DERMA SCIENCES, INC.
Form 10-K
March 31, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

x Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2009

¨ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from _____ to _____

Commission file number: 1-31070

DERMA SCIENCES, INC.
(Name of Issuer in Its Charter)

Pennsylvania	23-2328753
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
214 Carnegie Center, Suite 300, Princeton, New Jersey	08540
(Address of principal executive offices)	(Zip code)

Registrant's telephone number: (609) 514-4744

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.01 par value	The NASDAQ Stock Market LLC

Securities registered under Section 12(g) of the Exchange Act:

Title of Class

Common Stock, $.01 par value

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes ¨ No x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes ¨ No x

Indicate by checkmark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant

was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No ¨

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).
Yes ¨ No ¨

Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.x

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).
Yes ¨ No x

The aggregate market value of the common equity stock held by non-affiliates, computed by reference to the average bid and asked prices of such stock as of June 30, 2009, was approximately $8,601,404.

The number of shares outstanding of the issuer's common equity as of February 28, 2010 was 6,557,855.

Documents Incorporated by Reference

Portions of the Registrant’s definitive proxy statement for its 2010 annual meeting of shareholders are incorporated by reference in Part III of this report.

Part I

Item 1. Description of Business

Overview

Derma Sciences and its subsidiaries Sunshine Products, Derma Canada and Derma First Aid Products, Inc. are referred to collectively as "We" and "Company." Our executive offices are located at 214 Carnegie Center, Suite 300 Princeton, New Jersey.

We are a specialty medical device/pharmaceutical company with a primary focus on wound care. We engage in the manufacture, marketing and sale of three proprietary dermatological related product lines: (1) wound care, (2) wound closure and specialty securement devices, and (3) skin care. In addition, we have leveraged our expanding manufacturing capabilities by building a growing private label/original equipment manufacture ("OEM") business. Our customers consist of various health care agencies and institutions such as wound care centers, long-term care facilities, hospitals, home healthcare agencies, physicians' offices and closed door pharmacies. We also sell our products through retail channels such as retail pharmacies, other retail outlets and first-aid kit manufacturers. While we have our own direct selling organization, our products are principally sold through medical products supply distributors. We currently sell our products in the United States, Canada and select international markets. Our principal U.S. distribution facilities are located in St. Louis, Missouri, and Houston, Texas. In Canada, our products are distributed exclusively by a third party distributor. Our principal manufacturing facility is located in Toronto, Canada. We, through our subsidiary Derma Sciences Canada, have a light manufacturing facility in Nantong, China producing low volume and/or labor intensive wound care products.

The markets we serve are large and growing. Our mission is to enhance shareholder value by servicing a significant portion of these markets as a fully integrated wound care product provider.

Derma Sciences, Inc. ("Derma Sciences") was incorporated under the laws of Colorado on September 10, 1984. On June 3, 1996 Derma Sciences changed its state of domicile to Pennsylvania.

In September, 1998 we acquired Genetic Laboratories Wound Care, Inc. ("Genetic Labs") by means of a tax-free reorganization whereby Genetic Labs became our wholly-owned subsidiary. In December, 1999, pursuant to an Agreement and Plan of Merger dated December 27, 1999, Genetic Labs was merged into Derma Sciences, Inc. by means of a tax-free reorganization whereby the separate corporate existence of Genetic Labs ceased. The Genetic Labs products constitute our wound closure – specialty securement device product line.

In November, 1998 we acquired the stock of Sunshine Products, Inc. ("Sunshine Products") in a cash transaction. As a result of the stock purchase, Sunshine Products became our wholly-owned subsidiary. The Sunshine Products products constitute our skin care product line.

In September, 2002 we acquired the assets of Dumex Medical Inc., a leading manufacturer and distributor of wound care and related medical devices to the Canadian market. The acquisition was effected by our wholly-owned Canadian subsidiary, Derma Sciences Canada Inc. ("Derma Canada") f/k/a Dumex Medical Canada Inc. The Dumex Medical products have been integrated into our wound care product line.

In January 2004, we acquired substantially all the assets of Kimberly-Clark Corporation's wound care segment. These assets have been integrated into both our existing wound care and wound closure — specialty securement device product lines.

In April 2006, we acquired certain assets and the business of Western Medical, Inc. (“Western Medical”), a manufacturer and marketer of a line of specialty medical textile compression, support and protective dressing products. These assets have been integrated into our existing wound care product line.

In November, 2007, we acquired certain assets and the business of Nutra Max Products, Inc.’s first aid division (“FAD”). FAD is a leading manufacturer and marketer of branded and private label adhesive strips and related first aid products to the medical, industrial and retail markets. These assets have been integrated into our existing wound care product line.

Products

Advanced/Active Wound Care

Our advanced/active wound care products include the following:

Medihoney is a line of novel, patented dressings, comprised of a high percentage of Active Leptospermum Honey. This unique type of honey has been shown to result in durable antimicrobial, anti-inflammatory and immunomodulatory activities. Medihoney dressings are ideal for the management of non-chronic and hard-to-heal wounds including chronic ulcers, burns and post-operative wounds. The dressings are non-toxic and have been shown in a large scale randomized controlled study to promote healing.

Bioguard is a line of novel, patented barrier dressings that contain an active antimicrobial compound. This compound, a cationic biocide, is intrinsically bound to the dressing through a proprietary process resulting in the inability for the compound to separate from the dressing. These dressings are ideal for prophylactic use in the prevention of hospital or community acquired infections through wound sites. The dressings have been shown to kill 99.9% of virulent bacteria such as methicillin resistant staphylococcus aureus (MRSA) in less than 1 minute, and 99.999% of MRSA in less than 1 hour. Bioguard's patented polymer technology known as NIMBUS (novel intrinsically micro-biocidal utility substrate) was licensed from QuickMed Technologies, Inc. in April, 2007.

Algicell Ag is a proprietary antimicrobial dressing utilizing ionic silver as its active ingredient. The dressing can absorb up to 20 times its weight in wound fluid. These dressings compare favorably to the market leading dressings at a cost-effective price point.

Xtrasorb is a novel, proprietary dressing that utilizes a super absorbent polymer. While other absorbing dressings currently on the market use open cell structures to capture fluid, Xtrasorb dressings convert fluid within the dressing to a gel thus locking the exudates into the dressing. Xtrasorb dressings have a distinct advantage over competitive dressings in that they absorb more fluid and hold the fluid away from the wound thus avoiding further deterioration of the wound.

TCC-EZ is a novel, patented advanced dressing system for the management of diabetic foot ulcers. It is considered a "next generation" total contact casting (TCC) system. TTC has been shown in multiple randomized controlled studies to achieve 89% heal rates. However, TTC is utilized in less than 2% of otherwise indicated cases due to various factors such as long application times, frequency of application error and patient dissatisfaction as a result of the heavy nature of the cast. TCC-EZ virtually eliminates these issues as it can be applied in less than one third the time of a traditional TCC, is a one-step process — so application errors are uncommon — and the cast itself is significantly lighter — due to its open weave pattern — than a traditional TCC.

