings

None

Item 6. 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, 2005, 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

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: May 13, 2005