

DERMA SCIENCES, INC.  
Form 10-Q  
August 07, 2015

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2015

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-31070

**Derma Sciences, Inc.**

(Exact name of registrant as specified in its charter)

Edgar Filing: DERMA SCIENCES, INC. - Form 10-Q

Delaware 23-2328753  
(State or other jurisdiction of Incorporation) (IRS employer identification number)

214 Carnegie Center, Suite 300

Princeton, NJ 08540

(Address of principal executive offices)

(609) 514-4744

(Issuer's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

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

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

Yes  No

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

Date: August 6, 2015 Class: Common Stock, par value \$.01 per share  
Shares Outstanding: 25,806,549

PART I – FINANCIAL INFORMATION

DERMA SCIENCES, INC.

FORM 10-Q

INDEX

Description	Page
<u>Part I – Financial Information</u>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated Balance Sheets (Unaudited) – June 30, 2015 and December 31, 2014</u>	2
<u>Consolidated Statements of Comprehensive Loss (Unaudited) – Three months ended June 30, 2015 and June 30, 2014</u>	3
<u>Consolidated Statements of Comprehensive Loss (Unaudited) – Six months ended June 30, 2015 and June 30, 2014</u>	4
<u>Consolidated Statements of Cash Flows (Unaudited) – Six months ended June 30, 2015 and June 30, 2014</u>	5
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	6
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	17
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	26
<u>Item 4. Controls and Procedures</u>	27
<u>Part II - Other Information</u>	
<u>Item 1. Legal Proceedings</u>	28
<u>Item 1A. Risk Factors</u>	28
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	30

<u>Item 3. Defaults upon Senior Securities</u>	30
<u>Item 4. Mine Safety Disclosures</u>	30
<u>Item 5. Other Information</u>	30
<u>Item 6. Exhibits</u>	30

**Part I – Financial Information****Item 1. Financial Statements.**

## DERMA SCIENCES, INC. AND SUBSIDIARIES

**Consolidated Balance Sheets (Unaudited)**

	<b>June 30, 2015</b>	<b>December 31, 2014</b>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 13,005,695	\$ 19,396,845
Short-term investments	45,000,230	55,996,000
Accounts receivable, net of allowances of \$713,962 and \$531,205, respectively	9,143,916	8,758,034
Inventories	17,545,944	13,280,940
Prepaid expenses and other current assets	1,572,907	3,411,934
Total current assets	86,268,692	100,843,753
Long-term investments	8,430,034	8,422,790
Equipment and improvements, net of accumulated depreciation and amortization of \$7,813,950 and \$7,681,863, respectively	3,883,087	3,614,439
Identifiable intangible assets, net of accumulated amortization of \$12,123,501 and \$10,631,372, respectively	11,323,375	12,815,504
Goodwill	13,457,693	13,457,693
Other assets	141,053	143,733
Total assets	\$ 123,503,934	\$ 139,297,912
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities		
Accounts payable	\$6,282,664	\$5,058,892
Accrued expenses and other current liabilities	4,752,998	6,452,358
Total current liabilities	11,035,662	11,511,250
Long-term liabilities	471,060	521,358
Deferred tax liability	1,789,313	1,700,640
Total liabilities	13,296,035	13,733,248
Commitments and contingencies (notes 9 and 10)		
Stockholders' Equity		
	733	733

Edgar Filing: DERMA SCIENCES, INC. - Form 10-Q

Convertible preferred stock, \$.01 par value; shares authorized 1,468,750; issued and outstanding 73,332 at June 30, 2015 and December 31, 2014 (liquidation preference of \$3,222,368 at June 30, 2015)

Common stock, \$.01 par value; shares authorized 50,000,000; issued and outstanding 25,806,549 at June 30, 2015 and 25,319,203 at December 31, 2014	258,065	253,192
Additional paid-in capital	233,129,197	228,341,542
Accumulated other comprehensive income	657,558	911,563
Accumulated deficit	(123,837,654)	(103,942,366)
Total stockholders' equity	110,207,899	125,564,664
Total liabilities and stockholders' equity	\$ 123,503,934	\$ 139,297,912

See accompanying notes to consolidated financial statements.

