DERMA SCIENCES INC
Form 10QSB
November 14, 2001

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For Quarter Ended	September 30, 2001
Commission File Number	1-31070

Derma Sciences, Inc.

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

Pennsylvania	**23-2328753**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

214 Carnegie Center, Suite 100
Princeton, New Jersey 08540
(609) 514-4744
(Address including zip code and telephone number, of principal executive offices)

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

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

Date: September 30, 2001	Class: Common Stock, par value $.01 per share Shares Outstanding: 2,407,109

DERMA SCIENCES, INC.

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DERMA SCIENCES, INC.

Consolidated Balance Sheets (Unaudited)

ASSETS	September 30, 2001	December 31, 2000
		(Restated)
Current Assets		
Cash and cash equivalents	$ 556,395	$ 424,165
Restricted cash	580,455	640,000
Accounts receivable, net	1,011,681	1,561,633
Inventories, net	1,165,032	1,282,370
Prepaid expenses and other current assets	118,605	75,916
Total current assets	3,432,168	3,984,084
Property and equipment, net	183,638	204,029
Goodwill, patents and trademarks	1,299,741	1,392,495
Total Assets	$ 4,915,547	$ 5,580,608
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Bank line of credit	$ 580,455	$ 640,000
Accounts payable	303,393	977,080
Accrued expenses and other current liabilities	389,006	501,922
Convertible bonds, net of bond discount	435,000	
Total current liabilities	1,707,854	2,119,002
Long-term liabilities		
Convertible bonds	-	475,000
Total Liabilities	1,707,854	2,594,002
Shareholders' Equity		
Common stock, $.01 par value, 30,000,000 shares authorized; issued and outstanding: 2,407,109 shares in 2001; 2,120,940 shares in 2000	24,071	21,209
Convertible preferred stock, $.01 par value; 11,750,000 shares authorized; issued and outstanding: 1,960,009 shares in 2001; 2,189,178 shares in 2000	19,600	21,892
Additional paid-in capital	13,987,882	13,866,849
Accumulated deficit	(10,823,860)	(10,923,344)
Total Shareholders' Equity	3,207,693	2,986,606
Total Liabilities and Shareholders' Equity	$ 4,915,547	$ 5,580,608

See accompanying notes.

DERMA SCIENCES, INC.

Consolidated Statement of Operations (Unaudited)

	Three months ended September 30, 2001	2000
		(Restated)
NET SALES	$ 2,090,486	$ 2,358,399
Cost of sales	1,004,616	1,198,799
GROSS PROFIT	1,085,870	1,159,600
Operating expenses	982,545	1,389,206
Other expense, net (including interest expense of $56,289 and $668,243 in 2001 and 2000)	25,063	650,083
TOTAL EXPENSES	1,007,608	2,039,289
Income (loss) before provision for income taxes	78,262	(879,689)
Provision for income taxes	8,971	-
NET INCOME (LOSS)	$ 69,291	$ (879,689)
Income (loss) per common share - basic	$ 0.03	$ (0.42)
Income (loss) per common share - fully diluted	$ 0.02	$ (0.42)
Shares used in computing income (loss) per common share - basic	2,407,109	2,075,940
Shares used in computing income (loss) per common share - fully diluted	4,445,805	2,075,940

See accompanying notes.

DERMA SCIENCES, INC.

Consolidated Statement of Operations (Unaudited)

	Nine months ended September 30, 2001	2000
		(Restated)
NET SALES	$ 6,843,352	$ 7,010,019
Cost of sales	3,509,266	3,402,732
GROSS PROFIT	3,334,086	3,607,287

Operating expenses	3,130,025	4,355,311
Other expense, net (including interest expense of $180,791 and $1,152,429 in 2001 and 2000)	92,577	1,103,107
TOTAL EXPENSES	3,222,602	5,458,418
Income (loss) before provision for income taxes	111,484	(1,851,131)
Provision for income taxes	12,000	-
NET INCOME (LOSS)	$ 99,484	$(1,851,131)
Income (loss) per common share - basic	$ 0.04	$ (1.15)
Income (loss) per common share - fully diluted	$ 0.02	$ (1.15)
Shares used in computing income (loss) per common share - basic	2,381,646	1,612,976
Shares used in computing income (loss) per common share - fully diluted	4,398,341	1,612,976

See accompanying notes.

