DERMA SCIENCES, INC.
Form 10QSB
May 15, 2006

# UNITED STATES
# 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, 2006 |
| 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 [ ]

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

Yes [ ] No [X]

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

| | | |
|---|---|---|
| Date: May 1, 2006 | Class: | Common Stock, par value $.01 per share |
| | | Shares Outstanding: 22,906,160 |

Transitional Small Business Disclosure Format (check one): Yes [ ] No [X]

**Part I**

**DERMA SCIENCES, INC.**

**FORM 10-QSB**

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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 CONSOLIDATED FINANCIAL STATEMENTS

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

**Condensed Consolidated Balance Sheets**

| | March 31, 2006 (Unaudited) | December 31, 2005 (Note 1) |
|---|---|---|
| **ASSETS** | | |
| Current Assets | | |
| Cash and cash equivalents | $ 68,246 | $ 1,105,330 |
| Accounts receivable, net | 1,303,068 | 1,225,639 |
| Inventories | 4,740,795 | 3,868,663 |
| Prepaid expenses and other current assets | 341,302 | 210,288 |
| Total current assets | 6,453,411 | 6,409,920 |
| Equipment and improvements, net | 3,312,597 | 3,385,862 |
| Goodwill | 200,000 | 200,000 |
| Other intangible assets, net | 278,779 | 299,776 |
| Other assets, net | 323,811 | 299,688 |
| Total Assets | $10,568,598 | $10,595,246 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current Liabilities | | |
| Line of credit borrowings | $ 854,144 | $ 1,080,561 |
| Current maturities of long-term debt | 289,227 | 285,945 |
| Accounts payable | 1,497,754 | 1,197,062 |
| Accrued expenses and other current liabilities | 386,683 | 491,559 |
| Total current liabilities | 3,027,808 | 3,055,127 |
| Long-term debt, net of current portion | 311,131 | 388,473 |
| Other long-term liabilities | 105,925 | 99,982 |
| Total Liabilities | 3,444,864 | 3,543,582 |
| Commitments | | |
| Shareholders' Equity | | |
| Convertible preferred stock, $.01 par value; 11,750,000 shares authorized; issued and outstanding: 2,280,407 shares at March 31, 2006 and December 31, 2005 (liquidation preference of $4,210,231 at March 31, 2006 and December 31, 2005) | 22,804 | 22,804 |
| Common stock, $.01 par value, 30,000,000 shares authorized; issued and outstanding: 12,285,768 shares at March 31, 2006 and December 31, 2005 | 122,858 | 122,858 |
| Additional paid-in capital | 19,943,684 | 19,905,059 |
| Accumulated other comprehensive income | 871,802 | 896,077 |
| Accumulated deficit | (13,837,414) | (13,895,134) |
| Total Shareholders' Equity | 7,123,734 | 7,051,664 |
| Total Liabilities and Shareholders' Equity | $10,568,598 | $10,595,246 |

See accompanying notes to condensed consolidated financial statements.

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

**Condensed Consolidated Statements of Operations (Unaudited)**

| | Three months ended March 31, | |
|---|---|---|
| | **2006** | **2005** |
| **Net sales** | $ 5,756,914 | $ 4,893,447 |
| Cost of sales | 3,564,913 | 3,422,603 |
| **Gross Profit** | 2,192,001 | 1,470,844 |
| Operating expenses | 2,121,752 | 1,764,513 |
| Interest expense, net | 82,050 | 84,584 |
| Other income, net | (69,521) | (165,201) |
| **Total Expenses** | 2,134,281 | 1,683,896 |
| Income (loss) before provision for income taxes | $ 57,720 | $ (213,052) |
| Provision for income taxes | | |
| **Net Income (Loss)** | $ 57,720 | $ (213,052) |
| Income (loss) per common share - basic | $0.00 | $(0.02) |
| Income (loss) per common share - fully diluted | $0.00 | $(0.02) |
| Shares used in computing income (loss) per common share - basic | 12,285,768 | 12,011,674 |
| Shares used in computing income (loss) per common share - fully diluted | 15,659,185 | 12,011,674 |

See accompanying notes to condensed consolidated financial statements.