Other advanced wound care products include a range of moist, occlusive dressings such as hydrocolloids, foams, hydrogels, alginates, additional silver antimicrobial dressings, cleansers and our proprietary Dermagran products.

Traditional Wound Care

Our traditional wound care line consists of gauze sponges and bandages, non-adherent impregnated dressings, retention devices, paste bandages and other compression devices. We also manufacture and market a broad line of adhesive bandages and related first aid products for the medical, industrial, private label and retail markets.

Private Label/OEM

We manufacture private label wound care and adhesive bandages for a number of United States and international customers.

Wound Closure and Specialty Securement Devices

We market a line of wound closure strips, nasal tube fasteners and a variety of catheter fasteners to doctors, clinics, nursing homes, hospitals and other institutions. Our specialty securement and closure device products incorporate our proprietary polyamide fabrics in combination with a pressure sensitive skin-friendly adhesive. These product combinations result in an ideal balance between elasticity and adherence, making the products unique in their ability to safely hold devices in place on the skin while assisting with the closure of sensitive areas of the skin where a good cosmetic outcome is a priority. We also market a line of traditional rigid wound closure strips.

Skin Care

We market general purpose and specialized skin care products to nursing homes, hospitals, home healthcare agencies and other institutions. These products include barrier creams and ointments, antibacterial cleansing foams and sprays, shampoos and body washes, hand sanitizers, bath additives, body oils and moisturizers

Product Pipeline

We are currently developing DSC127, an angiotensin analog licensed from the University of Southern California in November, 2007, for use in wound healing and scar reduction. The compound has shown activity in these areas in pre-clinical animal model testing. The compound has successfully completed a phase I human trial and is presently undergoing phase II human trials. This trial will assess safety and efficacy of DSC127 on non-healing diabetic ulcers. We expect to receive the results of the phase II trials in the third quarter, 2010. If the results are favorable, we will ascertain whether it is in our best interests to conduct phase III trials or license the rights to the product.

The potential markets for DSC127 include: (1) the $10 billion chronic wound market, (2) the $8 billion scar prevention/reduction market, (3) the $6 billion burn market, and (4) the $6 billion radiation and other wound markets. The markets we enter will depend on the results of the DSC127 clinical trials.

We continue to evaluate certain products and technologies within the advanced/active wound care market. Once products and technologies are located, we may enter into licensing agreements or joint venture relationships with owners of the products and technologies.

We have several ongoing product development programs involving line-extensions of our key brands including Medihoney , Bioguard and Xtrasorb . We anticipate new line extensions to begin coming to market in the second quarter, 2010 and continuing through the third quarter, 2011.

Sales and Marketing

Sales in the United States and Canada account for approximately 70% and 25%, respectively, of our total sales with sales to Europe and Latin America comprising the balance of 5%.

United States

In the United States, we employ a direct sales force and a number of national, regional and local distributors (with their own sales forces) to sell our products. The majority of our sales are made to distributors and large institutional customers who sell the products to end users. Direct sales to end users are not a significant part of our business.

Our direct sales force consists of an executive vice president – sales, a national director – sales, ten direct territory representatives and one clinical resource specialist. Our sales employees receive a base salary together with

commissions based upon sales and gross profit achievement within their area of responsibility.

Canada

In Canada, we employ a sales manager, one direct sales representative in Ontario and a manufacturer's representative located in British Colombia. Our sales representative receives a base salary together with commissions based upon territory sales achievement. Our manufacturer's representative is paid commission based upon territory sales achievement and is reimbursed for expenses. The majority of our Canadian sales are to hospitals pursuant to tender contracts with national, provincial and local buying groups. These institutional contracts are generally exclusive in nature and are awarded for a term of 1 to 5 years. Nursing home, home healthcare, physician office and retail sales are for the most part made through local dealers and government sponsored Community Care Access Centre's (CCAC) agencies.

In May 2005, we entered into a five year agreement with a Canadian company to serve as the exclusive distributor of our products in Canada. In November 2009, this agreement was extended for one year through May, 2011. The distributor maintains strategically located distribution centers and over 40 sales representatives throughout Canada. We believe the agreement provides better service to our customers throughout Canada and greater opportunity for sales growth.

Other Foreign Markets

Our products are sold throughout the rest of the world through various licensing and distribution agreements. Foreign sales are made principally to Europe and Latin America. Sales made to other foreign markets totaled $2,448,342 in 2009 and $2,743,388 in 2008.

Competition

The wound and skin care sectors of the medical products industry are characterized by rapidly evolving technology and intense competition. Many suppliers of competing products are considerably larger and have much greater resources than us. In addition, many specialized products companies have formed collaborations with large, established companies to support research, development and commercialization of wound and skin care products which may be competitive with ours. Academic institutions, government agencies and other public and private research organizations are also conducting research activities and may commercialize wound and skin care products on their own or through joint ventures.

In the United States, our basic wound care products compete in a commodity oriented marketplace with Covidien, Medical Action and a number of others. In the advanced wound care products marketplace, we compete principally with Convatec, Smith & Nephew, MoInlycke and Systagenix (formerly Johnson & Johnson's wound care division) and Johnson & Johnson. Our adhesive bandage and related first aid products compete with Medline, ASO and Dynerex in the medical market, Medline and ASO in the industrial market, ASO, Medline and Liberty in the private label market and Johnson & Johnson, 3M and Medline in the retail market. The market for wound closure strips and catheter fasteners is characterized by a wide range of generic competition. The most dominant competitor in the suture strip market is 3M. Our skin care products compete in a commodity oriented marketplace with Medline, Provon and a number of others.

In Canada, our basic wound care products compete in a commodity-oriented marketplace with Covidien, Medicom, Medical Mart and a number of others. In the advanced wound care products marketplace, we compete principally with the same competitors as we compete with in the United States together with a number of domestic generic companies.

Our ability to remain competitive is based on our ability to provide our customers with a broad range of quality products at a competitive price with superior customer service. The prospective ability to develop cost effectively

and/or acquire and commercialize new products that provide superior value is an integral component of our ability to stay competitive. We believe that the breadth and quality of our existing product lines, the infrastructure in place to cost effectively source and market our products and the skill and dedication of our employees will allow us to successfully compete.

Product Sourcing

We lease manufacturing and warehousing facilities in Toronto, Canada, and Nantong, China, and employ contract manufacturers in Mexico City, Mexico, and ZhongShan, China. Approximately 60% of our products are manufactured at these four locations. The remaining 40% of our products are manufactured by third party manufacturers in the U.S., China and other countries.

Our four manufacturing facilities are monitored and controlled by our management and quality control teams. These teams oversee product production. Most of the equipment in these facilities is owned by us and used exclusively by us.

Our 76,399 square foot facility in Toronto manufactures our line of basic and advanced wound care and wound closure-specialty securement device products. This facility has the capability of liquid packaging, blister/vacuum packaging, impregnation, die-cutting and steam sterilization. We also have research and development laboratories on site. The Toronto facility is ISO 13485:2003, ISO 9001:2000, and Directive 93/42/EEC certified and SGS registered.