**DERMA SCIENCES, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Loss (Unaudited)**

	Three Months Ended June 30,	
	2015	2014
Net Sales	\$ 22,556,364	\$ 20,916,225
Cost of sales	14,185,116	13,071,408
Gross Profit	8,371,248	7,844,817
Operating Expenses		
Selling, general and administrative	13,701,728	12,631,590
Research and development	4,490,888	4,365,267
Total operating expenses	18,192,616	16,996,857
Operating loss	(9,821,368 )	(9,152,040 )
Other income, net	(880,514 )	(233,050 )
Loss before income taxes	(8,940,854 )	(8,918,990 )
Income tax provision (benefit)	344,857	(232,188 )
Net Loss	(9,285,711 )	(8,686,802 )
Other Comprehensive (Loss) Income		
Foreign currency translation adjustment	(102,652 )	117,750
Unrealized (loss) gain on equity securities, net of taxes	(4,347 )	862,685
Total other comprehensive (loss) income	(106,999 )	980,435
Comprehensive Loss	\$ (9,392,710 )	\$ (7,706,367 )
Net loss per common share – basic and diluted	\$ (0.36 )	\$ (0.34 )
Shares used in computing net loss per common share – basic and diluted	25,759,843	25,199,805

See accompanying notes to consolidated financial statements.



**DERMA SCIENCES, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Loss (Unaudited)**

	Six Months Ended June 30,	
	2015	2014
Net Sales	\$42,055,016	\$40,703,258
Cost of sales	26,148,642	25,946,117
Gross Profit	15,906,374	14,757,141
Operating Expenses		
Selling, general and administrative	26,998,363	25,681,143
Research and development	8,963,117	8,548,868
Total operating expenses	35,961,480	34,230,011
Operating loss	(20,055,106)	(19,472,870)
Other income, net	(512,726 )	(272,300 )
Loss before income taxes	(19,542,380)	(19,200,570)
Income tax provision (benefit)	352,908	(243,753 )
Net Loss	(19,895,288)	(18,956,817)
Other Comprehensive (Loss) Income		
Foreign currency translation adjustment	(258,463 )	(84,862 )
Unrealized gain on equity securities, net of taxes	4,458	486,010
Total other comprehensive (loss) income	(254,005 )	401,148
Comprehensive Loss	\$(20,149,293)	\$(18,555,669)
Net loss per common share – basic and diluted	\$(0.78 )	\$(0.79 )
Shares used in computing net loss per common share – basic and diluted	25,656,875	23,889,487

See accompanying notes to consolidated financial statements.

**DERMA SCIENCES, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (Unaudited)**

	Six Months Ended June 30,	
	2015	2014
<b>Operating Activities</b>		
Net loss	\$(19,895,288)	\$(18,956,817)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization of equipment and improvements	527,987	450,734
Amortization of identifiable intangible assets	1,492,129	1,480,998
Provision for bad debts	18,235	9,942
Allowance for sales adjustments	168,184	(5,642 )
Provision for inventory obsolescence	(47,474 )	65,069
Deferred rent	(43,506 )	(10,142 )
Stock-based compensation	2,868,808	3,495,944
Deferred income taxes	270,255	(219,514 )
Changes in operating assets and liabilities:		
Accounts receivable	(560,785 )	(521,797 )
Inventories	(4,555,063 )	(1,333,931 )
Prepaid expenses and other current assets	1,685,126	785,061
Other assets	(10 )	25,541
Accounts payable	1,333,982	89,676
Accrued expenses and other current liabilities	(1,782,281 )	(424,585 )
Net cash used in operating activities	(18,519,701)	(15,069,463)
<b>Investing Activities</b>		
Purchase of investments	(35,000,230)	(35,000,000)
Proceeds from sale of investments	45,996,000	19,981,000
Purchase of equipment and improvements	(964,061 )	(733,436 )
Purchase of intangible assets	-	(1,250,000 )
Net cash provided by (used in) investing activities	10,031,709	(17,002,436)
<b>Financing Activities</b>		
Proceeds from the sale of common stock, net of costs	-	80,616,032
Proceeds from exercise of stock options and warrants	1,991,130	2,245,782
Payment of withholding taxes related to employee stock-based compensation	(67,409 )	(121,618 )
Net cash provided by financing activities	1,923,721	82,740,196
Effect of exchange rate changes on cash and cash equivalents	173,121	(79,997 )
Net (decrease) increase in cash and cash equivalents	(6,391,150 )	50,588,300
Cash and cash equivalents		
Beginning of period	19,396,845	6,501,586
End of period	\$13,005,695	\$57,089,886
Supplemental disclosures of cash flow information:		
Issuance of a warrant in connection with a licensing agreement	\$-	\$129,750
Cash paid during the period for:		
Interest	\$119	\$5,442