DERMA SCIENCES, INC.

Consolidated Statement of Cash Flows (Unaudited)

	Nine months ended September 30,	
	2001	2000
		(Restated)
OPERATING ACTIVITIES		
Net income (loss)	$ 99,484	$(1,851,131)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	150,032	214,683
Non-cash financing costs	120,000	1,031,367
Provision for bad debts and rebates	76,326	100,000
Provision for inventory obsolescence	57,308	-
Changes in operating assets and liabilities		
Restricted cash	59,545	10,000
Accounts receivable	473,626	173,699
Inventories	60,030	133,356
Prepaid expenses and other current assets	(42,689)	(197,767)
Accounts payable	(673,687)	(326,690)
Accrued expenses and other current liabilities	(112,916)	170,708
Net cash provided by (used in) operating activities	267,059	(541,775)
INVESTING ACTIVITIES		
Purchases of property and equipment	(36,887)	(12,764)
Net cash used in investing activities	(36,887)	(12,764)
FINANCING ACTIVITIES		

Net change in bank line of credit	(59,545)	(10,000)
Proceeds from issuance of convertible securities	-	150,000
Proceeds from the issuance of stock, net of issuance costs	(38,397)	381,396
Net cash (used in) provided by financing activities	(97,942)	521,396
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	132,230	(33,143)
Cash and cash equivalents		
Beginning of period	424,165	571,691
End of period	$556,395	$ 538,548
Supplemental cash flow information		
Conversion of bonds payable to preferred stock	-	$ 1,000,000
Conversion of accounts payable to common stock	-	$ 45,000
Common stock and warrants issued for debt extension	$160,000	-

See accompanying notes.

DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiary (the Company) is a full line provider of advanced wound care, wound closure-fasteners and skin care products. The Company markets its products principally through independent distributors servicing the long-term care, home health and acute care markets in the United States and select international markets.

Restatements

Subsequent to the filing of its Annual Report on Form 10-KSB for the year ended December 31, 2000 with the Securities and Exchange Commission, and its Quarterly Report on Form 10-QSB for the quarter ended March 31, 2001, the Company became aware that certain beneficial conversion features and consideration associated with the issuance of Series C Convertible Bonds and Series D Convertible Bonds were not correctly accounted for during the years ended December 31, 2000 and 1999. The Company determined that additional interest expense should have been recorded related to the beneficial conversion features and consideration given in 2000 and 1999.

The Company has restated its financial statements for the years ended December 31, 2000 and 1999, and for interim periods, as appropriate. The impact of the restatement in 2000 was to increase interest expense (recorded in other expense, net) by $1,143,866. Net loss increased to $2,581,337 from $1,437,471 and net loss per share increased $0.66 per share to $1.48 from $0.82. The restatement also results in unamortized bond discount of $732,387 at December 31, 1999 and an increase in additional paid-in capital at December 31, 2000 and 1999 of $1,736,479 and $1,325,000, respectively.

The following is a summary of the effects of the restatement for the three and nine months ended September 30, 2000:

	Three Months Ended September 30, 2000		Nine Months Ended September 30, 2000	
	As Reported	As Restated	As Reported	As Restated
Other expense, net	$ 11,538	$650,083	$ 71,741	$1,103,107
Net loss	($241,144)	($879,689)	($819,765)	($1,851,131)

Loss per common share basic and diluted	($0.12)	($0.42)	($0.51)	($1.15)
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Basis of Presentation

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-QSB and Item 310(b) of Regulation S-B. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2001, are not necessarily indicative of the results that may be expected for the year ending December 31, 2001. For further information, refer to the financial statements and footnotes thereto for the year ended December 31, 2000, included in Form 10-KSB/A-1 filed with the Securities and Exchange Commission.

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

Summary of Significant Accounting Policies

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

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

Cash and Cash Equivalents The Company considers cash and cash equivalents as amounts on hand, on deposit in financial institutions and highly liquid investments purchased with an original maturity not greater than three months.