Our 11,388 square foot facility in Nantong manufactures our line of basic and some advanced wound care products. This facility is primarily designed for production of low volume and specialty products. The quality control team at Nantong has the responsibility to oversee and inspect all products produced in China for us. The Nantong facility is ISO 9002 certified and TUV registered.

Both our Mexico City and ZhongShan facilities manufacture adhesive bandages and related first aid products. The Mexico City facility is ISO 9001:2000 and ISO 13485:2004 certified and Aenor IQNET registered. The ZhongShan facility is ISO 13485:2003 certified and NQA registered.

A number of basic and advanced wound care products are sourced in semi-finished and finished form directly from suppliers. Derma Sciences Canada also serves in a distributor capacity (sourcing finished products directly from suppliers) for a number of medical device products in Canada.

We maintain a long-standing network of suppliers for our outsourced products. The majority of our outsourced products utilize readily available components. Accordingly, there are numerous companies capable of manufacturing these products to applicable regulatory standards. Given the availability of other suppliers, as well as our policy regarding maintenance of adequate safety stock levels, we do not believe that a temporary interruption in supply or loss of one or more of our suppliers would have a long-term detrimental impact on our operations.

We require that all of our suppliers conform to the standards set forth in the Good Manufacturing Practice (“GMP”) regulations promulgated by the United States FDA and local health agencies.

Patents, Trademarks, Proprietary and Non-Proprietary Technology

We own or license the following trademarks: Derma Sciences, Dermagran, American White Cross, Dumex, Medihoney, Algicell, Xtrasorb, TCC-EZ and Bioguard. In addition, we own or license over fifty United States patents, corresponding foreign patents and patent applications. Most of our patents related to our DSC127 technology are held under license agreements of indefinite duration. The license agreement relative to our Bioguard technology expires in June, 2014. We recently entered into an agreement extending our Medihoney license in perpetuity. Subject to meeting minimum royalty and other specified conditions, we expect to maintain these licenses indefinitely. We also have a number of non-patented formulations and process technologies that, together with the aforementioned patents, provide competitive advantages in the marketplace.

We believe our patents, proprietary and non-proprietary technology afford us reasonable protection against the unauthorized copying of the technology embodied in the subject products. However, the specific means whereby these products promote wound healing and skin care are unknown and the chemical and biological processes bearing upon wound healing and skin care are highly complex and subject to a wide variety of influences and stimuli. As such, it is possible that competitors will develop products equal, or superior, to ours without infringing upon our intellectual property.

Patent law relating to the scope of claims with respect to wound care products is still evolving and our patent rights are subject to uncertainty. Furthermore, the existence of patent rights does not provide absolute assurance against infringement of these rights. The prosecution and defense of patent claims is both costly and time consuming, regardless of the outcome.

An important component of our growth strategy is to acquire, by purchase or license, both proprietary and non-proprietary wound and skin care technology. There can be no assurance that we will be able to obtain such technology on acceptable terms, if at all. Future inability to acquire or license wound and skin care technology could have a material adverse effect on our business.

Government Regulation

United States — Scope of Regulation

Agencies

The manufacture, distribution and advertising of our products are subject to regulation by numerous federal and state governmental agencies in the United States. The United States Food and Drug Administration ("FDA") is responsible for enforcement of the Federal Food, Drug and Cosmetic Act, as amended, ("FDC Act") which regulates drugs and devices manufactured and distributed in interstate commerce. Many of our products are classified either as over-the-counter drugs or medical devices pursuant to the FDC Act. The Federal Trade Commission ("FTC") administers the Federal Trade Commission Act ("FTC Act") which regulates the advertising of products including over-the-counter drugs and devices. All states have individual laws analagous to the FDC Act and the FTC Act.

Medical Devices

The FDC Act requires that all devices for human use marketed in the United States prior to May 28, 1976 ("Pre-amendment Devices") be classified by the FDA, based on recommendations of expert panels, into one of three regulatory classes. Class I products are subject only to the general controls which apply to all devices, irrespective of class. General controls include the registration of manufacturers, record-keeping requirements, labeling requirements, and Good Manufacturing Practice ("GMP") regulations.

Class II devices are those for which general controls are not sufficient to ensure safety and effectiveness, and for which enough information exists to develop a standard. These devices are required to meet performance standards established by the FDA. Performance standards may specify materials, construction components, ingredients, labeling and other properties of the device. A standard may also provide for the testing of devices to ensure that different lots of individual products conform to the requirements.

The most restrictive controls are applied to devices placed in Class III. Class III devices are required to have FDA approval for safety and effectiveness before they can be marketed unless the FDA determines that pre-market approval is not necessary. Pre-market approval necessitates the compilation of extensive safety and effectiveness data which is normally expensive to compile. Approval of Class III devices may require several years.

Devices marketed after May 28, 1976 are considered to be one of two kinds: those that are and those that are not substantially the same as a Pre-amendment Device. Those that are substantially equivalent to a Pre-amendment Device are given the same classification as the equivalent Pre-amendment Device. New devices which are not substantially equivalent to Pre-amendment Devices are automatically placed in Class III thereby requiring pre-market approval.

All manufacturers are required to give the FDA ninety days notice before they can introduce a device on the market. During the ninety-day period, the FDA will determine whether the device is or is not substantially equivalent to a Pre-amendment Device. If the FDA determines that the device is not substantially equivalent to a Pre-amendment Device, it is automatically placed in Class III and the manufacturer will have to provide the FDA with a Premarket Approval Application ("PMA") containing evidence that the device is safe and effective before the device may be commercially distributed to the public. However, the manufacturer may request that the FDA reclassify the device by filing a reclassification petition.

All of the devices currently marketed by us, with the exceptions of Sterile Water and Sterile Saline, have been found by the FDA to be substantially equivalent to a Pre-amendment Device and are, therefore, classified in Class I. Sterile Water and Sterile Saline are classified in Class II and meet the performance standards established by the FDA. Algicell Ag Dressings with antimicrobial silver and Medihoney Wound & Burn Dressings with Active Leptospermum Honey are unclassified. We and our principal suppliers with respect to products sold to us operate in accordance with GMP.

Over-the-Counter Drugs

Prescription drugs may be dispensed only on the prescription of a licensed practitioner and must be labeled: “Caution: Federal law prohibits dispensing without prescription.” In general, a drug is restricted to the prescription class if it is not safe for use except under professional supervision. All drugs having characteristics that do not require prescription dispensing are considered to be over-the-counter (“OTC”) drugs.

In 1972, the FDA began a comprehensive review of the safety, efficacy and labeling of all OTC drugs for the purpose of establishing the conditions under which such drugs could be generally recognized as safe, effective and not misbranded. To facilitate the review, these drug products were grouped into therapeutic classes and advisory panels were established to review each class. The panels completed their review in 1983 and it remains for the FDA to complete the rulemaking process.

