DERMA SCIENCES, INC.
Form 10QSB
August 15, 2005

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For Quarter Ended	June 30, 2005
Commission File Number	1-31070

Derma Sciences, Inc.

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

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

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

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

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

Date: June 30, 2005	Class: Common Stock, par value $.01 per share Shares Outstanding: 12,284,007

DERMA SCIENCES, INC.

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Forward Looking Statements

This document includes certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on management s current expectations and are subject to uncertainty and changes in circumstances. Actual results may differ materially from these expectations due to changes in political, economic, business, competitive, market and regulatory factors.

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Part I - Financial Information

Item 1. CONDENSED FINANCIAL STATEMENTS

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DERMA SCIENCES, INC.

Consolidated Balance Sheets

	June 30, 2005 (Unaudited)	Decembe 200 (Note
ASSETS		
Current Assets		
Cash and cash equivalents	$ 362,941	$ 46
Accounts receivable, net	1,465,806	2,601
Inventories	3,884,924	4,932
Prepaid expenses and other current assets	245,746	181
Total current assets	5,959,417	7,761
Equipment and improvements, net	3,386,028	3,662
Goodwill	1,110,967	1,110
Other intangible assets, net	341,840	383
Other assets, net	346,980	132
Total Assets	$ 11,145,232	$ 13,050
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit borrowings	$ 693,325	$ 2,820
Current maturities of long-term debt	261,576	247
Accounts payable	1,370,317	1,249
Accrued expenses and other current liabilities	596,444	594
Total current liabilities	2,921,662	4,911
Long-term debt	520,848	867
Other long-term liabilities	82,664	53

Total Liabilities	3,525,174	5,832
Commitments		
Shareholders' Equity		
Convertible preferred stock, $.01 par value; 11,750,000 shares authorized; issued and outstanding: 2,280,407 shares at June 30, 2005 and December 31, 2004 (liquidation preference of $4,210,231 at June 30, 2005 and December 31, 2004)	22,804	22
Common stock, $.01 par value, 30,000,000 shares authorized; issued and outstanding: 12,284,007 shares at June 30, 2005 and 11,079,007 shares at December 31, 2004	122,840	110
Additional paid-in capital	19,882,090	19,371
Accumulated other comprehensive income - cumulative translation adjustments	633,222	699
Accumulated deficit	(13,040,898)	(12,986
Total Shareholders' Equity	7,620,058	7,218
Total Liabilities and Shareholders' Equity	$ 11,145,232	$ 13,050

See accompanying consolidated notes.

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DERMA SCIENCES, INC.

Consolidated Statements of Operations (Unaudited)

	Three months ended June 30, 2005	200
Net sales	$6,934,218	$4,914,
Cost of sales	4,761,611	3,520,
Gross Profit	2,172,607	1,393,
Operating expenses	1,900,157	1,678,
Interest expense, net	95,269	51,
Other expense (income), net	18,997	(6,
Total Expenses	2,014,423	1,724,
Income (loss) before provision for income taxes	158,184	(330,
Provision for income taxes	-	-
Net Income (Loss)	$ 158,184	$ (330,
Income (loss) per common share - basic	$0.01	$(0.
Income (loss) per common share - fully diluted	$0.01	$(0.

Shares used in computing income (loss) per common share - basic	12,284,007	9,524,
Shares used in computing income (loss) per common share - diluted	14,745,538	9,524,

See accompanying consolidated notes.

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DERMA SCIENCES, INC.

Consolidated Statements of Operations (Unaudited)

	Six months ended June 30, 2005	2004
Net sales	$11,827,665	$ 9,943,
Cost of sales	8,267,672	7,116,
Gross Profit	3,559,993	2,826,
Operating expenses	3,581,212	3,923,
Interest expense, net	179,853	98,
Other (income) expense, net	(146,204)	111,
Total Expenses	3,614,861	4,133,
Loss before provision for income taxes	(54,868)	(1,306,
Provision for income taxes	-	-
Net Loss	$ (54,868)	$(1,306,
Loss per common share - basic and diluted	$0.00	$(0.
Shares used in computing loss per common share - basic and diluted	12,147,841	9,166,

See accompanying consolidated notes.

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DERMA SCIENCES, INC.

Consolidated Statements of Cash Flows (Unaudited)

	Six months ended June 30,

	2005	20
Operating Activities		
Net loss	$ (54,868)	$(1,306,
Adjustments to reconcile net loss to		
net cash provided by (used in) operating activities:		
Depreciation of equipment and improvements	245,878	132,
Amortization of intangible assets	42,071	47,
Amortization of deferred financing costs	35,820	42,
Provision for bad debts and rebates	1,067,024	5,
Provision for inventory obsolescence	45,519	89,
Loss on disposal of equipment	4,146	82,
Deferred rent expense	22,113	21,
Employee stock options	1,000	-
Changes in operating assets and liabilities:		
Restricted cash	-	(1,002,
Accounts receivable	48,144	27,
Inventories	982,316	(1,200,
Prepaid expenses and other current assets	(92,067)	(1,
Other assets	(145,614)	10,
Accounts payable	135,449	1,040,
Accrued expenses and other current liabilities	(3,339)	87,
Long-term liabilities	7,273	205,
Net cash provided by (used in) operating activities	2,340,865	(1,717,
Investing Activities		
Cash paid for wound care business	-	(376,
Purchase of equipment and improvements	(61,879)	(695,
Proceeds from sale of equipment	24,998	
Net cash used in investing activities	(36,881)	(1,072,
Financing Activities		
Net change in bank lines of credit	(2,084,029)	583,
Deferred financing costs	(116,590)	(60,
Long-term debt repayments	(312,142)	(98,
Proceeds from issuance of stock, net of issuance costs	539,415	1,962,
Net cash (used in) provided by financing activities	(1,973,346)	2,387,
Effect of exchange rate changes on cash	(14,205)	(7,
Net increase (decrease) in cash and cash equivalents	316,433	(409,
Cash and cash equivalents		
Beginning of period	46,508	43
End of period	$ 362,941	$ 3
Supplemental cash flow information		
Note payable for acquisition of Kimberly-Clark wound care assets	-	$ 1,566,
Equipment obtained with capital leases	-	$ 211,

See accompanying consolidated notes.

DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiaries (the Company) are full line providers of wound care, wound closure-fasteners and skin care products. The Company markets its products principally through independent distributors servicing the long-term care, home health and acute care markets in the United States, Canada and other select international markets. The Company s principal manufacturing and distribution facilities are located in St. Louis, Missouri and Toronto, Canada. The Company also has a manufacturing facility in Nantong, China.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB and Item 310(b) of Regulation S-B. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2005, are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2004, included in Form 10-KSB previously filed with the Securities and Exchange Commission.

Summary of Significant Accounting Policies:

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

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

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

Cash and Cash Equivalents The Company considers cash and cash equivalents as amounts on hand, on deposit in financial institutions and highly liquid investments with a maturity of three months or less when purchased.

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

Foreign Operations Risk The Company s future operations and earnings will depend to a large extent on the results of its operations in Canada and its ability to continue to maintain a continuous supply of basic wound

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

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

Equipment and improvements Equipment and improvements are stated at cost and are depreciated principally by the straight-line method over the estimated useful lives of the assets ranging from three to ten years. Leasehold improvements are amortized over the lesser of their useful lives or the remaining lease term.

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

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

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

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

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

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

Pro forma information regarding net income (loss) and net income (loss) per share is required by SFAS No. 123, which also requires that the information be determined as if the Company has accounted for its stock options granted to employees under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for 2005 and 2004: risk-free interest rate of 4.25% and 3.90% for the three months ended March 31, 2005 and June 30, 2005, respectively, and 4.0% for 2004; dividend yield of 0%; a volatility factor of the expected market price of the Company s Common Stock of 1.376 and 1.353 for the three months ended March 31, 2005 and June 30, 2005, respectively, and 1.463 for 2004; and an expected option life of 5 years.

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

For purposes of pro forma disclosures, the estimated fair value of stock options is amortized to expense over the options vesting period. Therefore, future pro forma compensation expense may be greater as additional options are granted. The Company s pro forma information follows:

	Three Months Ended June 30,		Six Months Ended Jun	
	2005	2004	2005	20
Net income (loss) as reported	$ 158,184	$(330,299)	$ (54,868)	$(1,306

Pro forma compensation expense	(302,162)	(352,442)	(472,388)	(534
Pro forma net loss	$(143,978)	$(682,741)	$(527,256)	$(1,841
Income (loss) per common share - basic				
As reported	$ 0.01	$(0.03)	$ 0.00	$(
Pro forma	$(0.01)	$(0.07)	$(0.04)	$(
Income (loss) per common share - diluted				
As reported	$ 0.00	$(0.03)	$ 0.00	$(
Pro forma	$(0.01)	$(0.07)	$(0.04)	$(

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

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

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

Revenue Recognition The Company operates in three segments: wound care, wound closure and fasteners and skin care. Sales are recorded when product is shipped, title passes to customers and collectability is reasonably assured. Gross sales are adjusted for cash discounts, returns and allowances, Medicaid rebates and trade rebates in the same period that the related sales are recorded. Freight costs billed to and reimbursed by customers are recorded as a component of revenue. Freight costs to ship product to customers are recorded as a component of cost of sales.

Net Income (Loss) per Share Net income (loss) per common share basic is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Net income (loss) per common share diluted reflects the potential dilution of earnings by including potentially issuable shares of common stock (potentially dilutive securities), including those attributable to stock options, warrants and convertible preferred stock in the weighted average number of common shares outstanding for a period, if dilutive. Potential common stock has not been included in the computation of diluted loss per share for the six months ended June 30, 2005 and the three and six months ended June 30, 2004 as the effect would be anti-dilutive.