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

**Condensed Consolidated Statements of Cash Flows (Unaudited)**

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|---|---|---|
| **Operating Activities** | | |
| Net income (loss) | $ 57,720 | $ (213,052) |
| Adjustments to reconcile net income (loss) | | |
| to net cash used in operating activities: | | |
| Depreciation of equipment and improvements | 138,077 | 121,885 |
| Amortization of intangible assets | 20,997 | 21,032 |
| Amortization of deferred financing costs | 18,161 | 16,869 |
| Provision for bad debts and rebates | 270,472 | 40,221 |
| Provision for inventory obsolescence | 24,489 | 27,519 |
| Deferred rent expense | 5,976 | 13,651 |
| Share based compensation expense | 38,625 | |
| Gain on settlement of accounts payable | (64,971) | |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (349,587) | (124,259) |
| Inventories | (911,176) | (87,500) |
| Prepaid expenses and other current assets | (132,049) | (52,817) |
| Other assets | 10,769 | (120,470) |
| Accounts payable | 369,496 | 145,365 |
| Accrued expenses and other current liabilities | (104,431) | (193,999) |
| Net cash used in operating activities | (607,432) | (405,555) |
| **Investing Activities** | | |
| Business acquisition costs related to Western Medical, Inc. | (51,352) | |
| Purchases of equipment and improvements | (76,908) | (25,480) |
| Net cash used in investing activities | (128,260) | (25,480) |
| **Financing Activities** | | |
| Net change in bank lines of credit | (226,417) | 277,161 |
| Deferred financing costs | | (108,804) |
| Long-term debt repayments | (72,820) | (255,229) |
| Proceeds from issuance of stock, net of issuance costs | | 547,797 |
| Net cash (used in) provided by financing activities | (299,237) | 460,925 |
| Effect of exchange rate changes on cash | (2,155) | 180 |
| **Net (decrease) increase in cash and cash equivalents** | (1,037,084) | 30,070 |
| | | |
| Cash and cash equivalents | | |
| Beginning of period | 1,105,330 | 46,508 |
| End of period | $ 68,246 | $ 76,578 |

See accompanying notes to condensed consolidated financial statements.

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes To Condensed Consolidated Financial Statements (Unaudited)

**1. Organization and Summary of Significant Accounting Policies**

Derma Sciences, Inc. and its subsidiaries (the Company ) 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 U.S. distribution facility is located in St. Louis, Missouri, while the Company s Canadian distribution facility is located in Toronto. The Company has manufacturing facilities in Toronto, Canada and Nantong, China.

**Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-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, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. Information included in the condensed balance sheet as of December 31, 2005 has been derived from the consolidated financial statements and footnotes thereto for the year ended December 31, 2005, included in Form 10-KSB previously filed with the Securities and Exchange Commission. For further information, refer to that Form 10-KSB.

**Summary of Significant Accounting Policies:**

**Stock-Based Compensation** Effective January 1, 2006 the Company adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment ( SFAS 123R ), which revises SFAS 123 Accounting for Stock-Based Compensation ( SFAS 123 ) and supercedes Accounting Principles Board Opinion 25 Accounting for Stock Issued to Employees. Under APB 25, the Company used the intrinsic value method for employee stock options and did not record any expense because option exercise prices equaled the market value at the date of grant. SFAS 123R requires that new, modified and unvested share-based payment transactions with employees, such as grants of stock options and restricted stock, be recognized in the financial statements based on their fair value at the grant date and recognized as compensation expense over their vesting periods. The Company estimates the fair value of stock options as of the date of grant using the Black-Scholes pricing model and restricted stock based on the quoted market price. The Company adopted SFAS 123R using the modified prospective method, and accordingly, prior period financial statements were not revised.

No charge is recorded as of the date of grant for performance-based options. An evaluation is conducted as of the end of each subsequent reporting period through the vesting date to determine the probability of the satisfaction of the performance criteria underlying the earning of the performance options being met. If it is determined that achievement of the underlying performance criteria is not probable as of the reporting date, no charge is recorded. If it is determined that achievement of the performance criteria is probable, then a charge is recorded. The charge represents the change in fair value of the option from the grant date through the reporting date. The charge is remeasured and adjusted each subsequent reporting period until the final determination as to the vesting of the performance-based options is made in accordance with the terms of the original grant.

**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.

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes To Condensed Consolidated Financial Statements (Unaudited)

Potential common stock has not been included in the computation of diluted loss per share for the three months ended March 31, 2005 as the effect would be anti-dilutive.

Total dilutive shares that have or would have been used to compute diluted income per common share for the three months ended March 31, 2006 and 2005 (assuming profitability in all periods) are outlined below:

| | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 |
|---|---|---|
| Weighted average common shares outstanding basic in 2006 and basic and diluted in 2005 | 12,285,768 | 12,011,674 |
| Potentially dilutive shares: | | |
| Preferred stock | 2,280,407 | 2,280,407 |
| Warrants | 155,723 | 4,578 |
| Stock options | 937,287 | 489,559 |
| Sub-total potentially dilutive shares | 3,373,417 | 2,774,544 |
| Weighted average common shares outstanding diluted in 2006 and potentially diluted in 2005 | 15,659,185 | 14,786,218 |

**Reclassifications** Certain reclassifications have been made to prior year reported amounts to conform with the 2006 presentation.