On the basis of the recommendations submitted by the panels, the FDA issues monographs setting forth the conditions under which OTC drugs in each class are deemed to be generally recognized as safe, effective and not misbranded. Generally, the administrative process includes the publication of a “Preliminary,” “Tentative Final” and “Final Monograph.” During the rulemaking process, products are placed into one of three categories describing whether a drug is deemed to be generally recognized as safe and effective and not misbranded (Category I), to be not generally recognized as safe and effective or misbranded (Category II) or to lack sufficient data for categorization (Category III). Products that do not comply with general OTC regulations or an applicable Final Monograph are subject to regulatory action. Any OTC drug not in compliance with the content and labeling requirements of a Final Monograph is subject to regulatory action unless it is the subject of an approved new drug application. The FDA has issued a Compliance Policy Guide in which it determined that it would not pursue regulatory action against OTC drugs prior to the adoption of a final regulation unless failure to do so presents a potential public health hazard. We believe all of the OTC products currently marketed by us have been deemed to be generally recognized as safe and effective and not misbranded.

Canada — Scope of Regulation

Medical Devices

The Medical Devices Regulations have been established under the authority of the Food and Drugs Act and apply to all medical devices imported and sold in Canada. The Medical Devices Bureau of the Therapeutic Products Directorate is the national authority that monitors and evaluates the safety, effectiveness and quality of diagnostic and therapeutic medical devices in Canada.

On July 1, 1998 the Medical Devices Regulations set forth the requirements governing the sale, importation and advertisement of medical devices in Canada. Regulatory scrutiny is applied in these areas based on risk management principles that classify medical devices into four classes, with Class I representing the lowest risk and Class IV the highest.

Every medical device imported or sold in Canada, with the exception of Class I medical devices, is required to be licensed prior to being imported or sold. A device license will be issued to the manufacturer of a device if it is

determined that the device meets applicable safety and effectiveness requirements. Although Class I devices do not require a license, they are monitored through Establishment Licenses. An Establishment License permits importers, distributors and manufacturers of Class I devices to operate in Canada without using a licensed importer.

As of January 1, 2003, manufacturers of Class II, III and IV devices are required to have a quality system registered to ISO 13485 or ISO 13488 by a registrar recognized by Health Canada. Proof of registration must be submitted with any new license application after January 1, 2003 and with the renewal of existing licenses after November 1, 2003.

Drugs

The Health Products and Food Branch Inspectorate of Health Canada regulates drugs and the processes used to manufacture drugs. A Drug Establishment License is required for activities such as fabrication, packaging/labeling, importation, distribution, wholesale and testing. Derma Canada last underwent an inspection by the Health Products and Food Branch Inspectorate in August 2007 which occasioned the renewal and subsequent annual renewal of its Drug Establishment License.

Once a drug has been approved, the Therapeutic Products Directorate issues a DIN (Drug Identification Number) which permits the manufacturer to market the drug in Canada. A DIN lets the user know that the product has undergone and passed a review of its formulation, labeling and instructions for use.

Registration and Status of Derma Canada Products Sold in United States

Derma Canada has passed inspection by the FDA.

Other Foreign Regulatory Authorities

Whether or not FDA approval has been obtained, approval of medical drugs and devices by regulatory authorities in foreign countries must be obtained prior to marketing drugs and devices in such countries. The requirements governing the conduct of clinical trials and product approval vary widely from country to country and the time required for approval may be longer or shorter than that required for FDA approval. Although there are procedures for unified filings for certain European countries, most countries currently maintain their own product approval procedures and requirements.

Other Regulatory Requirements

In addition to the regulatory framework for product approvals, we are subject to regulation under state and federal law, including requirements regarding occupational safety, laboratory practices, environmental protection and hazardous substance control, and may be subject to other present and future local, state, federal and foreign regulation.

We are also subject to federal, state and foreign laws and regulations adopted for the protection of the environment and the health and safety of employees. Management believes that we are in compliance with all such laws, regulations and standards currently in effect and that the cost of compliance with such laws, regulations and standards will not have a material adverse effect on us.

Third Party Reimbursement in the United States

In the United States, we sell our wound care products to nursing homes, hospitals, home healthcare agencies, retail and “closed door” pharmacies and similar institutions. The patients at these institutions for whose care our products are purchased often are covered by medical insurance. Accordingly, our customers routinely seek reimbursement for the cost of our wound care products from third party payors such as Medicare, Medicaid, health maintenance organizations and private insurers. The availability of reimbursement from such third party payors is a factor in our sales of wound care products.

Medicaid is a federally funded program administered by the states. Medicaid insurance is available to individuals who have no Medicare or private health insurance or to individuals who have exhausted their Medicare benefits. Included in the Medicaid insurance coverage are in-patient stays in long term care facilities, hospitalization and drugs.

Medicare is a federally funded program administered by private insurance companies. Medicare insurance generally is available to individuals who have paid social security taxes and are over the age of 65 years. Several of our wound care and fixation products are eligible for Medicare reimbursement.

Federal and state governments, as well as private insurers, will continue their pursuit of programs designed to control or reduce the cost of health care. These cost cutting measures may include reductions in reimbursements and/or increases in mandatory rebates for wound care products. As such, there is uncertainty as to whether, and to what extent, reimbursements for our products will continue to be available.

Employees

We maintained 163 full-time and 11 part-time employees at December 31, 2009. Of these employees, 67 are located in the United States, 67 in Canada and 40 in China. We consider our employee relations to be satisfactory.

Item 1A. Risk Factors

We have a history of losses and can offer no assurance of future profitability.

We incurred losses of $1,143,272 in 2009, $3,961,937 in 2008, $2,284,605 in 2007, $1,099,990 in 2005, $2,338,693 in 2004, $2,581,337 in 2000 and $2,998,919 in 1999. At December 31, 2009, we had an accumulated deficit of $20,807,095. We cannot offer any assurance that we will be able to generate sustained or significant future earnings.

Our liquidity may be dependent upon amounts available under our existing line of credit or amounts available through additional debt or equity financings.

We have a history of operating losses and negative cash flow from operating activities. As such, we have utilized funds from offerings of our equity securities and lines of credit to fund our operations. We have taken steps to improve our overall liquidity and believe we have sufficient liquidity to meet our needs for the foreseeable future. However, in the event our cash flow from operating activities is insufficient to meet our requirements, we may be forced either to refinance our current line of credit or seek additional equity financing. The sale of additional securities could result in additional dilution to our shareholders. The incurrence of indebtedness would result in increased debt service obligations and could result in operating and financing covenants that would restrict our operations. There can be no assurance that such financing would be available or, if available, that such financing could be obtained upon terms acceptable to us.

Our foreign operations are essential to our economic success and are subject to various unique risks.

Our future operations and earnings will depend to a large extent on the results of our operations in Canada and our ability to maintain a continuous supply of basic wound care products from our operations in China and suppliers in China and Mexico. While we do not envision any adverse change to our operations in Canada, China or Mexico, adverse changes to these operations, as a result of political, governmental, regulatory, economic, exchange rate, labor, logistical or other factors, could have an adverse effect on our future operating results.

The rate of reimbursement for the purchase of our products by government and private insurance is subject to change.