Total dilutive shares that have or would have been used to compute income per common share on a fully diluted basis for the three months and six months ended June 30, 2005 and 2004 (assuming profitability in all periods) are outlined below:

	Three Months Ended June 30,		Six Months Ended June	
	2005	2004	2005	20
Weighted average common shares outstanding - Basic	12,284,007	9,524,007	12,147,841	9,166
Potentially dilutive shares:				
Preferred stock	2,280,407	2,280,407	2,280,407	2,282
Warrants	-	651,431	2,289	1,020
Stock options	181,124	912,706	335,342	1,327
Sub-total potentially dilutive shares	2,461,531	3,844,544	2,618,038	4,630
Weighted average common shares outstanding - Dilutive	14,745,538	13,368,551	14,765,879	13,797

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

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

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

Kimberly-Clark manufactured wound care products, for the account of the Company, at its facility through April 9, 2004 to meet current customer demand and to build sufficient inventory to cover the period during which production at the Kimberly-Clark facility was discontinued and the equipment was transferred to the Company s

facility in Toronto, Canada. Upon cessation of manufacturing at Kimberly-Clark s facility, the Company purchased, in accordance with a pre-determined formula, inventory consisting of raw and packaging materials and up to four months supply of finished goods. The purchase price of this inventory was approximately $550,000. Cash on hand and borrowings against available credit lines were used to pay for this inventory.

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

3. Accounts Receivable

Accounts receivable include the following:

	June 30, 2005	December 31, 2004
Trade accounts receivable	$2,774,633	$2,774,293
Less: Allowance for doubtful accounts	(52,242)	(57,090)
Allowance for trade rebates	(1,332,333)	(164,000)
Net trade receivables	1,390,058	2,553,203
Other receivables	75,748	47,889
Total receivables	$1,465,806	$2,601,092

4. Inventories

Inventories include the following:

	June 30, 2005	December 31, 2004
Finished goods	$2,272,818	$3,531,095
Work in process	54,634	71,423
Packaging materials	651,085	461,052
Raw materials	906,387	868,662
Total inventories	$3,884,924	$4,932,232

5. Equipment and Improvements, net

Equipment and improvements include the following:

	June 30, 2005	December 31, 2004
Machinery and equipment	$3,356,474	$3,407,073
Furniture and fixtures	210,874	196,506
Leasehold improvements	716,847	714,992
Gross equipment and improvements	4,284,195	4,318,571
Less: accumulated depreciation	(898,167)	(656,014)
Total equipment and improvements, net	$3,386,028	$3,662,557

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements (Unaudited)

Included in equipment and improvements at June 30, 2005 and December 31, 2004 were machinery and equipment with a cost of $228,518 and accumulated amortization of $40,119 and $22,989, respectively, attributable to leased equipment. Amortization of assets under capital leases is included in depreciation expense.

6. Other Intangible Assets, net

	June 30, 2005	December 31, 2004
Patents and trademarks	$ 444,067	$ 444,067
Other intangible assets	342,797	342,797
Gross other intangible assets	786,864	786,864
Less: accumulated amortization	(445,024)	(402,953)
Other intangible assets, net	$ 341,840	$ 383,911

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

7. Other Assets, net

Other assets, net include the following:

	June 30, 2005	December 31, 2004
Deferred financing costs, net	$130,600	$ 60,728
Deposits	69,752	71,736
Long-term receivable	110,203	-
Other	36,425	-
Total other assets, net	$346,980	$132,464

Deferred financing costs are being amortized over the terms of the related loan agreement which range from three to five years. The long-term receivable relates to amounts due in connection with a distribution agreement upset fee (see Note 15).

8. Line of Credit Borrowings

Short-term borrowings include the following:

	June 30, 2005	December 31, 2004
U.S. line of credit	$693,325	$1,312,756
Canadian line of credit	-	1,507,528
Total line of credit borrowings	$693,325	$2,820,284

U.S. Line of Credit

On January 31, 2005, the Company entered into a three year revolving credit facility agreement (the New Agreement) with a new U.S. lender for a maximum principal amount of $2,000,000. The New Agreement replaces a $2,000,000 revolving credit facility that expired on January 31, 2005. On January 31, 2005, the Company applied advances of approximately $1,300,000 under the New Agreement in satisfaction of the prior U.S. lender s outstanding obligations. Future advances will be utilized to fund strategic initiatives and general working capital requirements. The Company incurred loan origination and legal fees of $147,300 in connection with the implementation of the New Agreement. These fees have been deferred and are being amortized to interest expense over the three year term of the New Agreement.

The Company may request advances under the New Agreement up to the value of 85% of eligible receivables (as defined) and 55% of eligible inventory (as defined). Interest on outstanding advances is payable monthly in arrears at the prime rate (as defined) plus 2.5%, but not less than 7.5% per annum. At June 30, 2005 the effective interest rate was 8.51%. In addition, the Company pays a monthly collateral management fee at the rate of 1.5% per annum upon the daily average amount of advances outstanding and a monthly unused line fee of 0.5% per annum upon the difference between the daily average amount of advances outstanding and $2,000,000. Outstanding advances are secured by all of the Company s existing and after-acquired tangible and intangible U.S. assets. In addition, the Company has accorded the new U.S. lender its guarantee of payment together with a second lien security interest in the assets of the Company s wholly owned Canadian subsidiary. The new U.S. lender has agreed not to exercise its rights under its second lien security interest and guarantee against the Canadian assets without the Canadian lender s approval.

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

Based upon consolidated operating results for March and April 2005, the Company was out of compliance with its EBITDA and fixed charge ratio covenant under the New Agreement. The U.S. lender agreed to waive these covenant violations. Effective June 30, 2005 the Company and the U.S. lender agreed to prospectively amend the Company s monthly minimum EBITDA and fixed change ratio covenants to better align these covenants with expected performance. The Company incurred fees of $10,000 associated with the granting of the covenant amendments. The Company expects to, but cannot assure that it will, maintain compliance with all applicable loan covenants in the future.

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

On January 13, 2005 in connection with the refinancing of the U.S. line of credit, the Company paid off and cancelled the outstanding irrevocable standby letter of credit issued by the former U.S. lender in the amount of $200,000 held by the Company s Canadian lender as additional security for its credit facility. The $200,000 paid to the Canadian lender was applied as a permanent principal reduction against the principal amount due in 2007 associated with the Company s outstanding term loan with the Canadian lender (see Note 10). Subsequently, on

January 31, 2005 the Canadian lender agreed as part of refinancing of the U.S. line of credit to retain its second lien security interest and guarantee position against the Company s U.S. assets and not to exercise its rights under its second lien security interest and guarantee against the U.S. assets without the U.S. lender s approval.

Canadian Line of Credit

In September 2004, the Company finalized the annual renewal of its revolving credit facility (the Canadian Agreement) for a maximum principal amount of $1,795,000 ($2,200,000 Canadian) with its Canadian lender. The Company s wholly owned Canadian subsidiary, Derma Sciences Canada Inc., may request advances under the Canadian Agreement up to the value of 75% of eligible receivables (as defined) plus the lesser of $897,000 ($1,100,000 Canadian) or 40% of eligible inventory (as defined), less priority claims. Interest on outstanding advances is payable monthly in arrears at prime rate (as defined) plus 1.0%, or 5.25% for Canadian dollar advances and 7.50% for U.S. dollar denominated advances at June 30, 2005. Outstanding advances are secured by all tangible and intangible assets of Derma Sciences Canada Inc. In addition, the Company has accorded the Canadian lender its guarantee of payment together with a second lien security interest in the Company s assets located in the U.S.

Over the term of the Canadian Agreement, the Company has agreed to comply with a number of financial covenants governing minimum working capital, current ratios, tangible net worth, interest coverage, total indebtedness to tangible net worth and total indebtedness to adjusted pre-tax earnings. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the Canadian Agreement. In the event of a margin deficiency (as defined) or covenant violation, the Company is required to advance up to an additional $408,000 ($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.

At June 30, 2005 Derma Sciences Canada was out of compliance with its minimum working capital covenant. The violation occurred due to the adverse impact on Derma Sciences Canada s working capital associated with accelerating repayment of an inter company loan and extending credit terms on regular inter company trade receivables to the U.S. parent in June 2005 in an effort to optimize the use of the positive cash flow associated with implementing the new distribution agreement in Canada (see note 17). The violation has been corrected and the Canadian lender agreed to waive the covenant violation at June 30, 2005.

9. Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities include the following:

	June 30, 2005	December 31, 2004
Accrued compensation and related taxes	$134,171	$218,037
Accrued sales, goods and services taxes	140,068	197,984
Accrued administrative fees	176,029	107,916
Accrued closure costs	121,483	-
Other	24,693	70,501
Total accrued expenses and other current liabilities	$596,444	$594,438

10. Long-Term Debt

Long-term debt includes the following:

	June 30,	December 31,

	2005	2004
Canadian term loan	$609,450	$ 916,805
Capital lease obligations	172,974	198,040
Total debt	782,424	1,114,845
Less: current maturities	261,576	247,306
Long-term debt	$520,848	$ 867,539

In connection with the acquisition of substantially all the assets of Dumex Medical Inc. in August 2002, the Company entered into a five-year term loan agreement with a Canadian Bank. The loan is repayable in monthly payments consisting of principal and interest. Interest on the outstanding principal balance is payable monthly at the bank s prime rate (as defined) plus 1.25%, or 5.5% at June 30, 2005. The term loan is secured by all tangible and intangible assets of Derma Canada and is subject to the same financial covenants applicable to the Canadian operating line of credit (see Note 8).

The Company has four capital lease obligations for certain distribution equipment and computer equipment totaling $172,974. The capital leases bear interest at annual rates ranging from 3.9% to 10.2% with the longest lease term expiring in April 2009.