Net Income and 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 fully diluted reflects the potential dilution of earnings by including other common stock equivalents, including stock options, warrants, convertible preferred stock and convertible bonds in the weighted average number of common shares outstanding for a period, if dilutive.

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

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

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

The majority of goodwill and other intangible assets represents goodwill obtained in the acquisition of Sunshine Products, Inc. in 1998. The Company does not believe that the goodwill is impaired. However, an impairment charge would be recognized if the Company expected that the present value of future earnings from Sunshine Products, Inc. did not exceed the unamortized goodwill.

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets,* effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill will no longer be amortized, but will be subject to an annual impairment test in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

The Company will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of 2002. During 2002, the Company will perform the first required impairment test of goodwill as of January 1, 2002 and has not yet determined what effect this test will have on the earnings and financial position of the Company.

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

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

2. Accounts Receivable

Accounts Receivable comprise the following:

	September 30, 2001	December 31, 2000
Trade accounts receivable	$1,374,080	$1,725,001
Less: Allowance for doubtful accounts and trade rebates	(380,000)	(310,000)
Net trade receivables	994,080	1,415,001
Other receivables	17,601	146,632
Total receivables	$1,011,681	$1,561,633

3. Inventories

Inventories comprise the following:

	September 30, 2001	December 31, 2000
Finished goods	$ 789,604	$ 919,872
Packaging materials	198,678	309,245
Raw materials	366,750	201,253
Gross inventory	1,355,032	1,430,370
Less: Reserve for obsolescence	(190,000)	(148,000)
Net inventory	$1,165,032	$1,282,370

4. Property and Equipment

Property and equipment comprise the following:

	September 30, 2001	December 31, 2000

Machinery and equipment	$ 357,723	$ 320,836
Furniture and fixtures	668,336	668,336
Gross property and equipment	1,026,059	989,172
Less: Accumulated depreciation	(842,421)	(785,143)
Net property and equipment	$ 183,638	$ 204,029

5. Goodwill, Patents and Trademarks

Goodwill, patents and trademarks comprise the following:

	September 30, 2001	December 31, 2000
Goodwill	$1,497,364	$1,497,364
Patents and trademarks	451,417	451,417
Gross goodwill, patents and trademarks	1,948,781	1,948,781
Less: Accumulated amortization	(649,040)	(556,286)
Net goodwill, patents and trademarks	$1,299,741	$1,392,495

The unamortized portion of goodwill was $1,137,467 and $1,216,967 at September 30, 2001 and December 31, 2000, respectively.

6. Bank Line of Credit

The Company has a $1,000,000 bank line of credit facility with $580,455 and $640,000 outstanding at September 30, 2001 and December 31, 2000, respectively. The line of credit agreement requires monthly interest payments at prime minus 1%, or 5.75%, at September 30, 2001. Cash deposited with the bank of $1,000,000 secures the line of credit.

Restricted cash of $580,455 and $640,000 collateralized the outstanding line of credit balance at September 30, 2001 and December 31, 2000, respectively.

7. Convertible Bonds

Convertible bonds comprise the following:

	September 30, 2001	December 31, 2000
Series C Bonds	$ 25,000	$ 25,000
Series D Bonds	450,000	450,000
Gross convertible bonds	475,000	475,000

Less bond discount	40,000	-
	------	-------
Net convertible bonds	$435,000	$475,000
	========	========

On August 16, 1999, the Company completed a private placement of its Series C Convertible Bonds (Series C Bonds) in which an aggregate of $875,000 was raised. The Series C Bonds pay interest only, at New York prime, until maturity.

Each Series C Unit consists of one share of Series C Preferred Stock convertible into one share of Common Stock and one warrant to purchase one share of Common Stock at $1.10 per share. In March 2000, bondholders owning $475,000 in aggregate principal amount of the Series C Bonds converted the principal of their Series C Bonds into Series C Units at the rate of $1.10 per Unit. In March, 2000, the bondholders extended the maturity of the Series C Bonds from the original maturity date of August 15, 2000 until January 7, 2001.

In July 2000, bondholders owning $375,000 in aggregate principal amount of the Series C Bonds converted the principal of their Series C Bonds into modified Series E Units at the rate $0.75 per Unit. Each modified Series E Unit consists of one share of Series C Preferred Stock and one and one tenth warrants to purchase one share of Common Stock at $0.85 per share. Investors who converted their bonds in March 2000 have had their conversions adjusted so as to receive conversion terms similar to those of the July 2000 conversion.