Sales of several of our wound care products depend partly on the ability of our customers to obtain reimbursement for the cost of our products from government health administration agencies such as Medicare and Medicaid. Both government health administration agencies and private insurance firms continuously seek to reduce healthcare costs. Our ability to commercialize our products successfully will depend in part on the extent to which reimbursement for

the costs of such products and related treatments will be available from government health administration authorities, private health insurers and other third-party payors. Significant uncertainty exists as to the reimbursement status of newly approved medical products. The continuing efforts of the government, insurance companies, managed care organizations and other payors of healthcare services to contain or reduce costs of healthcare may adversely affect:

- Our ability to set a price we believe is fair for our products;
- Our ability to generate revenues or achieve or maintain profitability; and
- The availability to us of capital.

Payors are increasingly attempting to contain healthcare costs by limiting both coverage and the level of reimbursement, particularly for new therapeutic products or where payors perceive that the target indication of the new product is well-served by existing drugs or other treatments. Accordingly, even if coverage and reimbursement are provided, market acceptance of our products would be adversely affected if the amount of coverage and/or reimbursement available for the use of our products proved to be unprofitable for healthcare providers or less profitable than alternative treatments.

There have been federal and state proposals to subject the pricing of healthcare goods and services to government control and to make other changes to the U.S. healthcare system. While we cannot predict the outcome of current or future legislation, we anticipate, particularly given the recent enactment of healthcare reform legislation, that Congress and state legislatures will introduce initiatives directed at lowering the total cost of healthcare. In addition, in certain foreign markets the pricing of drugs is subject to government control and reimbursement may in some cases be unavailable or insufficient. It is uncertain if future legislative proposals, whether domestic or abroad, will be adopted that might affect our products. It is also uncertain what actions federal, state or private payors for healthcare treatment and services may take in response to any such healthcare reform proposals or legislation. Any such healthcare reforms could have a material and adverse effect on the marketability of any products for which we ultimately receive FDA or other regulatory agency approval or for which we receive government sponsored reimbursements.

Our success may depend upon our ability to protect our patents and proprietary technology.

We own patents, both in the United States and abroad, for several of our products, and rely upon the protection afforded by our patents and trade secrets to protect our technology. Our future success, if any, may depend upon our ability to protect our intellectual property. However, the enforcement of intellectual property rights can be both expensive and time consuming. Therefore, we may not be able to devote the resources necessary to prevent infringement of our intellectual property. Also, our competitors may develop or acquire substantially similar technologies without infringing our patents or trade secrets. For these reasons, we cannot be certain that our patents and proprietary technology will provide us with a competitive advantage.

Government regulation plays a significant role in our ability to acquire and market products.

Government regulation by the United States Food and Drug Administration and similar agencies in other countries is a significant factor in the development, manufacturing and marketing of many of our products and in our acquisition or licensing of new products. Complying with government regulations is often time consuming and expensive and may involve delays or actions adversely impacting the marketing and sale of our current or future products.

Approximately forty percent of our products are sourced from third parties.

Approximately forty percent of our products are sourced in raw, semi-finished and finished form directly from third party suppliers. None of these suppliers presently account for more than ten percent of our sales. We maintain good relations with our third party suppliers. There are several third party suppliers available for each of our products. If a current supplier were unable or unwilling to continue to supply our products, sale of the affected products could be delayed for the period necessary to secure a replacement.

The technology utilized in many of our advanced wound care products is licensed from third parties and could become unavailable.

Many of our advanced wound care products utilize technology that we license on an exclusive basis from third parties. These products include Medihoney dressings, Bioguard dressings and MedEfficiency TM total contact casts. The licensing agreements that we have with the owners of these technologies are of limited duration (with the exception of Medihoney which is in perpetuity) and renewals of the agreements are in the discretion of the licensors. In addition, the maintenance of the license agreements requires that we meet various minimum sales and/or minimum royalty requirements. If we fail to meet the minimum sales or minimum royalty requirements of a given license agreement, there is a possibility that the agreement will be cancelled or not renewed or that our exclusivity under the license agreement will be withdrawn. If any of these events were to occur, our ability to sell the products utilizing the licensed technology could be lost or compromised and our revenues and potential profits could be adversely affected.

Competitors could invent products superior to ours and cause our products and technology to become obsolete.

We operate in an industry where technological developments occur at a rapid pace. We compete with a large number of established companies and institutions many of which have more capital, larger staffs and greater expertise than we do. We also compete with a number of smaller companies. Our competitors currently manufacture and distribute a variety of products that are in many respects comparable to our products. While we have no specific knowledge of products under development by our competitors, it is possible that these competitors may develop technologies and products that are more effective than any we currently have. If this occurs, any of our products and technology affected by these developments could become obsolete.

Although we are insured, any material product liability claims could adversely affect our business.

We sell over-the-counter products and medical devices and are exposed to the risk of lawsuits claiming alleged injury caused by our products. Among the grounds for potential claims against us are injuries due to alleged product inefficacy and injuries resulting from infection due to allegedly non-sterile products. Although we carry product liability insurance with limits of $1.0 million per occurrence and $2.0 million aggregate with $10.0 million in umbrella coverage, this insurance may not be adequate to reimburse us for all damages that we could suffer as a result of successful product liability claims. No material product liability claim has ever been made against us and we are not aware of any pending product liability claims. However, a successful material product liability suit could adversely affect our business.

The potential increase in common shares due to the conversion, exercise or vesting of outstanding dilutive securities may have a depressive effect upon the market value of our shares.

Up to 3,111,348 shares of our common stock are potentially issuable upon the conversion, exercise or vesting of outstanding convertible preferred stock, warrants and options (“dilutive securities”). The shares of common stock potentially issuable upon conversion, exercise or vesting of dilutive securities are substantial compared to the 6,557,855 shares of common stock currently outstanding.

Earnings per share of common stock may be substantially diluted by the existence of these dilutive securities regardless of whether they are converted, exercised or issued. This dilution of earnings per share could have a depressive effect upon the market value of our common stock.

Our stock price has been volatile and this volatility is likely to continue.

Historically, the market price of our common stock has been volatile. The high and low stock prices (after reflecting the impact of the 1-for-8 reverse split) for the years 2004 through 2009 are set forth in the table below:

Derma Sciences, Inc.
Trading Range – Common Stock

Year	Low	High
2004	$ 3.44	$ 15.20
2005	$ 3.36	$ 6.24
2006	$ 3.60	$ 7.20
2007	$ 4.64	$ 11.20
2008	$ 1.60	$ 10.80
2009	$ 1.92	$ 6.80

Events that may affect our common stock price include:

- Quarter to quarter variations in our operating results;
- Changes in earnings estimates by securities analysts;
- Changes in interest rates or other general economic conditions;
- Changes in market conditions in the wound care industry;
- Fluctuations in stock market prices and trading volumes of similar companies;
- Discussion of us or our stock price by the financial and scientific press and in online investor communities;
- Additions or departures of key personnel;
- Changes in third party reimbursement policies;
- The introduction of new products either by us or by our competitors; and
- The loss of a major customer.