See accompanying notes to consolidated financial statements.

5

## DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

Derma Sciences, Inc. and its subsidiaries (the “Company”) is a tissue regeneration company focused on three segments of the wound care marketplace: advanced wound care, traditional wound care and pharmaceutical wound care products. The Company has one drug candidate that initiated its Phase 3 study during the first quarter of 2013. The Company markets its products principally through direct sales representatives in the United States (“U.S.”), Canada and the United Kingdom (“U.K.”), and through independent distributors within other select international markets. The Company’s U.S. distribution facilities are located in St. Louis, Missouri and Houston, Texas. The Company utilizes third party distributors for distribution in Canada, Europe, Latin America, Asia and the Pacific. The Company has manufacturing facilities in Toronto, Canada and Nantong, China.

#### Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. Information included in the consolidated balance sheet as of December 31, 2014 has been derived from the consolidated financial statements and footnotes thereto for the year ended December 31, 2014, included in the Annual Report on Form 10-K previously filed with the Securities and Exchange Commission. For further information refer to the Annual Report on Form 10-K for the year ended December 31, 2014.

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

**Use of Estimates** – The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Although these

estimates are based on knowledge of current events and actions which may be undertaken in the future, actual results may ultimately differ from these estimates. Estimates and assumptions are required in the determination of sales deductions for trade rebates, sales incentives, discounts and allowances. Significant estimates and assumptions are also required in determining the appropriateness of amortization periods for identifiable intangible assets, the potential impairment of goodwill and the valuation of inventory.

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

**Net Loss per Share** – Net loss per common share – basic is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Net loss per common share – diluted reflects the potential dilution of earnings by including the effects of the assumed exercise, conversion or issuance of potentially issuable shares of common stock (“potentially dilutive securities”), including those attributable to stock options, warrants, convertible preferred stock and restricted stock units, in the weighted average number of common shares outstanding for a period, if dilutive. The effects of the assumed exercise of warrants and stock options are determined using the treasury stock method. Potentially dilutive securities have not been included in the computation of diluted loss per share for the three and six months ended June 30, 2015 and 2014 as the effect would be anti-dilutive.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

## Notes to Consolidated Financial Statements (Unaudited)

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

	Three and Six Months Ended June 30,	
	2015	2014
Excluded dilutive shares:		
Convertible preferred stock	73,332	73,332
Additional stock issuable related to conversion of preferred stock	49,782	49,782
Restricted share units	677,500	744,850
Warrants	1,755,330	2,143,584
Stock options	2,540,607	2,324,554
Total dilutive shares	5,096,551	5,336,102

**Recently Issued Accounting Pronouncements** – In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, *Revenue from Contracts with Customers*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. In July 2015, the FASB voted to defer the effective date of the new standard until fiscal years beginning after December 15, 2017 with early application permitted for fiscal years beginning after December 15, 2016. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

In April 2015, the FASB issued ASU No. 2015-05, *Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*, which provides criteria for customers in a cloud computing arrangement to use to determine whether the arrangement includes a license of software. The standard is effective for annual and interim periods in fiscal years beginning after December 15, 2015 for public business entities. Early adoption is permitted. The Company is evaluating the effect that ASU 2015-05 may have on its consolidated financial statements and related disclosures.