In December 1999, the Company received $450,000 of a total of $600,000 in subscriptions for its Series D Convertible Bonds (Series D Bonds). Payments of $50,000 and $100,000 representing the balance of these subscriptions were received in January and February, 2000, respectively. The Series D Bonds pay interest only, at New York prime, until maturity.

Each Series D Unit consists of one share of Series D Preferred Stock convertible into one share of Common Stock and one warrant to purchase one share of common stock at $1.01 per share. In March 2000, bondholders owning $150,000 in aggregate principal amount of the Series D Bonds converted the principal of their

Series D Bonds into Series D Units at the rate of $1.0125 per Unit. In March 2000, the bondholders extended the maturity of the Series D Bonds from the original maturity date of December 31, 2000 until January 7, 2001. Investors who converted their bonds in March 2000 have had their conversions adjusted so as to receive conversion terms similar to those of the July 2000 conversion of Series C Bonds.

The total expense recognized for the beneficial conversion features and other consideration given in connection with the original issuance and subsequent reset of the conversion terms of the Series C and Series D convertible bonds in 2000 and 1999 was $1,143,866 and $592,613, respectively.

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

8. Shareholders Equity

Preferred Stock

There are 272,503 shares of Series A Convertible Preferred Stock (Series A Preferred) outstanding. The Series A Preferred is convertible into Common Stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $4.00 per share, votes as a class on matters affecting the Series A Preferred and maintains voting rights identical to the Common Stock on all other matters.

There are 554,171 shares of Series B Convertible Preferred Stock (Series B Preferred) outstanding. The Series B Preferred is convertible into Common Stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $6.00 per share, votes as a class on matters affecting the Series B Preferred and maintains voting rights identical to the Common Stock on all other matters.

There are 1,000,001 shares of Series C Convertible Preferred Stock (Series C Preferred) outstanding. The Company s directors, on February 10, 2000, designated 795,457 shares of the Company s non-designated preferred stock as Series C Preferred. The directors, on July 17, 2000, designated an additional 437,878 shares of non-designated preferred stock as Series C Preferred. The Series C Preferred is a component of the Company s Series C Units described above under Convertible Bonds Series C. The Series C Preferred is convertible into Common Stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $1.10 per share, votes as a class on matters affecting the Series C Preferred and maintains voting rights identical to the Common Stock on all other matters.

There are 133,334 shares of Series D Convertible Preferred Stock (Series D Preferred) outstanding. The Company s directors, on February 10, 2000, designated 592,597 shares of the Company s non-designated preferred stock as Series D Preferred. The Series D Preferred is a component of the Company s Series D Units described above under Convertible Bonds Series D. The Series D Preferred is convertible into Common Stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $1.0125 per share, votes as a class on matters affecting the Series D Preferred and maintains voting rights identical to the Common Stock on all other matters.

Series E Financing

On August 11, 2000, the Company completed a private placement of its Series E Units in which an aggregate of $500,000 was raised. The Series E Units each consist of one share of Common Stock and one and one tenth Series E Warrants to purchase one share of Common Sock at $0.85 per share (Series E Warrants). The warrants will expire on July 18, 2005. An additional 733,336 Series E Warrants were issued in connection with the Series E Common Stock private placement.

Stock Purchase Warrants

At September 30, 2001, the Company had 4,361,683 warrants outstanding and/or reserved for issuance to purchase the Company s common stock as outlined below:

Series	Number of Warrants	Exercise Price	Expiration Date
A	450,002	$4.50	November 15, 2001
B	666,672	$6.75	June 15, 2002
E	2,200,009	$0.85	July 18, 2005
F	1,045,000	$0.57	July 18, 2005

Other Equity Transactions

In March 2000, 83,334 shares of Series B Preferred Stock were converted into 83,334 shares of Common Stock. In January 2001, 57,000 shares of Common Stock were issued as consideration for extending the maturity date of the Convertible Bonds. In February 2001, a total of 229,169 shares of Series B, C and D Preferred Stock were converted into 229,169 shares of Common Stock.