Although all publicly traded securities are subject to price and volume fluctuations, it is likely that our common stock will experience these fluctuations to a greater degree than the securities of more established and better capitalized organizations.

We have not paid, and we are unlikely to pay in the near future, cash dividends on our securities.

We have never paid any cash dividends on our common or preferred stock and do not anticipate paying cash dividends in the foreseeable future. The payment of dividends by us will depend on our future earnings, financial condition and such other business and economic factors as our management may consider relevant.

If members of our management and their affiliates were to exercise all warrants and options held by them, members of management and their affiliates could acquire effective control of us.

The executive officers and directors, together with institutions with which they are affiliated, own substantial amounts of our common stock, together with outstanding options and warrants to purchase our common stock. Depending upon the warrants and options exercised by outside investors, if directors, executive officers and affiliates were to exercise their options and warrants, members of management and their affiliates could obtain effective control of us. As a result, these officers, directors and affiliates would be in a position to significantly influence our strategic direction, the composition of our board of directors and the outcome of fundamental transactions requiring shareholder approval.

Our common stock does not have a vigorous trading market and you may not be able to sell your securities when desired.

We have a limited active public market for our common shares. We cannot assure you that a more active public market will develop thereby allowing you to sell large quantities of our shares. Consequently, you may not be able to readily liquidate your investment.

Our common stock may be delisted from the NASDAQ Capital Market which could negatively impact the price of our common stock and our ability to access the capital markets.

The listing standards of the NASDAQ Capital Market (referred to as the “NASDAQ Market”) provide that a company, in order to qualify for continued listing, must maintain a minimum stock price of $1.00 and satisfy standards relative to minimum shareholders’ equity, minimum market value of publicly held shares and various additional requirements. If we fail to comply with all listing standards applicable to issuers listed on the NASDAQ Market, our common stock may be delisted. If our common stock is delisted, it could reduce the price of our common stock and the levels of liquidity available to our shareholders. In addition, the delisting of our common stock could materially adversely affect our access to the capital markets and any limitation on liquidity or reduction in the price of our common stock could materially adversely affect our ability to raise capital. Delisting from the NASDAQ Market could also result in

other negative consequences, including the potential loss of confidence by suppliers, customers and employees, the loss of institutional investor interest and fewer business development opportunities.

The liquidity of our common stock and market capitalization could be adversely affected by our reverse stock split.

We implemented a 1-for-8 reverse split of our common and preferred stock effective February 1, 2010. A reverse stock split is often viewed negatively by the market and, consequently, our reverse stock split could ultimately lead to a decrease in our price per share and overall market capitalization.

Item 2. Properties

Our headquarters are located in Princeton, New Jersey. In addition to the lease relative to our headquarters, we have entered into leases for manufacturing, warehousing and distribution facilities. Our facilities, locations, size, monthly rent and lease expirations are set forth in the table below:

Location	Use	Square Footage	Base Monthly Rent	Lease Expiration
Princeton, New Jersey	Headquarters	8,024	$ 19,726	July, 2012
Fenton, Missouri	Warehouse	42,400	$ 21,604	March, 2011
Houston, Texas	Warehouse	52,770	$ 18,206	March, 2012
Toronto, Canada	Manufacturing, Warehouse & Offices	76,399	$ 32,115	August, 2012
Nantong, China	Manufacturing & Offices	11,388	$ 1,546	December, 2013

We believe that our facilities are adequate to meet our office, manufacturing and distribution requirements for the foreseeable future.

Item 3. Legal Proceedings

We are not a party to any legal proceedings that we believe will have a material adverse effect upon the conduct of our business or our financial position.

Part II

Item 5. Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases ofEquity Securities

Our common stock is traded on the NASDAQ Capital Market under the symbol "DSCI." Until February 10, 2010 our common stock traded on the OTC Bulletin Board. The following table sets forth the high and low bid prices for our common stock on the OTC Bulletin Board during each of the indicated calendar quarters:

Quarter Ended	High	Low
March 31, 2009	$ 5.60	$ 2.80
June 30, 2009	$ 4.40	$ 1.92
September 30, 2009	$ 6.80	$ 2.64
December 31, 2009	$ 6.16	$ 4.32
March 31, 2008	$ 10.80	$ 5.92
June 30, 2008	$ 8.40	$ 6.40
September 30, 2008	$ 7.60	$ 2.16
December 31, 2008	$ 5.60	$ 1.60

The stock prices reflect inter-dealer prices without retail mark-up, mark-down or commission and may not necessarily represent actual transactions. The stock prices also reflect a 1-for-8 reverse split of our common stock effective February 1, 2010. There is no public market for our preferred stock. As of the close of business on February 26, 2010 there were 1,167 holders of record of the common stock.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Year Ended December 31, 2009 Compared to Year Ended December 31, 2008

Overview

The following table highlights the year ended December 31, 2009 versus 2008 operating results:

	Year Ended December 31,		Variance	
	2009	2008		
Gross Sales	$ 57,829,670	$ 60,431,835	$ (2,602,165)	(4.3)%
Sales adjustments	(9,303,512)	(10,232,407)	(928,895)	(9.1)%
Net sales	48,526,158	50,199,428	(1,673,270)	(3.3)%
Cost of sales	33,468,440	35,289,684	(1,821,244)	(5.2)%
Gross profit	15,057,718	14,909,744	147,974	0.1%
Selling, general and administrative expense	15,135,233	17,196,863	(2,061,630)	(12.0)%
Research and development expense	399,558	653,326	(253,768)	(38.8)%
Interest expense	842,132	940,148	(98,016)	(10.4)%
Other (income) expense, net	(244,596)	22,529	(267,125)	
Total expenses	16,132,327	18,812,866	(2,680,539)	(14.3)%
Loss before income taxes	(1,074,609)	(3,903,122)	2,828,513	72.5%
Provision for income taxes	68,663	58,815	9,848	16.7%
Net loss	$ (1,143,272)	$ (3,961,937)	$ 2,818,665	71.1%

Gross to Net Sales Adjustments

Gross to net sales adjustments comprise the following:

	Year Ended December 31,	
	2009	2008
Gross Sales	$ 57,829,670	$ 60,431,835
Trade rebates	(6,822,694)	(7,446,780)
Distributor fees	(1,022,311)	(1,135,901)
Sales incentives	(561,653)	(481,803)
Returns and allowances	(470,893)	(694,765)
Cash discounts	(425,941)	(473,158)
Total adjustments	(9,303,512)	(10,232,407)
Net sales	$ 48,526,158	$ 50,199,428

Trade rebates decreased in 2009 versus 2008 due principally to lower Canadian sales subject to rebate which, in turn, resulted from lower demand as a result of the exclusive Canadian distributor reducing its inventory, unfavorable exchange and a slight increase in sales not subject to rebate. U.S. rebates increased due to an increase in regular sales subject to rebate, coupled with an increase in the percentage of rebates to sales due to list price increases (without a commensurate increase in contract pricing). This increase was partially offset by the discontinuation of a significant private label customer rebate program effective November 1, 2009. The decrease in distribution fee expense is commensurate with the change in Canadian net sales upon which it is based, coupled with a slight increase in sales not

subject to the fee. The increase in sales incentive expense relates principally to an expansion of the traditional wound care and first aid products sales incentive programs. The sales returns and allowances decrease is principally due to the non-recurrence of higher first aid products integration related returns and allowances in 2008. The decrease in cash discounts reflects lower U.S. sales subject to cash discount.