11. Shareholders Equity

Preferred Stock

There are 150,003 shares of series A convertible preferred stock outstanding at June 30, 2005. The series A preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $4.00 per share, votes as a class on matters affecting the series A preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 440,003 shares of series B convertible preferred stock outstanding at June 30, 2005. The series B preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $6.00 per share, votes as a class on matters affecting the series B preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 619,055 shares of series C convertible preferred stock outstanding at June 30, 2005. The series C preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.70 per share, votes as a class on matters affecting the series C preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 1,071,346 shares of series D convertible preferred stock outstanding at June 30, 2005. The series D preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.50 per share, votes as a class on matters affecting the series D preferred stock and maintains voting rights identical to the common stock on all other matters.

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DERMA SCIENCES, INC.

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Common Stock

On February 8, 2005, the Company closed a private offering of 2,760,000 units at $0.50 per unit, each unit consisting of one share of the Company s common stock and one four-year series G warrant to purchase one share of common stock at a price of $1.05. Total offering proceeds of $1,220,774, net of $159,226 in offering expenses, were used for working capital. The offering commenced prior to December 31, 2004. During 2005, the Company sold 1,205,000 units at $0.50 per unit and received total offering proceeds of $539,415, net of $80,585 in offering expenses. As of December 31, 2004, the Company had sold 1,555,000 units at $0.50 per unit and received total offering proceeds of $681,359, net of $78,641 in offering expenses.

Stock Options

During the three and six months ended June 30, 2005, the Company issued stock options as follows:

	Number of Issued Stock Options	Per Share Exercise Price
Three months ended March 31, 2005	1,021,000	$0.50
Three months ended June 30, 2005	465,000	$0.42
Total for six months ended June 30, 2005	1,486,000	

There were no other changes in outstanding options during the six months ended June 30, 2005.

Stock Purchase Warrants

During the three months ended March 31, 2005, the Company issued 1,205,000 series G warrants in conjunction with the private offering discussed above. There were no other changes in outstanding warrants during the six months ended June 30, 2005.

At June 30, 2005, the Company had warrants outstanding to purchase 5,939,448 shares of the Company s common stock as outlined below:

Series	Number of Warrants	Exercise Price	Expiration Date
E	1,870,007	$0.85	July 18, 2005
F	1,309,441	$0.57	January 6, 2007
G	2,760,000	$1.05	December 31, 2008

Shares Reserved for Future Issuance

At June 30, 2005, the Company had reserved the following shares of common stock for future issuance:

Convertible preferred shares (series A - D)	2,280,407
Common stock options outstanding	5,950,655
Common stock options available for grant	286,000
Common stock warrants (series E - G)	5,939,448
Total common stock shares reserved	14,456,510

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DERMA SCIENCES, INC.

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12. Comprehensive Income (Loss)

The Company s comprehensive income (loss) was as follows:

	Three Months Ended June 30,		Six Months Ended J	
	2005	2004	2005	
Net income (loss) as reported	$158,184	$(330,299)	$ (54,868)	$(1,
Other comprehensive (loss) income:				
Foreign currency translation adjustment	(39,550)	6,419	(66,738)	
Comprehensive income (loss)	$118,634	$(323,880)	$(121,606)	$(1,

13. Operating Segments

The Company consists of three operating segments: wound care, wound closure-fasteners and skin care. Products in the wound care segment consist of basic and advanced dressings, ointments and sprays designed to treat wounds. Wound closure-fasteners products include wound closure strips, nasal tube fasteners, a variety of catheter fasteners and net dressings. The skin care segment consists of bath sponges, antibacterial skin cleansers, hair and body soaps, lotions and moisturizers designed to enable customers to implement and maintain successful skin care / hygiene programs.

Products in all three operating segments are marketed to long-term care facilities, hospitals, physicians, clinics, home health care agencies and other healthcare institutions. The manufacture of advanced wound care and wound closure-fastener products is primarily outsourced. Basic wound care and skin care products are manufactured in-house with the exception of the bath sponge line. Internally, the segments are managed at the gross profit level. The aggregation or allocation of other costs by segment is not practical.

Segment net sales and gross profit for the three months and six months ended June 30, 2005 and 2004 were as follows:

	Three Months Ended June 30, 2005				
	Wound Care	Wound Closure- Fasteners	Skin Care	Other Costs	Total Compan
Net sales	$5,880,353	$ 669,973	$ 383,892	-	$ 6,934,
Gross profit (loss)	1,932,826	339,126	(99,345)	-	2,172,
Total expenses	-	-	-	$(2,014,423)	(2,014,
Net income					$ 158,
Net long-lived assets	$3,260,200	-	$1,331,758	$ 246,877	$ 4,838,

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	Three Months Ended June 30, 2004				
	Wound Care	Wound Closure- Fasteners	Skin Care	Other Costs	Total Compan
Net sales	$3,455,605	$ 939,998	$ 518,408	-	$ 4,914,
Gross profit	826,778	469,021	98,025	-	1,393,
Total expenses	-	-	-	$(1,724,123)	$(1,724,
Net loss					$ (330,
Net long-lived assets	$3,359,891	-	$1,313,221	$ 283,372	$ 4,956,

	Six Months Ended June 30, 2005				
	Wound Care	Wound Closure- Fasteners	Skin Care	Other Costs	Total Compan

Net sales	$9,751,483	$1,298,271	$ 777,911	-	$11,827,
Gross profit (loss)	2,990,814	663,262	(94,083)	-	3,559,
Total expenses	-	-	-	$(3,614,861)	$(3,614,
Net loss					$ (54,
Net long-lived assets	$3,260,200	-	$1,331,758	$ 246,877	$ 4,838,

Six Months Ended June 30, 2004

	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Compan
Net sales	$7,064,952	$1,898,268	$ 980,213	-	$ 9,943,
Gross profit	1,692,918	936,404	197,408	-	2,826,
Total expenses	-	-	-	$(4,133,495)	$(4,133,
Net loss					$(1,306,
Net long-lived assets	$3,359,891	-	$1,313,221	$ 283,372	$ 4,956,

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

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For the three and six months ended June 30, 2005 the skin care segment gross profit (loss) includes a $98,000 charge for closure of the Company s soap and lotion manufacturing facility in St. Louis, Missouri (see footnote 18).

The following table presents net sales by geographic region.

	Three Months Ended June 30, 2005	Three Months Ended June 30, 2004	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
United States	34%	53%	40%	55%
Canada	62%	43%	56%	41%
Other	4%	4%	4%	4%

Canada net sales for the three and six months ended June 30, 2005 represent a higher percentage of total net sales compared with 2004 as a result of the one-time benefit of approximately $1,840,000 related to the sale of inventory on hand to fill the distribution pipeline in conjunction with the appointment of an exclusive third party distributor for the Company s Canadian subsidiary in the second quarter 2005 (see footnote 17).

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

	June 30, 2005	June 30, 2004
United States	$1,933,897	$2,053,409
Canada	2,879,830	2,863,666
Other	25,108	39,409
Total	$4,838,835	$4,956,484

14. Income Taxes

No provision for income taxes has been made in the second quarter 2005 and 2004 and the six months ended June 30, 2005 and 2004 given the Company s net operating losses. No benefit has been recorded as the realization of the net operating losses is not assured.

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

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15. Distribution Agreement Upset Fee

In August 2004, the Company s exclusive distribution agreement for certain catheter fasteners expired and was not renewed by the manufacturer. Sales and gross profit of these catheter fasteners for the three and six months ended June 30, 2005 and 2004 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Sales	$29,000	$313,000	$95,300	$624,000
Gross profit	$15,400	$141,000	$46,100	$282,000

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

16. Employee Termination Costs

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

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

17. Appointment of Canadian Distributor

On May 9, 2005 the Company entered into a five-year agreement expiring May 1, 2010 with a Canadian company to serve as the exclusive distributor of its products in Canada. The agreement also appoints the distributor as the Company s servicing agent to fulfill supply contracts held directly by the Company. The agreement automatically renews thereafter for consecutive periods of one year each on the same terms and conditions unless either party gives notice of its intent not to renew 180 days prior to expiry. Either party shall have the right to terminate the agreement when an event of default (as defined) has occurred with respect to the other party.

Effective June 1, 2005 the distributor assumed responsibility for order processing, product delivery and maintenance and warehousing of sufficient inventory to meet agreed upon order fulfillment requirements. On an ongoing basis, the distributor will place inventory replenishment orders with the Company at agreed upon prices, 120 days in advance of scheduled delivery. Unless amended, each order becomes non-cancelable 90 days in advance of scheduled delivery.

With respect to sales made by the distributor to the Company s contract customers in its capacity as a servicing agent, the Company will pay the distributor an agreed upon distribution fee and a specified incentive for growth (as achieved). The Company will reimburse the distributor for the difference between the price paid by the distributor and the Company s contract price with its customer upon submission by the distributor of an agreed upon

DERMA SCIENCES, INC.

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rebate report. With respect to sales made by the distributor to its customers, the distributors compensation will consist solely of the excess of the proceeds over the cost of the product and the Company will not be responsible for payment of any distribution fee. Further, the agreement requires the distributor to meet specified minimum sales growth targets of 15%, 12%, 12% and 12% in the first four years and private label product purchase targets failing which the Company may cancel the agreement. The Company believes that the agreement will provide better service to its customers throughout Canada and greater opportunity for sales growth.

In connection with implementing the agreement, the Company sold to the distributor its existing inventory of saleable finished product on hand and will sell all saleable finished product it committed to manufacture prior to signing of the agreement for delivery by the Company through September 2005 at the agreed upon prices to initially stock and maintain its distribution pipeline. It is expected the Company s saleable finished product commitments will be fulfilled by October 2005 at which time the distributor will begin to receive product based upon its initial orders placed with the Company beginning in June 2005. Other than the one-time sale in May and June 2005 of its existing inventory on hand which is estimated to represent two to two and one-half months sales, prospective sales are expected to resume historical trends affected only by existing market conditions and the growth opportunities inherent in the agreement. Given economic order quantities and normal lead times associated with the products sold to the distributor, it is expected that a two to three month safety stock will be required prospectively by the distributor to maintain required customer service requirements. In addition, the Company incurred one-time costs consisting of severance and other costs to dismantle its distribution capabilities and sub-lease its distribution warehouse. A summary of the estimated one-time benefit and cost of the agreement recognized in the three months ended June 30, 2005 is outlined below:

Net Sales	$1,840,000
Cost of Sales	1,240,000
Gross Profit	600,000
Expenses	105,000
Pretax Income	$ 495,000

Further, implementation of the agreement resulted in an estimated one-time positive cash flow benefit of $2,705,000 stemming from lower receivable and inventory requirements going forward and the one-time pretax income benefit of the sale of existing saleable finished product inventory on hand to the distributor.