In July 2015, the FASB issued ASU No. 2015-11, *Simplifying the Measurement of Inventory*, which requires an entity that uses the first in first out method for inventory to report inventory cost at the lower of cost or net realizable value

versus the current measurement principle of lower of cost or market. The ASU requires prospective adoption for inventory measurements for fiscal years beginning after December 15, 2016. Early adoption is permitted. The Company is evaluating the effect that ASU 2015-11 may have on its consolidated financial statements and related disclosures.

## **2. Cash and Cash Equivalents and Investments**

### **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. Money market mutual funds consist of funds deposited into mutual funds investing in U.S. government and non-government obligations. The Company maintains cash and cash equivalents and money market mutual funds with various domestic and foreign financial institutions within the ordinary course of business, which at times may exceed jurisdictional insurance limits.

### **Investments in Debt Securities**

Investments in debt securities includes certificates of deposit purchased with an original maturity greater than three months which are deposited in various U.S. financial institutions and are fully insured by the Federal Deposit Insurance Corporation. The Company intends to hold the certificates of deposit to maturity and accordingly these investments are carried at amortized cost. Investments in debt securities with maturities greater than one year from the balance sheet date are classified as a long-term asset.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

**Investment in Equity Securities**

In 2013 and 2014, the Company purchased an aggregate 2,802,277 shares of Comvita Limited (“Comvita”) common stock for \$8,483,693. In conjunction with this investment, the Company’s chairman and chief executive officer was named to Comvita’s board of directors. At June 30, 2015, the 2,802,277 shares of Comvita common stock owned by the Company represented 7.1% of Comvita’s outstanding shares.

The investment in Comvita common stock is classified as an available-for-sale investment carried at fair value, with any unrealized gains and losses associated with the investment included in accumulated other comprehensive income and any dividends received recorded in other income. The investment is classified as a long term asset. As of June 30, 2015, the fair value of the Comvita common stock was \$8,430,034 as determined by the quoted market price of the outstanding stock on the New Zealand stock exchange. The cumulative decrease in fair value from cost of \$53,659 has been recorded in accumulated other comprehensive income, net of taxes.

Cash and cash equivalents and investments at June 30, 2015 and December 31, 2014 consisted of the following:

	June 30, 2015	December 31, 2014
Cash	\$ 12,152,935	\$ 7,665,958
Money market mutual funds	852,760	11,730,887
Cash and cash equivalents	13,005,695	19,396,845
Investments in debt securities	45,000,230	55,996,000
Investment in equity securities	8,430,034	8,422,790
Total investments	53,430,264	64,418,790
Total cash and cash equivalents and investments	\$ 66,435,959	\$ 83,815,635

The following table provides fair value information as of June 30, 2015:



	Total carrying value as of June 30, 2015	Fair Value Measurements, Using Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash and cash equivalents	\$ 13,005,695	\$ 13,005,695	\$ -	\$ -
Investments in debt securities	45,000,230	45,000,230	-	-
Investment in equity securities	8,430,034	8,430,034	-	-
Total investments	53,430,264	53,430,264	-	-
Total	\$ 66,435,959	\$ 66,435,959	\$ -	\$ -

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

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

**3. Inventories**

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

	June 30, 2015	December 31, 2014
Finished goods	\$ 14,119,038	\$ 8,386,356
Work in process	77,115	838,679
Packaging materials	1,950,225	1,343,927
Raw materials	1,399,566	2,711,978
Total inventory	\$ 17,545,944	\$ 13,280,940

**4. Accrued Expenses and Other Current Liabilities**

Accrued expenses and other current liabilities include the following:

	June 30, 2015	December 31, 2014
Accrued compensation and related taxes	\$ 1,729,056	\$ 2,930,525
Accrued Canadian sales rebate, net	121,945	633,162
Accrued royalties	571,212	463,823
Accrued sales incentives and other fees	487,995	557,918
Accrued research and development	610,315	844,230
Other	1,232,475	1,022,700
Total accrued expenses and other current liabilities	\$ 4,752,998	\$ 6,452,358