Rebate Reserve Roll Forward

A twelve month roll forward of the trade rebate accruals at December 31, 2009 and 2008 is outlined below:

	Year Ended December 31,	
	2009	2008
Beginning balance – January 1	$ 2,660,086	$ 2,407,709
Rebates paid	(6,989,548)	(7,194,403)
Rebates accrued	6,822,694	7,446,780
Ending balance – December 31	$ 2,493,232	$ 2,660,086

The $166,854 decrease in the trade rebate reserve balance for the twelve months ended December 31, 2009 reflects a reduction in the Canadian reserve due to lower sales to the exclusive Canadian distributor in response to the distributors' plan to reduce its investment in inventory coupled with the timing of payment of U.S. private label rebates and the decision of one significant private label customer to discontinue its rebate program effective November 1, 2009. There has been no other discernable change in the nature of our business in 2009 as it relates to the accrual and subsequent payment of rebates.

Net Sales and Gross Margin

The following table highlights the December 31, 2009 versus 2008 product line net sales and gross profit:

	Year Ended December 31,		Variance	
	2009	2008		
Net Sales	$ 48,526,158	$ 50,199,428	$ (1,673,270)	(3.3)%
Cost of sales	33,468,440	35,289,684	(1,821,244)	(5.2)%
Gross Profit	$ 15,057,718	$ 14,909,744	$ 147,974	0.1%
Gross Profit %	31.0%	29.7%		

Consolidated net sales decreased $1,673,270, or 3.3% (1.6% adjusted for exchange), in 2009 versus 2008. Canadian net sales decreased $826,206, or 6.8%, to $11,265,652 in 2009 from $12,091,858 in 2008. This decrease was driven by unfavorable exchange of $880,834 associated with a 7.0% weakening of the Canadian dollar, partially offset by sales growth of $54,628. Excluding exchange, inventory rationalization on the part of our Company's exclusive Canadian distributor is principally responsible for the modest sales growth in 2009. Real growth as measured by sales of our Company's products reported by our exclusive distributor, unadjusted for foreign exchange, approximated 6.3%. U.S. net sales decreased $847,064, or 2.2%, to $37,260,507 in 2009 from $38,107,571 in 2008. The decrease was driven by lower first aid product sales of $4,458,782, or 26.2%, and traditional wound care sales of $446,842, or 6.6%, partially offset by higher advanced wound care sales of $2,962,462, or 65.9%, and private label sales of $1,251,965, or 18.3%. Specialty fixation, burn care and skin care and bathing sales were down $33,867, or 1.3%, period to period. The lower first aid product sales reflect the non-recurrence of higher sales in 2008 due to integration related backorder fulfillment, lower demand and customers rationalizing their inventory in 2009 in response to the economy and lost business. The lower traditional wound care sales reflect the non-recurrence of a spot sale (customer's normal supplier was unable to supply) realized in 2008 and lower demand. The higher advanced wound care sales reflect continued growth of Medihoney together with the balance of the product line in response to our focused sales and marketing effort. Gross U.S. Medihoney sales increased $1,275,586, or 93.7%, to $2,637,210 in 2009 versus $1,361,624 in 2008. Bioguard, our new novel anti-microbial advanced wound care product launched in June, recorded gross sales of $634,922 in its first seven months. Algicell, Xtrasorb and MedEfficiency have also exhibited strong growth in 2009. The increase in private label sales reflects improved demand from a number of our core customers, coupled with some modest new business. Excluding first aid products, U.S. sales increased $3,733,718, or 18.1%.

17

Consolidated gross profit increased $147,974, or 0.1%, in 2009 versus 2008, despite the decrease in sales. The consolidated gross profit margin percentage increased to 31.0% in 2009 from 29.7% in 2008. Canadian gross profit decreased $760,501, or 19.3%, to $3,186,683 in 2009 from $3,947,184 in 2008. The Canadian gross profit margin percentage decreased to 28.3% in 2009 from 32.6% in 2008. The decrease in Canadian 2009 gross profit dollars reflects the lower sales and gross profit margin percentage decrease. The change in Canadian gross profit margin percentage principally reflects the adverse effect of price erosion coupled with higher product costs, partially offset by the favorable impact of higher production volumes on labor efficiency and overhead absorption and lower overhead spending in 2009 versus 2008. U.S. gross profit increased $908,475, or 8.3%, to $11,871,034 in 2009 from $10,962,559 in 2008. The U.S. gross profit margin percentage increased to 31.9% in 2009 from 28.8% in 2008. The increase in U.S. gross profit dollars and margin principally reflects the increase in higher margined advanced wound care sales, partially offset by the decrease in lower margined first aid product sales. An improvement in first aid product margin due to the discontinuation of higher cost domestic manufacturing in the fourth quarter 2008 and lower freight costs, partially offset by higher other product costs, also contributed. Excluding first aid products, favorable product mix partially offset by higher product costs served to increase U.S. margin dollars $1,711,276, or 24.7%, and the gross profit percentage to 35.4% from 33.5%.

Selling, General and Administrative Expenses

The following table highlights December 31, 2009 versus 2008 selling, general and administrative expenses by type:

	Year Ended December 31,		Variance	
	2009	2008		
Distribution	$ 1,754,414	$ 1,893,146	$ (138,732)	(7.3)%
Marketing	1,544,862	1,781,128	(236,266)	(13.3)%
Sales	5,093,252	5,714,899	(621,647)	(10.9)%
General and administrative	6,742,705	7,807,690	(1,064,985)	(13.6)%
Total	$ 15,135,233	$ 17,196,863	$ (2,061,630)	(12.0)%

Selling, general and administrative expenses decreased $2,061,630, or 12.0%, in 2009 versus 2008, including a decrease of $203,692 in Canadian selling, general and administrative expenses attributable to exchange.

Distribution expense decreased $138,732, or 7.3%, in 2009 versus 2008. Expenses in Canada decreased $102,037 (including a $25,626 benefit related to exchange) while expenses in the U.S decreased $36,695. The decrease in Canada was driven by the non-recurrence of incremental expense related to the buy out of the former distribution center lease in the second quarter 2008. The U.S. decrease was driven by the non-recurrence of incremental first aid product related integration expenses in Houston incurred in 2008, partially offset by higher lease costs in Houston (relocated to new facility in April 2009) and St. Louis (higher cost lease extension effective March 2009) together with higher personnel and operating costs in St. Louis in support of the growing non-first aid product business.