18. Manufacturing Facility Closure

In June 2005, the Company announced its intention to close its skin care manufacturing facility in St. Louis, Missouri and outsource the facility s production with a view to reducing overhead and improving cost competitiveness. Facility closure and transition to the new supplier are expected to be complete by the end of September 2005.

As of June 30, 2005, the Company recorded a charge of $98,000 for estimated severances and lease costs associated with the closure. The existing equipment will either be transferred to the Company s Toronto, Canada facility, leased to the supplier or sold. Other one-time closure related costs estimated at $50,000, consisting principally of facility clean up, inventory write-offs and equipment write-offs and ongoing estimated monthly lease and facility maintenance costs of $7,500, net of existing committed lease costs and estimated sub-lease income through lease expiration on January 31, 2007, will be expensed to cost of sales as incurred.

19. Subsequent Events

Expiration of Series E Stock Purchase Warrants

The Company s 1,870,007 Series E stock purchase warrants expired unexercised on July 18, 2005.

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

QUARTER ENDED JUNE 30, 2005 COMPARED TO QUARTER ENDED JUNE 30, 2004.

Results of Operations

Overview

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

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

The following table highlights the quarters ended June 30, 2005 versus June 30, 2004 operating results:

	Quarter Ended June 30,			
	2005	2004	Variance	
Gross Sales	$ 8,210,230	$5,167,851	$ 3,042,379	58.9%
Adjustments	(1,276,012)	(253,840)	(1,022,172)	402.7%
Net sales	6,934,218	4,914,011	2,020,207	41.1%
Cost of sales	4,761,611	3,520,187	1,241,424	35.3%
Gross profit	2,172,607	1,393,824	778,783	55.9%
Gross profit percentage	31.3%	28.4%		
Operating expenses	1,900,157	1,678,804	221,353	13.2%
Interest expense, net	95,269	51,479	43,790	85.1%
Other expense (income), net	18,997	(6,160)	25,157	-
Total expenses	2,014,423	1,724,123	290,300	16.8%
Income (loss) before income taxes	158,184	(330,299)	488,483	
Provision for income taxes	-	-	-	-
Net income (loss)	$ 158,184	$ (330,299)	$ 488,483	-

Gross to Net Sales Adjustments

Gross sales are adjusted for trade rebates, Medicaid rebates, returns and allowances and cash discounts to derive net sales. Trade rebates are trued-up monthly based upon an analysis of historical sales subject to rebate and actual rebates received by distributor. The normal rebate cycle is one month. Non-exclusive distributors generally carry one month s inventory. As distributor inventory is depleted via sales, it is replenished via purchases from the Company. Rebates are processed and submitted for credit on a timely basis consistent with distributor sales. If the normal rebate cycle were one-half month at June 30, 2005, the trade rebate reserve would be overstated by approximately $35,000. If the normal rebate cycle were two months at June 30, 2005, the trade rebate reserve would be understated by approximately $70,000. To minimize its cash outflow invested in rebates, distributors generally strive to optimize the rebate credit submission process.

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Given the nature of the Company s products and business, there is no external information available to further validate the reasonableness of the trade rebate accrual balance. Historical trends of sales subject to rebate and rebates received are evaluated monthly, by distributor, on a 3 month, 6 month and 12 month rolling basis to update the continued reasonableness of the assumptions used to quantify the accrual trade rebate balance. Deviations in the trends resulting, among other causes, from distributors not submitting their rebates on a timely basis are analyzed and factored in determining the required accrual balance.

Medicaid rebates are accrued monthly based upon recent historical activity and reconciled quarterly based upon receipt of rebate reports from participating state agencies. Returns and allowances and cash discounts have historically been accounted for on a cash basis which approximates accrual based accounting given the month to month consistency of these charges.

Gross to net sales adjustments comprise the following:

	Quarter Ended June 30, 2005	Quarter Ended June 30, 2004
Gross Sales	$8,210,230	$5,167,851
Trade rebates	(1,222,550)	(186,715)
Medicaid rebates	(6,000)	(9,342)
Returns and allowances	(6,911)	(29,467)
Cash discounts	(40,551)	(28,316)
Total adjustments	(1,276,012)	(253,840)
Net sales	$6,934,218	$4,914,011

Trade rebates increased significantly in the second quarter 2005 versus 2004 due to the Company s implementing an exclusive third party distribution agreement in the second quarter for its Canadian business, continuing growth of rebate intensive U.S. private label sales and a general increase in the level of sales subject to rebate (contract business) in other areas of the Company s business. Implementing the third party distribution agreement was responsible for approximately $972,000 of the increase as the majority of the Canadian sales represents contract business subject to rebate. Canadian sales subject to rebate were made in May and June 2005, while the payment of rebates on these sales did not commence until July 2005. A continuing trend towards lower levels of Medicaid reimbursed sales is responsible for the lower level of Medicaid rebates. The decrease in sales returns and allowances stems from several large returns received in the second quarter 2004 that were not repeated in 2005. The increase in cash discounts principally reflects the growth of sales to larger customers that routinely take advantage of available discount terms.

Rebate Reserve Roll Forward

A quarterly roll forward of the trade rebate accruals at June 30, 2005 and 2004 is outlined below:

	Quarter Ended June 30, 2005	Quarter Ended June 30, 2004
Beginning balance - April 1	$ 305,700	$ 195,000
Rebates paid	(164,787)	(213,715)
Rebates accrued	1,222,550	186,715

Ending balance - June 30	$1,363,463	$ 168,000
	===========	==========

The $1,057,763 net increase in the second quarter 2005 trade rebate reserve reflects the $972,000 incremental reserve associated with implementing the third party distribution agreement in Canada during the second quarter coupled with lower rebates paid due to extended rebate payment terms with two large customers. There has been no other discernable change in the nature of the Company s business as it relates to the accrual and

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subsequent payment of rebates, nor has there been any material prior period related adjustments to the trade rebate accrual in the second quarter 2005. The $27,000 decrease in the second quarter 2004 trade rebate reserve reflects the work down of a higher than normal beginning accrual balance due to significant sales of product subject to rebate in December 2003 and January 2004 partially offset by the commencement of extended rebate payment terms with two large customers.

Net Sales and Gross Margin

The following table highlights the June 30, 2005 versus June 30, 2004 product line net sales and gross profit:

	Quarter Ended June 30,		Variance	
	2005	2004		
Product Line Net Sales				
Wound care	$5,880,353	$3,455,605	$2,424,748	70.2%
Wound closure and fasteners	669,973	939,998	(270,025)	(28.7%)
Skin care	383,892	518,408	(134,516)	(25.9%)
Total	$6,934,218	$4,914,011	$2,020,207	41.1%
Product Line Gross Profit				
Wound care	$1,932,826	$ 826,778	$1,106,048	133.8%
Wound closure and fasteners	339,126	469,021	(129,895)	(27.7%)
Skin care	(99,345)	98,025	(197,370)	-
Total	$2,172,607	$1,393,824	$ 778,783	55.9%

Wound care sales increased $2,424,748, or 70.2%, to $5,880,353 in 2005 from $3,455,605 in 2004. The increase is attributable to a basic wound care increase of $2,186,701, or 87.0%. This increase was driven by a significant increase in Canadian basic wound care sales of $2,206,202 comprised of growth of $2,019,015 and favorable exchange of $187,187 (reflecting a 8.3% strengthening of the Canadian dollar) while U.S. sales were down $19,501, or 4.5%, due to competitive pressure. The Canadian sales growth was driven by a one-time benefit of approximately $1,840,000 related to the sale of inventory on hand to fill the distribution pipeline in conjunction with the appointment of an exclusive third party distributor for Canada in the second quarter coupled with normal growth of $179,015, or 8.6%, due principally to improved contract compliance and improving sales in the home healthcare market, partially offset by the loss of contract business in the eastern provinces due to competitive pressure. Advanced wound care sales increased $238,049, or 25.3%, to $1,179,005 in 2005 from $940,956 in 2004. This increase was driven by continued growth of the Company s private label sales to U.S. customers and improving Dermagran sales. These increases were partially offset by lower former Kimberly-Clark branded and private label product sales attributable to competitive pressure and the absence in 2005 of the 2004 buy-in of product that preceded closure of the Kimberly-Clark manufacturing facility and transfer of the equipment to the Company s facility in Canada and lower silver product sales as customer demand for these products remains soft.

Wound care gross profit increased $1,106,048, or 133.8%, to $1,932,826 in 2005 from $826,778 in 2004. Gross profit margin increased to 32.9% in 2005 from 23.9% in 2004. Approximately $600,000 of the increased gross margin dollars relates to the one-time sale of inventory to fill the new Canadian distributor s pipeline. The balance of the margin dollar increase and improved gross margin percentage are due to the increase in sales and the flow through of lower basic wound care costs negotiated in 2004, lower advanced wound care costs associated with manufacturing the former Kimberly-Clark products in-house versus the acquisition related negotiated costing used in 2004 and the non-recurrence of one-time advanced wound care private label manufacturing start-up costs incurred in the second quarter 2004.