**5. Stockholders' Equity**

## **Preferred Stock**

Subsequent to the issuances of the preferred stock, the Company has undertaken a number of common stock offerings that impact the preferred stock conversion ratios. As of June 30, 2015, current Series A and B preferred stockholders holding 73,332 preferred shares are entitled to receive an aggregate of 123,114 shares (49,782 additional shares) of common stock upon conversion of their holdings, as a result of the conversion ratio adjustments. The number of shares issuable upon conversion is subject to further adjustment should the Company in the future undertake one or more offerings of its common stock at less than the prevailing market price.

The 49,782 incremental shares associated with the conversion ratio adjustments will be recorded to common stock upon conversion at par with the offset to additional paid in capital as all of the convertible preferred stock was issued prior to the November 16, 2000 effective date of certain provisions of Accounting Standards Codification 470 (formerly Emerging Issues Task Force Issue No. 00-27 *Application of Issue No. 98-5 to Certain Convertible Instruments*).

## **Common Stock**

During the six months ended June 30, 2015, the Company issued 487,346 shares of common stock consisting of: 403,687 shares upon the exercise of stock purchase warrants and options for which the Company received \$1,991,130; and 83,659 shares in connection with the vesting of 90,850 restricted share units.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

**Stock Purchase Warrants**

At June 30, 2015, the Company had warrants outstanding to purchase shares of the Company's common stock consisting of the following:

Series	Number of Warrants	Exercise Price	Expiration Date
R	1,705,330	\$ 9.90	June 22, 2016
S	50,000	\$ 11.81	January 14, 2019
Total	1,755,330		

During the six months ended June 30, 2015, a total of 326,933 warrants were exercised on a for cash basis consisting of 133,333 Series Q, 100,000 Series N, and 93,600 Series O warrants. A total of 326,933 shares of common stock were issued in connection with the warrant exercises. During the six months ended June 30, 2015, a total of 6,821 warrants were forfeited consisting of 4,634 Series O warrants and 2,187 Series P warrants.

**Equity Based Compensation**

Under the Equity Incentive Plan (the "EIP Plan") the Company is authorized to issue 6,000,000 shares of common stock. The EIP Plan authorizes the Company to grant equity-based and cash-based incentive compensation in the form of stock options, stock appreciation rights, restricted shares, restricted share units, other share-based awards and cash-based awards, for the purpose of providing the Company's employees, non-employee directors and consultants with incentives and rewards for performance. At June 30, 2015, options to purchase 2,540,607 shares and 677,500 restricted share units were issued and outstanding under the EIP Plan and 1,751,339 shares were available for grant.

**Stock Options**

Edgar Filing: DERMA SCIENCES, INC. - Form 10-Q

The EIP Plan permits the granting of both incentive and nonqualified stock options to employees and nonqualified stock options to non-employee directors and consultants of the Company. The option exercise price may not be less than the fair market value of the stock on the date of the grant of the option. The duration of each option may not exceed 10 years from the date of grant.

For the three and six months ended June 30, 2015 and 2014, the fair value of each option award was estimated at the date of grant using the Black-Scholes option-pricing model. The weighted-average assumptions used were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,					
	2015	2014	2015	2014				
Risk-free interest rate	1.12	%	1.97	%	1.61	%	1.79	%
Volatility factor	36.8	%	61.9	%	45.7	%	63.2	%
Dividend yield	0	%	0	%	0	%	0	%
Expected option life (years)	3.59		6.25		5.69		5.89	

The risk-free rate utilized represents the U.S. treasury yield curve rate for the expected option life at the time of grant. The volatility factor was calculated based on the Company's historical stock price volatility equal to the expected life of the option at the grant date. The dividend yield is 0% since the Company does not anticipate paying dividends in the near future. The simplified expected option life method is used to determine the expected option life for Company employees and directors while the contractual option life period is utilized for consultants.