9. Income Taxes

The Company has established a provision of $12,000 for estimated federal and state income taxes due based upon operating income through September 30, 2001. The provision differs from statutory federal and state rates due primarily to the use of available net operating loss carryforwards.

At December 31, 2000, the Company has net operating loss carryforwards of approximately $7,100,000 for federal income tax purposes that begin to expire in years 2012 through 2020. For state income tax purposes, the Company has net operating loss carryforwards of $7,100,000 that expire in years 2004 through 2010. During 1998 the Company had a change in control as defined by the Internal Revenue Code Section 382. Consequently, certain limitations may apply to the timing and amount of the utilization of such net operating loss carryforwards.

10. Operating Segments

The Company consists of three operating segments, wound care, wound closure-fasteners and skin care. Products in the wound care segment consist of dressings, ointments and sprays designed to treat chronic wounds. Wound closure-fasteners products include wound closure strips, a variety of catheter fasteners and net dressings. The skin care segment consists of 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 wound care and wound closure-fastener products is primarily outsourced. Skin care products are manufactured in-house. 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 nine months ended September 30, 2001 and 2000 are as follows:

	Nine Months Ended September 30, 2001				
	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company
Sales	$2,241,948	$2,196,836	$2,404,568	---	$ 6,843,352
Gross profit	1,727,218	1,097,781	509,087	---	3,334,086
Total expenses	---	---	---	($3,222,602)	(3,222,602)
Income taxes	---	---	---	(12,000)	(12,000)
Net income					$ 99,484

	Nine Months Ended September 30, 2001				
	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company
Sales	$1,863,309	$2,296,443	$2,850,267	---	$ 7,010,019
Gross profit	1,379,165	1,333,708	894,414	---	3,607,287
Total expenses	---	---	---	($5,458,418)	(5,458,418)
Income taxes	---	---	---	---	---
Net loss					($ 1,851,131)

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

International sales for the nine months ended September 30 were $460,200 in 2001 and $353,600 in 2000. Wound closure-fastener sales represent the majority of international sales.

DERMA SCIENCES, INC.

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

QUARTER ENDED SEPTEMBER 30, 2001 COMPARED TO QUARTER ENDED SEPTEMBER 30, 2000

Results of Operations

Net Sales decreased $267,913, or 11.4%, to $2,090,486 in the third quarter 2001 from $2,358,399 in the third quarter 2000. Gross profit margins increased to 51.9% in the third quarter 2001 from 49.2% in the third quarter 2000. Operating expenses decreased $406,661, or 29.3%, in the third quarter 2001 to $982,545 from $1,389,206 in the third quarter 2000. Other expenses, net decreased $625,020 in the third quarter 2001 to $25,063 from $650,083 in the third quarter 2000. Net income of $69,291 was generated in the third quarter of 2001 versus a loss of $879,689 in the third quarter 2000.

Sales Overview

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

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

	Quarter Ended September 30,	
	2001	2000
Gross Sales	$2,300,940	$2,701,368
Trade rebates	(147,827)	(273,743)
Cash discounts	(43,877)	(49,126)
Medicaid rebates	(18,750)	(20,100)
Net Sales	$2,090,486	$2,358,399

Gross sales were down $400,428, or 14.8%, quarter to quarter reflecting lower skin care sales associated principally with the loss of the Beverly Contract and lower wound closure- fastener sales related to lower Percu-Stay sales, partially offset by stronger wound care sales. Trade rebates were down due principally to the reduction in rebate intensive Beverly skin care sales.

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

	Quarter Ended September 30,			
	2001	2000	Variance	
Product Line				
Wound care	$ 824,529	$ 570,917	$ 253,612	44.4%
Wound closure-fasteners	591,129	812,032	(220,903)	(27.2%)
Skin care	674,828	975,450	(300,622)	(30.8%)

Total	$2,090,486	$2,358,399	$(267,913)	(11.4%)

Net sales were down $267,913, or 11.4%, to $2,090,486 in the third quarter 2001 versus $2,358,399 in the third quarter 2000. Skin care sales decreased $300,622, or 30.8%, due principally to the loss of the Beverly supply agreement effective May 31, 2001. Wound closure-fastener sales decreased $220,903, or 27.2%, due principally to lower Percu-Stay sales that, in turn, were the results of a large customer s reduction of excess inventory. Wound care sales increased $253,612, or 44.4%, due to the continued success of the company s clinical education programs and focused sales efforts.