Wound closure and fastener sales decreased $270,025, or 28.7%, to $669,973 in 2005 from $939,998 in 2004. A reduction of approximately $284,000 in sales of certain catheter fasteners in 2005 versus 2004 associated with the loss of the Company s exclusive distribution agreement for the sale of these products in August 2004 is

primarily responsible for the decrease. Sales in the balance of the line were relatively stable in the aggregate with higher suture strip sales partially offset by lower other catheter sales.

Wound closure-fastener gross profit decreased $129,895, or 27.7%, to $339,126 in 2005 from $469,021 in 2004. Gross profit margins improved slightly to 50.6% in 2005 from 49.9% in 2004. The decrease in margin dollars is consistent with the sales shortfall. The margin improvement principally reflects the benefit of the loss of the exclusive catheter fastener business which was slightly lower margined than the average for the line.

Skin care sales decreased $134,516, or 25.9%, to $383,892 in 2005 from $518,408 in 2004 due to continuing competitive pressure and the loss of several key customers. Skin care gross profit decreased $197,370 to a loss of $99,345 in 2005 from a profit of $98,025 in 2004. Included in the 2005 loss is a provision of $98,000 for severance and lease costs associated with the closure of the skin care manufacturing facility in St. Louis. Excluding the $98,000 provision, the skin care line operated at essentially break even for the second quarter 2005. This performance continues to reflect a highly competitive marketplace characterized by declining market prices and higher internal manufacturing costs associated with increasing material and freight costs and the adverse impact of lower production volumes on operating efficiency and fixed overhead absorption.

Operating Expense

The following table highlights June 30, 2005 versus June 30, 2004 operating expenses by type:

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                    Quarter Ended June 30,
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	2005	2004	Variance	
Distribution	$ 340,020	$ 256,524	$ 83,496	32.5%
Marketing	128,507	121,376	7,131	5.9%
Sales	476,958	446,420	30,538	6.8%
General administrative	954,672	854,484	100,188	11.7%
Total	$1,900,157	$1,678,804	$221,353	13.2%

Operating expense increased $221,353, or 13.2%, to $1,900,157 in 2005 from $1,678,804 in 2004 including an increase of $38,692, or 2.3%, attributable to exchange associated with a 8.3% strengthening of the Canadian dollar on the Canadian operations.

Distribution expense increased $83,496, or 32.5%, in 2005 versus 2004. Expenses in Canada increased $129,987 (including $7,881 expense related to exchange) while expenses in the U.S decreased $46,491. The increase in Canada was attributable to implementation of the new distribution agreement. Effective June 1, 2005 the new distributor assumed responsibility for order processing, product delivery and inventory maintenance and warehousing. The fee for these services in June 2005 preceded the Company s plan to offload the corresponding costs of its own distribution network primarily in the area of lease costs, public warehouse fees and other fixed costs resulting in incremental costs for the month. In addition, the Company incurred approximately $52,000 in one-time severance and other related costs associated with the transition to the new distribution agreement. The U.S. decrease was attributable to lower compensation costs associated with running the new U.S. distribution facility opened in March 2004 more cost effectively in 2005 and the absence in 2005 of start up related costs incurred in 2004 associated with bringing the new U.S distribution center on line and closing one of the Company s other distribution centers.

Marketing expense increased $7,131, or 5.9%, in 2005 versus 2004. The increase is principally attributable to higher literature and promotion expense in support of the Company s growth initiatives.

Sales expense increased $30,538, or 6.8%, in 2005 versus 2004. Expenses in Canada increased $67,416 (including $7,787 expense related to exchange) while expenses in the U.S. decreased $36,878. The increase in Canada is attributable to a higher level of sales support activities consisting principally of travel, convention attendance and sampling to expand market visibility and improve contract compliance and one-time severance and travel costs associated with implementing the new distribution agreement. The U.S. decrease was attributable to lower compensation of approximately $41,000 associated with lower sales representative commissions, lower

manufacturers representative commissions due to the discontinuance of manufacturers representatives in the second quarter 2004 and an open position in the second quarter 2005. Elimination of a sales database consultant and related expenses generated savings of approximately $17,400. Offsetting these decreases were higher recruiting cost of $14,000 to fill the open position and higher travel expenses of $7,800 associated with the Company s growth initiatives.

General administrative expense increased $100,188, or 11.7%, in 2005 versus 2004. Expenses in Canada increased $74,708 (including $23,024 expense related to exchange) while expenses in the U.S. increased $25,480. The increase in Canada reflects one-time costs of $41,700 for severance and other costs associated with implementing the new distribution agreement together with higher compensation costs associated with the hiring of a Director of Materials and Logistics in the second quarter 2005. The U.S. increase principally reflects board of directors fees initiated in January 2005, higher benefit costs and higher travel expense partially offset by the impact of various cost reduction and containment initiatives in the administrative overhead area.

Interest Expense, Net

Interest expense, net increased $43,790, or 85.1%, to $95,269 in 2005 from $51,479 in 2004. Interest expense in Canada decreased $2,870 (net of $2,726 expense related to exchange) while interest expense in the U.S. increased $45,668. The decrease in Canada reflects lower outstanding line of credit and term loan balances in 2005, partially offset by slightly higher interest rates and fees. Canada s outstanding line of credit balance was significantly reduced beginning in mid-May 2005 and reached zero by the end of June 2005 through use of the initial one-time positive cash flow generated by implementation of the new distribution agreement. Canada s term loan was significantly reduced in January 2005 as a result of the pay off of an outstanding irrevocable standby letter of credit issued by the U.S. lender in the amount of $200,000 held by the Canadian lender as additional security for its credit facility. The $200,000 payment was applied to the term loan as a permanent principal reduction against the principal amount due in 2007. The U.S. increase is due to higher outstanding line of credit balances, higher interest rates and higher line of credit fees in 2005 versus 2004. In January 2005, the U.S. operation refinanced its line of credit at a higher overall cost. In addition, in 2004 the Company did not move into a net borrowing position until June 2004.

Other Income/Expense

Other income/expense increased $25,157 to $18,997 expense in 2005 from $6,160 income in 2004. The increase is primarily driven by foreign exchange losses in Canada and other net miscellaneous expenses in 2005 compared to 2004 that included a couple of one-time gain items related to the sale of excess equipment and slow moving inventory.

Income Taxes

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

Net Income (Loss)

The Company generated net income of $158,184, or $0.01 income per share basic and $0.01 income per share diluted in 2005, compared to a $330,299 loss, or $0.03 loss per share (basic and diluted) in 2004.

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SIX MONTHS ENDED JUNE 30, 2005 COMPARED TO SIX MONTHS ENDED JUNE 30, 2004.

Results of Operations

Overview

The following table highlights the six months ended June 30, 2005 versus June 30, 2004 operating results:

	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004	Variance	
Gross Sales	$13,447,268	$10,450,881	$ 2,996,387	28.7%
Adjustments	(1,619,603)	(507,448)	(1,112,155)	219.2%
Net sales	11,827,665	9,943,433	1,884,232	18.9%
Cost of sales	8,267,672	7,116,703	1,150,969	16.2%
Gross profit	3,559,993	2,826,730	733,263	25.9%
Gross profit percentage	30.1%	28.4%		
Operating expenses	3,581,212	3,923,859	(342,647)	(8.7%)
Interest expense, net	179,853	98,146	81,707	83.3%
Other (income) expense, net	(146,204)	111,490	(257,694)	-
Total expenses	3,614,861	4,133,495	(518,634)	12.5%
Loss before income taxes	(54,868)	(1,306,765)	1,251,897	95.8%
Provision for income taxes	-	-	-	-
Net loss	$ (54,868)	$(1,306,765)	$ 1,251,897	95.8%

Gross to Net Sales Adjustments

Gross to net sales adjustments comprise the following:

	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Gross Sales	$13,447,268	$10,450,881
Trade rebates	(1,495,734)	(374,632)
Medicaid rebates	(13,420)	(23,742)
Returns and allowances	(38,494)	(33,249)
Cash discounts	(71,955)	(75,825)
Total adjustments	(1,619,603)	(507,448)
Net sales	$11,827,665	$ 9,943,433

Trade rebates increased significantly in the first half 2005 versus 2004 due to the Company s implementing an exclusive third party distribution agreement in the second quarter 2005 for its Canadian business, continuing growth of rebate intensive U.S. private label sales and a general increase in the level of sales subject to rebate (contract business) in other areas of the Company s business. Implementing the third party distribution agreement was responsible for approximately $972,000 of the increase as the majority of the Canadian sales represent contract business subject to rebate. Canadian sales subject to rebate were made in May and June 2005, while payment of rebates on these sales did not commence until July 2005. A continuing trend towards lower levels of Medicaid reimbursed sales is responsible for the lower level of Medicaid rebates. Sales returns and allowances were comparable period to period and on balance reflect a normal level of activity. The slight decrease in cash discounts

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reflects the Company s efforts to tighten its discount terms while experiencing a trend in sales growth towards larger customers that routinely take advantage of available discount terms.

Rebate Reserve Roll Forward

A six month roll forward of the trade rebate accruals at June 30, 2005 and 2004 is outlined below:

	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Beginning balance - January 1	$ 235,200	$ 212,000
Rebates paid	(367,471)	(418,632)
Rebates accrued	1,495,734	374,632
Ending balance - June 30	$1,363,463	$ 168,000

The $1,128,263 net increase in the first half 2005 trade rebate reserve reflects the $972,000 incremental reserve associated with implementing the third party distribution agreement in Canada during the second quarter 2005 coupled with lower rebates paid due to extended rebate payment terms with two large customers. There has been no other discernable change in the nature of the Company s business as it relates to the accrual and subsequent payment of rebates, nor has there been any material prior period related adjustments to the trade rebate accruals in 2005. The $44,000 decrease in the first half 2004 trade rebate reserve reflects the work down of a higher than normal beginning accrual balance due to significant sales of product subject to rebate in December 2003 and January 2004 coupled with a decrease in the amount of corresponding sales subject to rebate in the following months as customers worked down their existing inventory levels. This decrease was partially offset by the commencement of extended rebate payment terms with two large customers during the first half of 2004.