**2. Inventories**

Inventories include the following:

| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Finished goods | $ 3,241,405 | $ 2,516,114 |
| Work in process | 69,667 | 144,390 |
| Packaging materials | 531,109 | 398,463 |
| Raw materials | 898,614 | 809,696 |
| Total inventories | $ 4,740,795 | $ 3,868,663 |

**3. Line of Credit Borrowings**

Short-term borrowings include the following:

| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| U.S. line of credit | $854,144 | $ 1,080,561 |

**U.S. Line of Credit**

On January 31, 2005, the Company entered into a three year revolving credit facility agreement (the Agreement ) with a new U.S. lender for a maximum principal amount of $2,000,000. The Agreement replaces a $2,000,000 revolving credit facility that expired on January 31, 2005. Advances will be utilized to fund strategic

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes To Condensed Consolidated Financial Statements (Unaudited)

initiatives and general working capital requirements. The Company incurred loan origination and legal fees of $147,300 in connection with the implementation of the Agreement. These fees have been deferred and are being amortized to interest expense over the three year term of the Agreement.

The Company may request advances under the Agreement up to the value of 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, 2006 the effective interest rate was 10.25%. 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 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 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 Agreement, the Company has agreed to comply with financial covenants governing minimum EBITDA (earnings before interest, taxes, depreciation and amortization) and its fixed charge ratio (EBITDA divided by the sum of debt service, capital expenditures, income taxes and dividends), measured at the end of each month for the average of the three most recent calendar months based upon its consolidated operating results. As it pertains to the Company s U.S. operations, cash collections may not be less than a defined amount each calendar month. In addition, at all times the Company s cash on hand (including unused borrowing capacity under the 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 Agreement.

Based upon consolidated operating results for October 2005 through February 2006, the Company was out of compliance with its EBITDA and fixed charge ratio covenants as amended effective June 30, 2005. For a fee of $20,000, the U.S. lender agreed to waive these covenant violations and to work with the Company to amend the existing covenants going forward. On April 18, 2006, the Company amended its financial covenants effective March 31, 2006 in connection with the amendment to the Agreement as part of the Western Medical, Inc. asset purchase (see Note 10). As of March 31, 2006, the Company was in compliance with its amended covenants.

The Company may terminate the Agreement at any time 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 Agreement divided by 12.

**Canadian Line of Credit**

In November 2005, the Company finalized the annual renewal of its revolving credit facility (the Canadian Agreement ) for a maximum principal amount of $685,000 ($800,000 Canadian) with its Canadian lender. In light of the favorable impact of the new distribution agreement on the borrowing requirements of the Company s wholly owned Canadian subsidiary, Derma Sciences Canada Inc., the maximum principal amount of the credit facility was reduced in line with the subsidiary s prospective maximum borrowing capacity. The next annual review is expected to be completed in the second quarter, 2006. 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 $342,000 ($400,000 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 6.5% for Canadian dollar advances and 9.25% for U.S. dollar denominated advances at March 31, 2006. 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.

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes To Condensed Consolidated Financial Statements (Unaudited)

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 $428,000 ($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.

**4. Long-Term Debt**

Long-term debt includes the following:

| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Canadian term loan | $ 472,448 | $ 533,809 |
| Capital lease obligations | 127,910 | 140,609 |
| Total debt | 600,358 | 674,418 |
| Less: current maturities | 289,227 | 285,945 |
| Long-term debt | $ 311,131 | $ 388,473 |

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 its Canadian lender. 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 6.75% at March 31, 2006. 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 Canadian operating line of credit (see Note 3).

The Company has three capital lease obligations for certain distribution and computer equipment totaling $127,910 as of March 31, 2006. The capital leases bear interest at annual rates ranging from 3.9% to 10.2% with the longest lease term expiring in April 2009.

**5. Shareholders Equity**

**Preferred Stock**

There are 150,003 shares of series A convertible preferred stock outstanding at March 31, 2006. 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, 2006. The series B preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $6.00 per share, votes as a class on matters affecting the series B preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 619,055 shares of series C convertible preferred stock outstanding at March 31, 2006. 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, 2006. The series D preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes To Condensed Consolidated Financial Statements (Unaudited)

liquidation preference averaging $0.50 per share, votes as a class on matters affecting the series D preferred stock and maintains voting rights identical to the common stock on all other matters.

**Common Stock**

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 received. The offering commenced prior to December 31, 2004. In 2005, the Company sold 1,205,000 units at $0.50 per unit and received total offering proceeds of $547,797, net of $54,703 in offering expenses. Proceeds from the offering were used for working capital.