Based on the Company's historical experience of options that were forfeited before becoming fully vested, the Company has assumed an annualized forfeiture rate of 1.0% for all options. The Company will record additional expense if the actual forfeiture rate is lower than estimated, and will record a recovery of prior expense if the actual forfeiture rate is higher than estimated.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

## Notes to Consolidated Financial Statements (Unaudited)

A summary of the Company's stock option activity and related information for the six months ended June 30, 2015 is as follows:

	Options	Weighted Average <u>Exercise Price</u>
Outstanding – January 1, 2015	2,166,959	\$ 9.03
Granted	586,690	\$ 8.68
Forfeited	(59,524 )	\$ 11.49
Exercised	(128,518 )	\$ 4.19
Expired	(25,000 )	\$ 9.58
Outstanding – June 30, 2015	2,540,607	\$ 9.13
Expected to vest – June 30, 2015	2,515,201	\$ 9.13
Exercisable at June 30, 2015	1,768,034	\$ 8.61

During the six months ended June 30, 2015, the Company granted 428,690 service based options and 158,000 performance based options to Company employees and consultants. The weighted average fair value per share of options granted during the six months ended June 30, 2015 was \$3.86.

During the six months ended June 30, 2015, 128,518 stock options were exercised on a for-cash and cashless basis. A total of 76,754 shares of common stock were issued in connection with the stock option exercises. The intrinsic value of options exercised in 2015 was \$518,884.

During the three and six months ended June 30, 2015 and 2014, stock option compensation expense was recorded as follows:

Three Months Ended June 30,    Six Months Ended June 30,

Edgar Filing: DERMA SCIENCES, INC. - Form 10-Q

	2015	2014	2015	2014
Cost of sales	\$ 36,898	\$ 32,870	\$ 109,601	\$ 118,046
Selling, general and administrative expenses	540,568	623,336	1,324,646	1,836,158
Research and development	(2,605 )	82,385	44,184	103,171
Total stock option compensation expense	\$ 574,861	\$ 738,591	\$ 1,478,431	\$ 2,057,375

As of June 30, 2015, there was \$2,993,118 of unrecognized compensation cost related to nonvested service based awards and \$306,540 related to nonvested performance based awards. These costs are expected to be recognized over the options' remaining weighted average vesting period of 2.04 years and 0.51 years for the service and performance based awards, respectively.

### Restricted Share Units

The Company has issued service, performance and market-based restricted share units to employees, consultants and directors of the Company. Expense for restricted share awards is amortized on a straight-line basis over the awards' vesting period. The fair value of service and performance awards are determined using the quoted market price of the Company's common stock on the date of grant, while market-based performance awards are valued using a binomial/lattice pricing model.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

The following table summarizes the restricted share unit activity for the period:

	Number of Units	Weighted Average Fair Value
Unvested–January 1, 2015	651,883	\$ 8.47
Granted	122,500	7.09
Vested	(90,850 )	10.22
Forfeited	(6,033 )	10.75
Unvested–June 30, 2015	677,500	\$ 7.97

In connection with the vesting of restricted share unit awards during the six months ended June 30, 2015, 7,191 common stock shares with a fair value of \$67,409 were withheld in satisfaction of employee tax withholding obligations.

During the three months ended June 30, 2015 and 2014, restricted share unit compensation expense was \$666,966 and \$715,117, respectively, and for the six months ended June 30, 2015 and 2014, restricted share unit compensation expense was \$1,319,707 and \$1,390,033, respectively, and included in selling, general and administrative expense.

As of June 30, 2015, there was \$2,309,461 of unrecognized compensation cost related to unvested restricted share units. These costs are expected to be recognized over the restricted shares units' remaining weighted average vesting period of 0.60 years.

In May of 2015, in consideration of prior service to the Company, the Company granted a retiring director 15,000 stock options, accelerated the vesting of his unvested stock options and restricted share units, and extended the expiration date of his vested stock options from 90 days from his retirement date to the earlier of (i) 36 months from his retirement date or (ii) the awards' original expiration date. An additional \$70,670 of stock based compensation was recognized during the three months ended June 30, 2015 and included in selling, general and administrative expense in connection with the retirement.