Net Sales and Gross Margin

The following table highlights the June 30, 2005 versus June 30, 2004 product line net sales and gross profit:

	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004	Variance	
Product Line Net Sales				
Wound care	$ 9,751,483	$7,064,952	$2,686,531	38.0%
Wound closure and fasteners	1,298,271	1,898,268	(599,997)	(31.6%)
Skin care	777,911	980,213	(202,302)	(20.6%)

Total	$11,827,665	$9,943,433	$1,884,232	18.9%
Product Line Gross Profit				
Wound care	$ 2,990,814	$1,692,918	$1,297,896	76.7%
Wound closure and fasteners	663,262	936,404	(273,142)	(29.2%)
Skin care	(94,083)	197,408	(291,491)	-
Total	$ 3,559,993	$2,826,730	$ 733,263	25.9%

Wound care sales increased $2,686,531, or 38.0%, to $9,751,483 in 2005 from $7,064,952 in 2004. The increase is attributable to a basic wound care increase of $2,551,446, or 51.8%. This increase was driven by a significant increase in Canadian basic wound care sales of $2,497,077 comprised of growth of $2,170,819 and favorable exchange of $326,258 (reflecting a 7.4% strengthening of the Canadian dollar) while U.S. sales increased $54,369, or 6.4%. The Canadian sales growth was driven by a one-time benefit of approximately $1,840,000 related to the sale of inventory on hand to fill the distribution pipeline in conjunction with the appointment of an exclusive third party distributor for Canada in the second quarter coupled with normal growth of $330,819, or 8.1%, due

principally to improved contract compliance and improving sales in the home healthcare market partially offset by the loss of contract business in the eastern provinces due to competitive pressure. Advanced wound care sales increased $135,085, or 6.3%, to $2,271,835 in 2005 from $2,136,750 in 2004. This increase was driven by continued growth of the Company s private label sales to U.S. customers and improving Dermagran sales. These increases were partially offset by lower former Kimberly-Clark branded and private label product sales attributable to competitive pressure and the absence in 2005 of the 2004 buy-in of product that preceded closure of the Kimberly-Clark manufacturing facility and transfer of the equipment to the Company s facility in Canada and lower silver product sales as customer demand for these products remain soft.

Wound care gross profit increased $1,297,896, or 76.7%, to $2,990,814 in 2005 from $1,692,918 in 2004. Gross profit margin increased to 30.7% in 2005 from 24.0% in 2004. Approximately $600,000 of the increased gross margin dollars relates to the one-time sale of inventory to fill the new Canadian distributor s pipeline. The balance of the margin dollar increase and improved gross margin are due to the increase in sales and the flow through of lower basic wound care costs negotiated in 2004, lower advanced wound care costs associated with manufacturing the former Kimberly-Clark products in-house versus the acquisition related negotiated costing used in 2004 and the non-recurrence of one-time advanced wound care private label manufacturing start-up costs incurred in the second quarter 2004, and a one-time $59,400 inventory write-off in the first quarter 2004.

Wound closure and fastener sales decreased $599,997, or 31.6%, to $1,298,271 in 2005 from $1,898,268 in 2004. A reduction of approximately $540,000 in sales of certain catheter fasteners in 2005 versus 2004 associated with the loss of the Company s exclusive distribution agreement for the sale of these products in August 2004 is primarily responsible for the decrease. Lower other catheter sales due to competitive pressure partially offset by a slight increase in suture strip sales are responsible for the balance of the sales decrease.

Wound closure and fastener gross profit decreased $273,142, or 29.2% to $663,262 in 2005 from $936,404 in 2004. Gross profit margins improved to 51.1% in 2005 from 49.3% in 2004. The decrease in margin dollars is consistent with the sales shortfall. The margin improvement principally reflects the benefit of the loss of the exclusive catheter fastener business, which was slightly lower margined than the average for the line.

Skin care sales decreased $202,302, or 20.6%, to $777,911 in 2005 from $980,213 in 2004 due to continuing competitive pressure and the loss of several key customers. Skin care gross profit decreased $291,491 to a loss of $94,083 in 2005 from a profit of $197,408 in 2004. Included in the 2005 loss is a provision of $98,000 for severance and lease costs associated with the decision in the second quarter to close the skin care manufacturing facility in St. Louis to improve cost efficiency. Excluding the $98,000 provision, the skin care line operated at essentially break even for the first half of 2005. This performance continues to reflect a highly competitive marketplace characterized by declining market prices and higher internal manufacturing costs associated with increasing material and freight costs and the adverse impact of lower production volumes on operating efficiency and fixed overhead absorption.

Operating Expense

The following table highlights June 30, 2005 versus June 30, 2004 operating expenses by type:

	Six Months Ended June 30,			
	2005	2004	Variance	
Distribution	$ 584,687	$ 563,449	$ 21,238	3.8%
Marketing	225,302	209,272	16,030	7.7%
Sales	932,172	903,093	29,079	3.2%
General administrative	1,839,051	2,248,045	(408,994)	(18.2%)
Total	$3,581,212	$3,923,859	$(342,647)	(8.7%)

Operating expense decreased $342,647, or 8.7% to $3,581,212 in 2005 from $3,923,859 in 2004 including an increase of $102,401, or 2.6% attributable to exchange associated with a 7.4% strengthening of the Canadian dollar on the Canadian operations.

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Distribution expense increased $21,238, or 3.8% in 2005 versus 2004. Expenses in Canada increased $136,342 (including $14,887 expense related to exchange) while expenses in the U.S. decreased $115,104. The increase in Canada was attributable to implementation of the new distribution agreement. Effective June 1, 2005 the new distributor assumed responsibility for order processing, product delivery and inventory maintenance and warehousing. The fee for these services in June 2005 preceded the Company s plan to offload the corresponding fixed costs of its own distribution network resulting in incremental costs for the month. In addition, the Company incurred approximately $52,000 in one-time severance and other related costs associated with the transition to the new distribution agreement. The U.S. decrease reflects the impact of the U.S. distribution integration initiative that took place in the first half of 2004 when the Company closed one facility and moved its St. Louis distribution center out of the skin care manufacturing facility into a new dedicated distribution center located nearby. The decrease in expense reflects the non recurrence of approximately $60,000 of one-time costs to close one of the distribution centers and various start-up related expenses associated with bringing the new distribution center opened in March 2004, on-line.

Partially offsetting these expense reductions were higher lease costs associated with the new, larger distribution center.

Marketing expense increased $16,030, or 7.7% in 2005 versus 2004. The increase is principally attributable to higher literature and promotion expense in support of the Company s growth initiatives.

Sales expense increased $29,079, or 3.2% in 2005 versus 2004. Expenses in Canada increased $93,329 (including $13,979 expense related to exchange) while expenses in the U.S. decreased $64,250. The increase in Canada is attributable to a higher level of sales support activities consisting principally of travel, convention attendance and sampling to expand market visibility and improve contract compliance and one-time severance and travel costs associated with implementing the new distribution agreement. The U.S. decrease was attributable to lower compensation of approximately $45,000 associated with lower sales representative commissions, lower manufacturers representative commissions due to the decision to discontinue the use of manufacturers representatives in the second quarter 2004 and an open position in the second quarter 2005. Elimination of a sales database consultant and related expenses generated savings of approximately $30,300. Partially offsetting these decreases were higher recruiting and travel costs.

General and administrative expense decreased $408,994, or 18.2% in 2005 versus 2004. Expenses in Canada decreased $385,801 (net of $73,534 expense related to exchange) while expenses in the U.S. decreased $23,193. The decrease in Canada reflects the non-recurrence in 2005 of a $450,000 charge for employee termination costs recorded in the first quarter 2004. Partially offsetting this decrease were one-time costs of $41,700 for severance and other costs associated with implementing the new distribution agreement together with higher compensation costs associated with the hiring of a Director of Materials and Logistics in the second quarter 2005. In the aggregate, other general administrative expenses were essentially flat period to period. The decrease in the U.S. reflects the non-recurrence in 2005 of a $42,600 bad debt write-off taken in the first quarter 2004 coupled with lower public relations, legal and regulatory costs due to cost containment efforts. These savings were partially offset by higher Sarbanes Oxley related accounting fees and higher information technology costs associated with the Company s decision in early 2004 to invest resources in this area to upgrade its hardware and overall systems capabilities.

Interest Expense, Net

Interest expense, net increased $81,707, or 83.3%, to $179,853 in 2005 from $98,146 in 2004. Interest expense in Canada decreased $2,425 (net of $4,980 expense related to exchange) while interest expense in the U.S. increased $80,658. The decrease in Canada reflects lower outstanding line of credit and term loan balances in 2005, partially offset by slightly higher interest rates and fees. Canada s outstanding line of credit balance was significantly reduced beginning in mid-May 2005 to zero by the end of June 2005 through the use of the initial one-time positive cash flow generated by implementation of the new distribution agreement. Canada s term loan was significantly reduced in January 2005 as a result of the pay off of an outstanding irrevocable standby letter of credit issued by the U.S. lender in the amount of $200,000 held by the Canadian lender as additional security for its credit facility. The $200,000 payment was applied to the term loan as a permanent principal reduction against the principal amount due in 2007. The increase in the U.S. is due to higher outstanding line of credit balances, higher interest rates and higher line of credit fees in 2005 versus 2004. In January 2005, the U.S. refinanced its line of credit at a higher overall cost. In addition, in 2004 the Company did not move into a net borrowing position until June 2004.

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Other Income/Expense

Other income/expense increased $257,694 to $146,204 income in 2005 from $111,490 expense in 2004. The increase is primarily driven by $164,300 of income relative to a distribution agreement upset fee recorded in the first quarter 2005 and the non-recurrence in 2005 of $94,428 in obsolete equipment write-offs recorded in the first quarter 2004. Aside from these items the net impact of miscellaneous income and expense items was comparable period to period.