**Stock Options**

The Company adopted the Stock Option Plan (the Plan ) July 18, 1991 and amended the Plan January 14, 1994, May 22, 1996, July 14, 1998, February 6, 2003 and February 24, 2004. The number of shares of Common Stock reserved for issuance pursuant to the Plan is 3,500,000 shares. The Plan authorizes the Company to grant two types of equity incentives: (i) options intended to qualify as incentive stock options ( ISOs ) as defined in Section 422 of the Internal Revenue Code of 1986, as amended, and (ii) nonqualified stock options ( NQSOs ). The Plan authorizes options to be granted to directors, officers, key employees and consultants of the Company, except that ISOs may be granted only to employees. The Plan is administered by a committee of disinterested directors designated by the Board of Directors (the Compensation Committee ). Subject to the provisions of the Plan, the Compensation Committee determines who is eligible to receive stock options, together with the nature, amount, timing, exercise price, vesting schedule and all other terms and conditions of the options to be granted.

Under the Plan, ISOs and NQSOs may have a term of up to ten years. Stock options are not assignable or transferable except by will or the laws of descent and distribution. Stock options granted under the Plan which have lapsed or terminated revert to the status of unissued and become available for reissuance. Stock options granted generally vest 25% at the date of grant and 25% on each anniversary date of grant until fully vested. The option exercise price is invariably established at the fair market value of the common stock on the date of grant.

At March 31, 2006, options to purchase 3,426,625 shares of the Company s Common Stock at prices in the range of $0.37 to $5.00 per share were issued and outstanding under the Plan. In addition to options granted under the Plan, at March 31, 2006 there are 2,736,655 options granted outside the Plan that were not approved by shareholders.

During the three months ended March 31, 2006 and 2005, the Company issued stock options as outlined below:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2006 | 2005 |
| Number of stock options issued | 390,000 | 1,021,000 |
| Average exercise price | $0.70 | $0.50 |

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes To Condensed Consolidated Financial Statements (Unaudited)

The fair value of each option award is estimated at the date of grant using the Black-Scholes option pricing model. The weighted-average assumptions for the three months ended March 31, 2006 and 2005 were as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2006 | 2005 |
| Risk-free interest rate | 4.60% | 4.25% |
| Volatility factor | .675 | 1.376 |
| Dividend yield | 0% | 0% |
| Expected option life (years) | 5 | 5 |
| Contractual life (years) | 10 | 10 |

The risk-free rate utilized represents the five year U.S. Treasury yield curve rate at the time of grant and coincides with the expected option life. The three months ended March 31, 2006 volatility factor is calculated based on the twenty-four month-end closing prices of the Company s common stock preceding the month of stock option grant. The twenty-four month time period was selected since it is representative of the Company s common stock price volatility. The dividend yield is 0% since the Company does not anticipate paying dividends in the near future. The expected option life of five years is one-half of the option contractual life and has been consistently utilized by the Company.

A summary of option activity as of March 31, 2006, and changes during the three months then ended, is presented below:

| Options | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at January 1, 2006 | 5,773,280 | $0.92 | | |
| Granted | 390,000 | $0.70 | | |
| Forfeited or expired | - | - | | |
| Outstanding at March 31, 2006 | 6,163,280 | $0.90 | 6.7 | $267,850 |
| Exercisable at March 31, 2006 | 5,889,530 | $0.91 | 6.5 | $267,850 |

The weighted average grant-date fair values of options granted during the three months ended March 31, 2006 and 2005 were $163,800, or $0.42 per option, and $170,226, or $0.17 per option, respectively.

As of March 31, 2006, there was $110,822 of total unrecognized compensation cost related to nonvested share-based awards granted under the Plan. That cost is expected to be recognized over the options remaining weighted average vesting period of 2.9 years.

During the three months ended March 31, 2006, stock option compensation expense was recorded using the fair value method under SFAS 123R as follows:

| | |
|---|---|
| Cost of sales | $ 6,251 |
| Distribution | 573 |
| Sales | 5,109 |
| General and administrative | 26,692 |
| Total stock option compensation expense | $38,625 |

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes To Condensed Consolidated Financial Statements (Unaudited)

For the three months ended March 31, 2006, no income tax benefit was recognized.

The Company s net loss and loss per common share and pro forma net loss and loss per common share assuming compensation expense had been determined for the three months ended March 31, 2005 based on the fair value at the grant date for all awards, using the Black-Scholes option pricing model consistent with the provisions of SFAS 123 and SFAS 123R, and amortized ratably over the vesting period, instead of the instrinsic value method under APB 25, are set forth below:

| | Quarter Ended March 31, 2005 |
|---|---|
| Net loss as reported | $ (213,052) |
| Pro forma compensation expense | (170,226) |
| Pro forma net loss | $ (383,278) |
| Loss per common share basic and diluted | |
| As reported | $(0.02) |
| Pro forma | $(0.03) |

**Stock Purchase Warrants**

 