During 2014, in consideration of a retiring director's prior service to the Company, the Company accelerated the vesting of his unvested stock options and restricted share units scheduled to vest in 2014, and extended the expiration date of his vested stock options from 90 days from his retirement date to 24 months from his retirement date. An additional \$48,536 of stock based compensation expense was recognized during the six months ended June 30, 2014 and included in selling, general and administrative expense in connection with the retirement.

### Shares Reserved for Future Issuance

At June 30, 2015, the Company had reserved the following shares of common stock for future issuance:

Convertible preferred stock (series A – B)	73,332
Additional stock issuable related to conversion of preferred stock (series A – B)	49,782
Common stock options outstanding	2,540,607
Common stock warrants outstanding	1,755,330
Restricted share units outstanding	677,500
Common stock equivalents available for grant	1,751,339
 Total common stock shares reserved	 6,847,890

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

**6. Accumulated Other Comprehensive Income**

The Company's accumulated other comprehensive income as of June 30, 2015 was as follows:

	Foreign Currency Translation <u>Adjustments</u>	Unrealized Loss on Equity <u>Securities</u>	Total
Balance at January 1, 2015	\$ 1,001,298	\$ (89,735 )	\$ 911,563
Current period - other comprehensive (loss) income	(258,463 )	4,458	(254,005)
Balance at June 30, 2015	\$ 742,835	\$ (85,277 )	\$ 657,558

**7. Operating Segments**

The Company operates in three segments: advanced wound care, traditional wound care and pharmaceutical wound care products. They are managed separately as each segment requires different technology, marketing and sales strategies. Advanced wound care products principally consist of both novel and otherwise differentiated dressings, devices and skin substitutes designed to promote wound healing and/or prevent infection. Traditional wound care products principally consist of commodity related dressings, ointments, gauze bandages, adhesive bandages, wound closure strips, catheter fasteners and skin care products. The pharmaceutical wound care segment is focused solely on Aclerastide (formerly referred to as DSC127), a novel, first in class angiotensin peptide currently involved in a Phase III clinical trial for the treatment of diabetic foot ulcers.

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

sales in the U.S. and the U.K. and for both advanced and traditional wound care products in Canada.

The pharmaceutical wound care segment is presently limited to the development of Aclerastide for diabetic foot ulcers and pre-clinical work on scar prevention.

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

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

## Notes to Consolidated Financial Statements (Unaudited)

Operating segment sales, gross profit, segment contribution and other related information for 2015 and 2014 were as follows:

Three Months Ended June 30, 2015

	Advanced Wound Care	Traditional Wound Care	Pharmaceutical Wound Care	Other	Total Company
Net sales	\$ 10,292,016	\$ 12,264,348	\$ -	\$ -	\$ 22,556,364
Gross profit	4,862,036	3,509,212	-	-	8,371,248
Direct expense	(8,694,042 )	(1,433,222 )	(4,259,947 )	-	(14,387,211 )
Segment contribution	\$(3,832,006 )	\$ 2,075,990	\$(4,259,947 )	-	(6,015,963 )
Indirect expenses				\$(3,269,748)	(3,269,748 )
Net loss					\$(9,285,711 )

Three Months Ended June 30, 2014

Net sales	\$ 8,812,685	\$ 12,103,540	\$ -	\$ -	\$ 20,916,225
Gross profit	4,446,075	3,398,742	-	-	7,844,817
Direct expense	(7,663,928)	(1,362,889 )	(4,361,559)	-	(13,388,376)
Segment contribution	\$(3,217,853)	\$ 2,035,853	\$(4,361,559)	-	(5,543,559 )
Indirect expenses				\$(3,143,243)	(3,143,243 )
Net loss					\$(8,686,802 )

Six Months Ended June 30, 2015

	Advanced Wound Care	Traditional Wound Care	Pharmaceutical Wound Care	Other	Total Company
--	------------------------	---------------------------	------------------------------	-------	------------------