Income Taxes

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

Net Loss

The Company incurred a net loss of $54,868, or $0.00 loss per share (basic and diluted) in the first half 2005 compared to a $1,306,765 loss, or $0.14 loss per share (basic and diluted) in the first half 2004.

Liquidity and Capital Resources

Operational Overview

In the first half of 2005, sales of the Company s U.S. private label products continued to increase at a slower than planned rate. In addition, the Company continues to experience competitive sales pressure in its U.S. skin care, silver and basic wound care business. Conversely, Dermagran and Canadian basic wound care sales exceeded plan.

In the second quarter 2005, the Company realized a significant one-time benefit associated with entering into an exclusive distribution agreement for its products in Canada. In connection with implementing the agreement in the second quarter 2005, the Company realized estimated one time net sales, gross margin and net income of $1,840,000, $600,000 and $495,000, respectively, related to the sale to the new distributor of its existing inventory required to stock the new distributor s pipeline, less the Company s one time costs to dismantle its existing distribution network. Further, implementation of the agreement resulted in an estimated one-time positive cash flow benefit of $2,705,000 stemming from prospective lower receivable and inventory requirements coupled with the net income realized.

As expected, the Company has realized the benefit of its major manufacturing and sourcing initiatives completed in 2004. Notwithstanding the adverse impact of sales pricing and mix on margins, the Company has realized an improvement in its overall gross margin percentage in 2005 stemming from lower product costs. In an effort to enhance manufacturing efficiency and competitiveness, the Company decided to shut down its relatively inefficient skin care manufacturing facility and outsource the manufacture of these products. A $98,000 reserve was recorded to cost of sales in the second quarter to cover the initial cost of closure. An agreement was signed in July 2005 to outsource the manufacture of the Company s skin care products.

Excluding one-time costs in both periods and the impact of exchange, 2005 operating costs were essentially flat with 2004 reflecting an effort to restrain expenses to the extent possible without adversely affecting the underlying infrastructure previously put in place to support planned growth.

Excluding a one-time gain of $164,300 related to a distribution agreement upset fee, the first quarter 2005 net loss was $377,352. Excluding the one-time gain of $495,000 associated with the implementation of the new distribution agreement and the $98,000 expense associated with the closure of the skin care manufacturing facility, the second quarter 2005 net loss was $238,816. Adjusting for one-time items, the loss for the first half of 2005 was $616,168 versus $54,868, as reported. Notwithstanding the benefit of the Canadian distribution agreement on liquidity, this performance continues to put pressure on the Company s overall liquidity. In response, the Company will continue to focus on, and take the steps necessary to accelerate sales growth while properly aligning operating expenses with expected revenues.

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

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

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

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

On February 8, 2005, the Company closed a private offering of 2,760,000 units at $0.50 per unit, each unit consisting of one share of the Company s common stock and one four-year series G warrant to purchase one share of common stock at a price of $1.05. Total offering proceeds of $1,220,774, net of $159,226 in offering expenses, were used for working capital. The offering was initiated in December 2004. In 2004, the Company sold 1,555,000 units and received offering proceeds of $681,359, net of $78,641 in offering expenses. In 2005, the Company sold 1,205,000 units and received offering proceeds of $539,415, net of $80,585 in offering expenses.

In 2004, the Company s exclusive distribution agreement for certain catheter fasteners expired and was not renewed by the manufacturer. In accordance with the Company s distribution agreement with a major customer for the fasteners, if the customer subsequently enters into an agreement with the manufacturer to distribute these products, then the customer shall pay the Company an upset fee of $200,000 in forty-eight monthly installments of $4,167. As of January 2005, the customer advised the Company that it had entered into an agreement with the manufacturer to distribute the catheter fasteners and that it was liable for payment of the upset fee. In January 2005, the Company discounted the future cash flow stream associated with the payment of the upset fee and recognized a gain of $164,300.

On May 9, 2005 the Company entered into a five-year agreement expiring May 1, 2010 with a Canadian company to serve as the exclusive distributor of its products in Canada. Effective June 1, 2005 the distributor assumed responsibility for order processing, product delivery and maintenance and warehousing of sufficient inventory to meet order fulfillment requirements. With respect to sales made by the distributor to the Company s contract customers in its capacity as a servicing agent, the Company will pay the distributor a distribution fee and a specified incentive for growth (as achieved). The Company will reimburse the distributor for the difference between the price paid by the distributor and the Company s contract price with its customer upon submission by the distributor of a rebate report. With respect to sales made by the distributor to its customers, the distributors compensation will consist solely of the excess of the proceeds over the cost of the product and the Company will not be responsible for payment of any distribution fee. Further, the agreement requires the distributor to meet specified minimum sales growth targets of 15%, 12%, 12% and 12% in the first four years and private label product purchase

targets failing which the Company may cancel the agreement. The Company believes that the agreement will provide better service to its customers throughout Canada and greater opportunity for prospective sales and profit growth.

In connection with implementing the agreement, the Company sold to the distributor its existing inventory of saleable finished product on hand and will sell all saleable finished product it committed to manufacture prior to signing of the agreement for delivery by the Company through September 2005 at the agreed upon prices to initially stock and maintain its distribution pipeline. It is expected the Company s saleable finished product commitments will be fulfilled by October 2005 at which time the distributor will begin to receive product based upon its initial orders placed with the Company beginning in June 2005. Other than the one-time sale in May and June 2005 of its existing inventory on hand, which is estimated to represent two to two and one-half months sales, prospective sales are expected to resume historical trends affected only by existing market conditions and the growth opportunities inherent in the agreement. Given economic order quantities and normal lead times associated with the products sold to the distributor, it is expected that a two to three month safety stock will be required prospectively by the distributor to maintain required customer service requirements. In addition, the Company incurred one-time costs consisting of severance and other costs to dismantle its distribution capabilities and sub-lease its distribution warehouse. A summary of the estimated one-time benefit and costs of the agreement recognized in the three months ended June 30, 2005 is outlined below:

Net Sales	$1,840,000
Cost of Sales	1,240,000
Gross Profit	600,000
Expenses	105,000
Pretax Income	$ 495,000

Further, implementation of the agreement resulted in an estimated one-time positive cash flow benefit of $2,705,000 stemming from lower receivable and inventory requirements going forward and the one-time pretax income benefit of the sale of existing saleable finished product inventory on hand to the distributor.

In June 2005, the Company announced its intention to close its skin care manufacturing facility in St. Louis, Missouri and outsource the facility s production with a view to reducing overhead and improving cost competitiveness. Facility closure and transition to the new supplier are expected to be complete by the end of September 2005.

As of June 30, 2005, the Company recorded a charge of $98,000 for estimated severances and lease costs associated with the closure. The existing equipment will either be transferred to the Company s Toronto, Canada facility, leased to the supplier or sold. Other one-time closure related costs estimated at $50,000, consisting principally of facility clean up, inventory write-offs and equipment write-offs and ongoing estimated monthly lease and facility maintenance costs of $7,500, net of existing committed lease cost and estimated sub-lease income through lease expiration on January 31, 2007, will be expensed as incurred.

In June 2005 in connection with implementation of the new distribution agreement, the Company sub-leased its Canadian distribution center through June 2008 at its existing rates and terms. The sub-lessee has the right to continue leasing the facility after June 2008 on a month to month basis with the Company s approval or extend the lease term for up to two additional years. The Company s lease expires August 2009. Total payments under the sub-lease agreement through June 2008 aggregate approximately $360,000.

Cash Flow

At June 30, 2005 and December 31, 2004, the Company had cash and cash equivalents on hand of $362,941 and $46,508, respectively. The $316,433 increase represents a timing difference that results from net cash provided by operating activities of $2,340,865 partially offset by net cash used in financing activities of $1,973,346, net cash used in investing activities of $36,881 and cash used as a result of exchange rate changes of $14,205. Subject to constraints surrounding the movement of cash between legal entities, the Company s objective is to

maintain minimum cash balances on hand while using available funds to pay down its outstanding line of credit balances.

Net cash provided by operating activities stems from an estimated $2,705,000 positive cash infusion associated with implementation of the Canadian distribution agreement in the second quarter 2005 partially offset by estimated cash used in ongoing operations of $381,000 (exclusive of a one-time distribution upset fee gain of $164,300 and the $98,000 provision for closure of the skin care manufacturing facility). Of the estimated $381,000 cash used in operations, approximately $125,000 represented cash burn (net losses less non cash items) and the balance of approximately $256,000 represented cash used from the net change in operating assets and liabilities. Replenishment of lower than normal inventory levels for several key products was the major driver behind the net change in ongoing operating assets and liabilities. Cash provided by operations of approximately $17,000 and increases in receivables and other assets related to the $164,300 distribution upset fee also contributed.

Net cash used in financing activities principally reflects the use of the funds generated from operating activities to pay down the Company s outstanding line of credit balance by $2,084,029. Other uses pertain to the debt repayment of $312,142, including, in addition to normal scheduled payments, a one-time payment of $200,000 in January 2005 related to the payoff of the outstanding standby letter of credit issued by the U.S. lender in favor of the Company s Canadian lender as additional security for the Company s credit facility and deferred financing costs of $116,590 related to refinancing the U.S. line of credit in January 2005. Partially offsetting these cash uses were net proceeds of $539,415 from the sale of common stock in the first quarter 2005.

Net cash used in investing activities of $36,881 reflects modest capital investment of $61,879 consistent with the Company s plan to limit capital expenditures to that necessary to continue running the business until operational performance improves, less proceeds from the sale of excess equipment.

Working Capital

Working capital increased $188,159, or 6.6%, at June 30, 2005 to $3,037,755 from $2,849,596 at December 31, 2004. The increase reflects the net impact of the cash inflows and outflows outlined in the Cash Flow section above.