Net Sales, Cost of Sales and Gross Profit

The Company's net sales, cost of sales, gross profit and gross profit margins for the third quarter of 2001 and 2000 are outlined in the table below:

	Quarter Ended September 30,					
	2001		2000		Variance	
Net sales	$2,090,486	100.0%	$2,358,399	100.0%	($267,913)	(11.4%)
Cost of sales	1,004,616	48.1%	1,198,799	50.8%	194,183	(16.2%)
Gross profit	$1,085,870	51.9%	$1,159,600	49.2%	($ 73,730)	(6.4%)

Gross Profit decreased $73,730, or 6.4%, to $1,085,870 in the third quarter 2001 from $1,159,600 in the third quarter 2000, reflecting the decrease in sales partially offset by improving margins. The higher third quarter 2001 gross profit margin of 51.9% reflects a favorable mix of increased higher margined wound care sales coupled with reduced sales of lower margined Percu-Stay fasteners and Beverly skin care products. Price erosion in a competitive marketplace, product cost increases, the reclassification of certain skin care line operating expenses to cost of sales and the adverse impact of lower overall skin care volumes due to the loss of the Beverly contract adversely impacted third quarter 2001 margins.

Operating Expenses

Operating expenses decreased $406,661, or 29.3%, to $982,545 in the third quarter 2001 from $1,389,206 in the third quarter 2000. A summary of selling, marketing and general administrative expenses for the third quarter 2001 and 2000 are outlined in the table below.

	Quarter Ended September 30,			
	2001	2000	Variance	
Selling	$323,452	$ 478,382	($154,930)	(32.4%)
Marketing	93,178	140,904	(47,726)	(33.9%)
General Administrative	565,915	769,920	(204,005)	(26.5%)
Total	$982,545	$1,389,206	($406,661)	(29.3%)

Restructuring of the sales and marketing operations, together with implementation of company-wide cost reduction initiatives beginning in the second quarter 2000, are primarily responsible for the quarter to quarter decrease in operating expenses.

Other Expense, net

Other expense, net decreased $625,020 to $25,063 in the third quarter 2001 from $650,083 in the third quarter 2000. The decrease is attributable to a reduction in interest expense of $611,954 and higher miscellaneous income of $13,066. The lower interest expense reflects the absence in 2001 of $638,545 of debt refinancing expense incurred in the third quarter 2000 associated with the Company s Series C and D convertible bonds, lower

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outstanding 2001 note payable and convertible bond balances and lower overall interest rates. These reductions were partially offset by $40,000 of incremental interest associated with amortizing the consideration granted in 2001 to extend the maturity date of the outstanding Series C and D convertible bonds. Included in other miscellaneous income is a one-time $18,800 Medicaid adjustment together with recurring profit sharing and royalty income.

Provision for Income Taxes

A provision for federal and state income taxes of $8,971 was provided for in the third quarter 2001. The provision is at less than statutory rates given available net operating losses.

Net Income

The Company generated net income of $69,291, or $0.03 per share (basic), for the quarter ended September 30, 2001 compared to a net loss of $879,689, or $0.42 per share (basic), for the quarter ended September 30, 2000.

NINE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2000.

Results of Operations

Net Sales decreased $166,667, or 2.4%, to $6,843,352 in the nine months ended September 2001 from $7,010,019 in the nine months ended September 2000. Gross profit margins declined to 48.7% in the nine months ended September 2001 from 51.5% in the nine months ended September 2000. Operating expenses decreased $1,225,286, or 28.1%, in the nine months ended September 2001 to $3,130,025 from $4,355,311 in the nine months ended September 2000. Other expense, net decreased $1,010,530 in the nine months ended September 2001 to $92,577 from $1,103,107 in the nine months ended September 2000. Net income of $99,484 was generated in the nine months ended September 2001 versus a net loss of $1,851,131 in the nine months ended September 2000.