Edgar Filing: DERMA SCIENCES, INC. - Form 10-Q

Net sales	\$20,063,040	\$21,991,976	\$-	\$-	\$42,055,016
Gross profit	9,763,160	6,143,214	-	-	15,906,374
Direct expense	(17,129,122)	(2,746,673)	(8,418,223)	-	(28,294,018)
Segment contribution	\$(7,365,962)	\$3,396,541	\$(8,418,223)	-	(12,387,644)
Indirect expenses				\$(7,507,644)	(7,507,644)
Net loss					\$(19,895,288)

Six Months Ended June 30, 2014

Net sales	\$17,164,748	\$23,538,510	\$-	\$-	\$40,703,258
Gross profit	8,373,050	6,384,091	-	-	14,757,141
Direct expense	(15,309,862)	(2,671,058)	(8,540,726)	-	(26,521,646)
Segment contribution	\$(6,936,812)	\$3,713,033	\$(8,540,726)	-	(11,764,505)
Indirect expenses				\$(7,192,312)	(7,192,312)
Net loss					\$(18,956,817)

The following table presents net sales by geographic region:

	Three Months Ended June 30,		Six Months Ended June 30,					
	2015	2014	2015	2014				
United States	83	%	75	%	83	%	74	%
Canada	12	%	16	%	11	%	16	%
Other	5	%	9	%	6	%	10	%

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

## Notes to Consolidated Financial Statements (Unaudited)

For the three months ended June 30, 2015 and 2014, the Company had a major Canadian customer comprising 12% and 16%, respectively, of consolidated net sales. For the six months ended June 30, 2015 and 2014, the Company had a major Canadian customer comprising 11% and 16%, respectively, of consolidated net sales. Due to outstanding rebate obligations, the Company was in a net liability position to this customer at June 30, 2015.

**8. Income Taxes**

The following table summarizes the income tax expense (benefit) and effective tax rate for the three and six months ended June 30, 2015 and 2014:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Current tax expense (benefit)	\$ 77,908	\$ (17,093 )	\$ 82,653	\$ (24,239 )
Deferred tax expense (benefit)	266,949	(215,095 )	270,255	(219,514 )
Income tax expense (benefit)	\$ 344,857	\$ (232,188 )	\$ 352,908	\$ (243,753 )
Effective tax rate	(3.9 )%	2.6 %	(1.8 )%	1.3 %

For the three and six months ended June 30, 2015, the Company recognized income tax expense consisting of foreign and U.S. income tax expenses. The foreign income tax expense relates to income taxes recognized as a result of the net income incurred by the Canadian operations and taxes paid on a dividend from the Comvita investment. The U.S. income tax expense consists of a deferred tax expense due to differences in financial reporting and tax treatment of goodwill net of amortization for financial reporting but not tax purposes of acquired identified intangible assets.

The income tax benefit for the three and six months ended June 30, 2014 consisted of a U.S. deferred income tax benefit related to a reduction in the Company's U.S. valuation allowance to offset the tax impact of the unrealized gain on equity securities included in accumulated other comprehensive income and a tax benefit from foreign operations. In addition, the U.S. income tax benefit for the three and six months ended June 30, 2014 was reduced by the tax effect of differences in financial reporting and tax treatment of goodwill, net of amortization for financial reporting but not for tax purposes of acquired identified intangible assets.

## **9. Comvita and BioDLogics License Agreements**

### **Comvita Licensing Agreement**

In February 2010, the Company entered into a new agreement with Comvita (the “Comvita Agreement”) under which the Company received perpetual and exclusive worldwide licensing rights for Manuka Honey based MEDIHONEY wound and skin care products for all markets outside of the consumer market (the “Comvita Agreement”). The Comvita Agreement also provides that Comvita will serve as the Company’s supplier for Manuka Honey and will not provide Manuka Honey to any other entities for use in the professional medical-surgical marketplace. The Comvita Agreement calls for graduated royalty payments based on sales and milestone payments. The license rights may be terminated or rendered non-exclusive by Comvita if the Company fails to meet certain minimum royalty requirements.

Comvita is a stockholder of the Company and its Ch