Financing Arrangements United States

On January 31, 2005 the Company entered into a three year revolving credit facility agreement (the New Agreement) with a new U.S. lender for a maximum principal amount of $2,000,000. The New Agreement replaces a $2,000,000 revolving credit facility that expired on January 31, 2005 with the previous U.S. lender. At January 31, 2005 maximum potential advances under the New Agreement were approximately $1,700,000. On January 31, 2005, the Company applied advances of approximately $1,300,000 under the New Agreement in satisfaction of the prior U.S. lender s outstanding obligations. Future advances will be utilized to fund strategic initiatives and general working capital requirements. The Company incurred loan origination and legal fees of approximately $147,300 in connection with the implementation of the New Agreement. These fees have been deferred and are being amortized to interest expense over the three year term of the New Agreement.

The Company may request advances under the New Agreement up to the value of 85% of eligible receivables (as defined) and 55% of eligible inventory (as defined). Interest on outstanding advances is payable monthly in arrears at the prime rate (as defined) plus 2.5%, but not less than 7.5% per annum. At June 30, 2005 the effective interest rate was 8.51%. In addition, the Company pays a monthly collateral management fee at the rate of 1.5% per annum upon the daily average amount of advances outstanding and a monthly unused line fee of 0.5% per annum upon the difference between the daily average amount of advances outstanding and $2,000,000. Outstanding advances are secured by all of the Company s existing and after-acquired tangible and intangible U.S. assets. In addition, the Company has accorded the new U.S. lender its guarantee of payment together with a second lien security interest in the assets of the Company s wholly owned Canadian subsidiary. The new U.S. lender has agreed not to exercise its rights under its second lien security interest and guarantee against the Canadian assets without the Canadian lender s approval.

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Maximum potential advances under the New Agreement at June 30, 2005 were $1,696,779. Advances outstanding against the line were $693,325 at June 30, 2005, leaving an additional $1,003,454 available for borrowing.

Over the term of the New Agreement, the Company has agreed to comply with the following covenants as measured at the end of each month for the average of the three most recent calendar months based upon its consolidated operating results: a) maintain EBITDA (earnings before interest, taxes, depreciation and amortization) in the range of negative $300,000 (as of January 31, 2005) transitioning to positive $600,000 (post December 31, 2005) and (b) maintain its fixed charge ratio (EBITDA divided by the sum of debt service, capital expenditures, income taxes and dividends) in the range of 1.0 to 1.0 (as of January 31, 2005) to 1.25 to 1.0 (post December 31, 2005). In addition, as it pertains to the Company s U.S. operations, cash collections may not be less than $800,000 for each calendar month through June 30, 2005 and $900,000 for each calendar month thereafter, and at all times the

Company s cash on hand (including unused borrowing capacity under the New Agreement) must not be less than $200,000. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the New Agreement.

Based upon consolidated operating results for March and April 2005, the Company was out of compliance with its EBITDA and fixed charge ratio covenant under the New Agreement. The U.S. lender agreed to waive these covenant violations. Effective June 30, 2005 the Company and the U.S. lender agreed to prospectively amend the Company s monthly minimum EBITDA and fixed change ratio covenants to better align these covenants with expected performance. The Company incurred fees of $10,000 associated with the granting of the covenant amendments. The Company expects to, but cannot assure that it will, maintain compliance with all applicable loan covenants in the future.

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

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

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

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

extended by the lender on the Company s behalf up to $1,000,000, less the aggregate amount of any outstanding letters of credit issued by the U.S. lender.

Outstanding advances were secured by all tangible and intangible assets of the Company s U.S. operations. Over the term of the Agreement, the Company agreed to maintain its fixed charge ratio (as defined) at not less than 1.25:1.0 as measured quarterly on a twelve month trailing basis. Additional covenants governing permitted indebtedness, changes in entity status, purchases of securities and protection of collateral were included in the Agreement. Ongoing operating losses resulted in the Company being out of compliance with certain of its U.S. line of credit covenants at March 31, June 30 and September 30, 2004. In return for a commitment to secure alternative financing for its U.S. obligations prior to the January 31, 2005 maturity date of the prior agreement, the U.S. lender agreed to waive the Company s prior covenant violations and to maintain the line of credit until maturity thereof. The Company has incurred waiver fees of $7,500 and agreed to an increase in the rate of interest payable under the line. All other terms of the prior agreement were maintained in full force and effect.

Financing Arrangements Canada

In September 2004, the Company finalized the annual renewal of its revolving credit facility (the Canadian Agreement) for a maximum principal amount of $1,795,000 ($2,200,000 Canadian) with its Canadian lender. The Company s wholly owned Canadian subsidiary, Derma Sciences Canada Inc., may request advances under the Canadian Agreement up to the value of 75% of eligible receivables (as defined) plus the lesser of $897,000 ($1,100,000 Canadian) or 40% of eligible inventory (as defined), less priority claims. Interest on outstanding advances is payable monthly in arrears at prime rate (as defined) plus 1.0%, or 5.25% for Canadian dollar advances and 7.50% for U.S. dollar denominated advances at June 30, 2005. Outstanding advances are secured by all tangible and intangible assets of Derma Sciences Canada Inc. In addition, the Company has accorded the Canadian lender its guarantee of payment together with a second lien security interest in the Company s assets located in the U.S. Maximum potential advances under the Canadian agreement at June 30, 2005 were $492,000. Advances outstanding against the Canadian agreement were zero at June 30, 2005, leaving an additional $492,000 available for borrowing.

Over the term of the Canadian Agreement, the Company has agreed to comply with a number of financial covenants governing minimum working capital, current ratios, tangible net worth, interest coverage, total indebtedness to tangible net worth and total indebtedness to adjusted pre-tax earnings. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the Canadian Agreement. In the event of a margin deficiency (as defined) or covenant violation, the Company is required to advance up to an additional $408,000 ($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.

At June 30, 2005 Derma Sciences Canada was out of compliance with its minimum working capital covenant. The violation occurred due to the adverse impact on Derma Sciences Canada s working capital associated with accelerating repayment of an inter company loan and extending credit terms on regular inter company trade receivables to the U.S. parent in June 2005 in an effort to optimize the use of the positive cash flow associated with implementing the new distribution agreement in Canada. The violation has been corrected and the Canadian lender agreed to waive the covenant violation at June 30, 2005.

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

Prospective Assessment

The Company seeks to increase sales and gross margins and return to profitability by increasing sales of contracted private label products and focusing on organic growth of its core product lines in the U.S. and Canada.

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The recently signed exclusive distribution agreement in Canada represents an opportunity for sales and profit growth in the second half of 2005. In the first half of 2005, the Company began to realize the benefit of lower basic wound care product costs negotiated in mid-2004 and lower advanced wound care costs associated with the commencement in late 2004 of in-house manufacture of a wide range of products using the equipment purchased from Kimberly-Clark Corporation. Further, over the balance of 2005 the Company expects to benefit from the non-recurrence of the one-time costs incurred in the last half of 2004 associated with bringing the manufacture of the Kimberly-Clark products on line. Steps have been taken to reduce operating expenses wherever possible and to limit incremental spending in this area to that necessary to support existing operations. Operational expenditures will continue to be closely monitored and adjusted as necessary to ensure alignment with expected sales and margin growth.

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

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

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

Additional Financial Information

Forward Looking Statements

Statements that are not historical facts, including statements about the Company s confidence, strategies, expectations about new or existing products, technologies, opportunities, market demand or acceptance of new or existing products are forward-looking statements that involve risks and uncertainties. These uncertainties include, but are not limited to, product demand and market acceptance risk, impact of competitive products and prices, product development, commercialization or technological delays or difficulties, and trade, legal, social, financial and economic risks.

Critical Accounting Policies

Estimates and assumptions are required in the determination of sales deductions for trade rebates, discounts and allowances. Significant estimates and assumptions are also required in determining the appropriateness of amortization periods for identifiable intangible assets, the potential impairment of goodwill and the valuation of inventory. Some of these judgments can be subjective and complex, and, consequently, actual results may differ from these estimates. For any individual estimate or assumption made by the Company, there may also be other reasonable estimates or assumptions. The Company believes, however, that given current facts and circumstances, it is unlikely that applying any such other reasonable judgment would cause a material adverse effect on the consolidated results of operations, financial position or cash flows for the periods represented in this section. The Company s most critical accounting policies are described below:

Revenue Recognition and Adjustments to Revenue

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

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impacted. The Company continually monitors the factors that influence these rebates and make adjustments as necessary.

Goodwill

At June 30, 2005, the Company s skin care segment had $1,110,967 of goodwill. The Company tests goodwill for impairment in the fourth quarter of each year or when impairment indicators are present. The process of evaluating the potential impairment of goodwill is highly subjective and requires significant judgments and assumptions in estimating future cash flows to determine the fair value of the reporting unit. These assumptions include future growth rates, discount factors, future tax rates and other factors. The Company s cash flow forecasts are based on assumptions that are consistent with the plans and estimates used to manage the underlying business. In addition, the Company makes certain judgments about allocating shared assets to the balance sheet for this segment. If the expected cash flows are not realized, impairment losses may be recorded in the future.

Inventory

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

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Item 3. CONTROLS AND PROCEDURES

The Company s management, with the participation of the Company s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company s disclosure controls and procedures as of June 30, 2005. Based on this evaluation, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective for gathering, analyzing and disclosing the information the Company is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC s rules and forms.

During the three months ended June 30, 2005, there was no change in the Company s internal controls over financial reporting that materially affected, or is reasonably likely to materially affect, the Company s internal controls over financial reporting.

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Part II Other Information

Item 1. Legal Proceedings

None

Item 6. Exhibits

All exhibits required by Item 601 of Regulation S-B and required hereunder, as filed with the Securities and Exchange Commission in Form 10-KSB on March 31, 2005, are incorporated herein by reference.

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

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DERMA SCIENCES, INC.

By: /s/ John E. Yetter

Dated: August 12, 2005

John E. Yetter, CPA

Chief Financial Officer