Sales Overview

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

	Nine Months Ended September 30,	
	2001	2000
Gross Sales	$7,658,838	$7,982,720
Trade rebates	(610,084)	(771,134)
Cash discounts	(149,152)	(138,220)
Medicaid rebates	(56,250)	(63,347)
Net Sales	$6,843,352	$7,010,019

Gross sales were down $323,882, or 4.1%, year-to-date reflecting lower skin care sales associated principally with the loss of the Beverly contract and lower third quarter wound closure-fastener sales related to the above mentioned Percu-Stay excess inventory reductions. Consistently strengthening quarterly wound care sales served to partially mitigate these declines. Trade rebates are down due principally to the reduction in rebate intensive Beverly skin care sales. Cash discounts are up due to more customers taking advantage of terms. While Medicaid sales are improving, rebates are down period to period due to lower sales.

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

Product Line	Nine Months Ended September 30, 2001	2000	Variance	
Wound care	$2,241,948	$1,863,309	$378,639	20.3%
Wound closure-fasteners	2,196,836	2,296,443	(99,607)	(4.3%)
Skin care	2,404,568	2,850,267	(445,699)	(15.6%)
Total	$6,843,352	$7,010,019	($166,667)	(2.4%)

Net sales were down $166,667, or 2.4%, in the first nine months of 2001 versus 2000. Wound care sales increased $378,639, or 20.3%, due to accelerating momentum created by the Company s clinical education program and focused sales efforts. Wound closure-fastener sales were down $99,607, or 4.3%, driven by a significant reduction in third quarter Percu-Stay sales. Excluding Percu-Stay sales, wound closure-fastener sales were essentially flat versus the previous year. Skin care sales were down $445,699, or 15.6%, versus the previous year. The decrease, which began in the second quarter, is principally due to the loss of the Beverly supply agreement effective May 31, 2001. To a lesser extent, skin care sales were adversely impacted by supply interruptions experienced late last year that continued into the first quarter of 2001.

Net Sales, Cost of Sales and Gross Profit

The Company s net sales, cost of sales, gross profit and gross profit margins for the nine months ended 2001 and 2000 are outlined in the table below:

	Nine Months Ended September 30, 2001		2000		Variance	
Net sales	$6,843,352	100.0%	$7,010,019	100.0%	($166,667)	(2.4%)
Cost of sales	3,509,266	51.3%	3,402,732	48.5%	(106,534)	(3.1%)
Gross profit	$3,334,086	48.7%	$3,607,287	51.5%	($273,201)	(7.6%)

Gross profit decreased $273,201, or 7.6%, to $3,334,086 in the first nine months of 2001 from $3,607,287 in the first nine months of 2000 reflecting lower sales and gross profit margins. Gross profit margins decreased to 48.7% in the first nine months of 2001 from 51.5% in the first nine months of 2000. Price erosion in a competitive market place, year-on-year product cost increases and the reclassification of certain skin care line operating expenses to cost of sales in 2001 contributed to the margin decrease. Further, in July 2000, the company granted a third party the exclusive right to market the Percu-Stay line of catheter fasteners to hospitals. The impact of this agreement was increased unit sales volume at lower per unit prices. While positively impacting profitability, the distribution agreement has adversely impacted the volume of wound care-fastener sales and the Company s overall gross profit margin.

While down versus the prior year, gross profit margins have improved steadily each quarter in 2001 reflecting increasing sales of higher margined wound care products coupled with decreasing sales of lower margined wound closure-fastener (Percu-Stay) and skin care (Beverly contract) products versus the prior year.

Operating Expenses

Operating expenses decreased $1,225,286, or 28.1%, to $3,130,025 in the first nine months of 2001 from $4,355,311 in the first nine months of 2000. A summary of selling, marketing and general administrative expenses for the nine months of 2001 and 2000 are outlined in the table below.

	Nine Months Ended September 30, 2001	2000	Variance	
Selling	$1,068,046	$1,925,179	($ 857,133)	(44.5%)
Marketing	288,139	539,487	(251,348)	(46.6%)
General Administrative	1,773,840	1,890,645	(116,805)	(6.2%)
Total	$3,130,025	$4,355,311	($1,225,286)	(28.1%)

Restructuring of the sales and marketing operations, together with implementation of company-wide cost reduction initiatives beginning in the second quarter 2000, are primarily responsible for the decrease. The decrease in general administrative expense has been somewhat mitigated by the re-establishment of the headquarters administrative staff.

Other Expense, net

Other expenses, net decreased $1,010,530 to $92,577 in the first nine months of 2001 from $1,103,107 in the first nine months of 2000. The decrease reflects a reduction in interest expense of $971,638 together with incremental miscellaneous income of $38,892. The lower interest expense reflects the absence in 2001 of $1,031,366 of debt refinancing expense incurred in 2000 associated with the Company s Series C and D convertible bonds, lower outstanding 2001 note payable and convertible bond balances and lower interest rates. These reductions were partially offset by $120,000 of interest associated with amortizing the consideration granted in 2001 to extend the maturity date of the outstanding Series C and D convertible bonds. Miscellaneous income includes one-time $31,300 Medicaid adjustments together with recurring profit sharing and royalty income.

Provision for Income Taxes

A provision for federal and state income taxes of $12,000 has been established in the first nine months of 2001 coincident with the Company s return to profitability. The provision is at less than corresponding statutory rates given the Company s available net operating losses.

Net Income

The Company generated net income of $99,484, or $0.04 per share (basic), for the first nine months of 2001 compared to a net loss of $1,851,131, or $1.15 per share (basic), for the first nine months of 2000.

Liquidity and Capital Resources

Operating results for the third quarter and nine months ended September 2001 versus the corresponding periods last year are positive. Sales are in line with expectations, operating expenses are down, cash flow is positive and the Company has achieved three consecutive quarters of profitability.

Third quarter sales were down versus the second quarter of 2001 but in line with expectations. Wound care sales continue to exhibit strong growth, increasing 12% quarter to quarter. Excluding Percu-Stay, wound closure-fasteners sales were down 10% due to market softness in September and backorders. Percu-Stay sales were down significantly as a large customer worked off excess inventory. Skin care sales were down 16% quarter to quarter reflecting the loss of Beverly sales commencing in June 2001. Excluding Beverly sales, skin care sales were consistent month to month during the third quarter. While gross margin dollars were down reflecting lower sales, gross margin percentages continued to improve in the third quarter versus the second quarter based upon a favorable sales mix. Higher margined wound care sales coupled with a decrease in lower margined wound closure-fastener and skin care sales are responsible. Operating expenses decreased 12% in the third quarter versus the second quarter due to ongoing cost reduction initiatives, several open positions during the quarter and the timing of certain expenses. All expense categories contributed. Other expense, net was slightly higher in the third quarter due to lower miscellaneous income items.

At September 30, 2001 and December 31, 2000, the Company had unrestricted cash and cash equivalents on hand of $556,395 and $424,165, respectively. Cash of $267,059 was provided by operations in the first nine months of 2001 versus $541,775 of cash used to fund operating activities in the first nine months of 2000. The Company s return to profitability and a significant improvement in the accounts receivable aging are principally responsible for the cash flow improvement. Excluding a reclassification of $435,000 of convertible bonds from long term to current, working capital improved $294,232, or 16%, to $2,159,314 at September 30, 2001 versus $1,865,082 at December 31, 2000.

As of January 5, 2001, bondholders owning an aggregate of $475,000 of the Company s Series C and Series D convertible bonds extended the maturity date of the bonds one year to January 7, 2002 in return for non-cash consideration valued at $160,000. This $160,000 of debt refinancing costs was recorded as bond discount and is being amortized to interest expense over the one-year maturity extension. Through September 30, 2001, $120,000 of bond discount has been amortized to interest expense. Prior to the bonds current maturity date of January 7, 2002, the Company expects to retire, convert or secure a long-term extension of the bonds maturity date.

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

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.

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Part II - Other Information

Item 1. Legal Proceedings

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits. All exhibits required by Item 601 of Regulation S-B and required hereunder, as filed with the Securities and Exchange Commission in Form 10-KSB/A-1 on August 10, 2001, are incorporated herein by reference.

(b) Reports on Form 8-K. No current reports on Form 8-K were filed by the registrant during the three month period ending September 30, 2001.

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

Dated: November 12, 2001

Vice President and Chief Financial Officer