Marketing expense decreased $236,266, or 13.3%, in 2009 versus 2008. The decrease is attributable to a U.S. decrease of $210,421 coupled with a decrease in Canada of $25,845 (including a $7,725 benefit related to exchange). The U.S. decrease stems from a planned reduction in advanced wound care clinical personnel, consulting, travel and trade show expenses in 2009, coupled with an increase in first aid product related marketing expenses reflecting implementation of a full marketing plan in 2009 versus a partial transition related plan in 2008. The Canada expense decrease reflects lower advanced wound care promotion expense, partially offset by higher product sampling expenses.

Sales expense decreased $621,647, or 10.9%, in 2009 versus 2008. Expenses in Canada decreased $106,170 (including a $55,718 benefit related to exchange) while expenses in the U.S. decreased $515,477. Expenses in Canada decreased principally due to lower 3rd party sales commission due to a change in the sales commission program in 2009, lower direct representative commissions due to lower sales and lower travel costs due to cost reduction initiatives, partially offset by higher increased rate related group purchasing organization fees. The U.S. decrease was attributable to lower compensation and commission expenses associated with open (timing related) sales representative positions, the elimination of three positions as a result of cost reduction initiatives and the non-recurrence of incremental integration related compensation expenses in customer service, lower first aid product broker commissions due to lower sales, lower travel expenses due to cost reduction initiatives, lower recruiting expenses (bulk of hiring took place in 2008) together with the non-recurrence in 2009 of first aid product integration related expenses. Offsetting these decreases were higher equity based compensation, regional show and sales tracing expenses associated with the implementation of a more structured sales tracing program in 2008.

General and administrative expense decreased $1,064,985, or 13.6%, in 2009 versus 2008. Expenses in Canada decreased $92,233 (including a $114,623 benefit related to exchange) while expenses in the U.S. decreased $972,752. Adjusted for exchange, the $22,390 increase in Canada reflects higher audit, insurance and equity based compensation expense, partially offset by lower travel, recruiting and operating expenses. The U.S. decrease principally reflects lower bad debt expense of $392,900 due to the non-recurrence of a significant provision for bad debts in 2008, lower travel of $158,100 and investor relation expenses of $147,200 due to cost reduction initiatives, non-recurring and lower legal expenses of $95,000, non-recurring and lower amortization expense of $52,900 and non-recurring recruiting expense of $45,700, together with lower other professional service fees of $70,300 and other net operating costs of $10,652 due principally to timing and cost saving initiatives.

Research and Development Expense

Research and development expense decreased $253,768 to $399,558 in 2009 from $653,326 in 2008. The decrease principally reflects the non-recurrence of a $320,000 payment for the active compound to be used in the DSC127 Phase II trial in 2008 and start up related consulting expense, partially offset by higher project management (full year in 2009 versus eleven months in 2008), data management (data management program implemented in second half of 2009) and ongoing patent related legal expenses in 2009.

Interest Expense

Interest expense decreased $98,016 to $842,132 in 2009 from $940,148 in 2008. The decrease is principally attributable to lower interest rates coupled with lower line of credit and term loan borrowing levels, partially offset by higher loan related fees and lower interest income in 2009 versus 2008.

Other Income

Other income increased $267,125 to income of $244,596 in 2009 from an expense of $22,529 in 2008. The main drivers for the net year-to-year increase was an exchange gain of $336,401 and a gain on miscellaneous asset sales principally associated with the closure of the first aid product manufacturing operation of $59,031, partially offset by non-income related taxes of $59,044, lower royalty income $36,250 and other miscellaneous income of $33,013.

Income Taxes

We recorded a $68,663 tax provision for 2009 consisting of a $101,408 current foreign tax provision and a $35,822 deferred foreign tax benefit based on our Canadian subsidiary’s operating results and a $3,077 U.S. current tax provision based on U.S. results. In 2008 a net foreign tax provision of $58,815 was recorded.

Due to uncertainties surrounding our ability to use our U.S. net operating loss carry forwards and net deferred tax assets, a full valuation allowance for the U.S. net deferred tax assets has been provided.

Net Loss

We generated a net loss of $1,143,272, or $0.23 per share (basic and diluted), in 2009 compared to a net loss of $3,961,937, or $0.82 per share (basic and diluted), in 2008.

Liquidity and Capital Resources

Cash Flow and Working Capital

Quarterly financial performance has improved steadily in 2009 culminating with net income in the third and fourth quarters after losses in the first and second quarters. We reported a cumulative net loss of $1,143,272 for 2009 versus a $3,961,937 net loss in 2008. While sales are lower in 2009, gross profit dollars and margin percentage increased due to a favorable sales mix (principally reflecting the growth of the higher margined advanced wound care business), the elimination of higher cost FAD domestic manufacturing in the fourth quarter 2008 and improved manufacturing performance in Canada, partially offset by higher product costs. Operating expenses were lower, as planned, to better align costs with revenues.

The launch of a number of new products bodes well for the future growth of our higher-margined advanced wound care product line. While overall FAD sales declined in 2009 versus 2008, we believe that the FAD product line continues to represents a solid growth opportunity. Sales for the balance of our product lines are expected to remain relatively stable. Further, we continue to actively pursue distributors in several countries to increase our international sales.

Improving financial performance and other steps taken to improve cash management have served to improve our liquidity. Operating cash flow has improved steadily in 2009 versus 2008. This is attributable to a significant reduction in net operating assets and liabilities employed, together with a lower net loss. In 2008, we increased our investment in inventory by approximately $3,600,000. In 2009 the inventory level was reduced by approximately $1,000,000. Operating cash flow is expected to continue to improve over the next twelve months given the expected improvement in financial performance and continuation of our inventory reduction initiative.

At December 31, 2009 and December 31, 2008, we had cash and cash equivalents on hand of $243,524 and $391,038, respectively. The $147,514 decrease in cash reflects net cash provided by operating activities of $2,654,204 and cash provided as a result of exchange rate changes of $169,972. These increases were essentially offset by cash used in financing activities of $2,766,964 and cash used in investing activities of $204,726.

Net cash provided by operating activities of $2,654,204 stems from $2,952,580 cash provided from operations (net loss plus non-cash items), together with $298,376 cash used from the net change in operating assets and liabilities. The increase in cash provided from operations reflects the non-cash items, partially offset by the operating loss. Lower accounts payable and accrued liabilities and higher accounts receivable partially offset by lower inventory were the main drivers behind the net change in operating assets and liabilities. The decrease in accounts payable reflects a significant reduction in payables related to inventory purchases (consistent with the plan to reduce inventory), lower overall spending levels and timing. The decrease in accrued expenses and other current liabilities principally reflects lower Canadian rebates due to lower sales and timing related changes. The increase in accounts receivable reflects higher fourth quarter sales. The reduced investment in inventory reflects our plan to reduce inventory levels whenever possible, without compromising customer service requirements.

Net cash used in investing activities of $204,726 reflects capital expenditures of $265,726, less receipt of $61,000 cash from the sale of assets associated with the discontinuation of FAD domestic manufacturing. Capital expenditures are lower in 2009 versus 2008.

Net cash used in financing activities of $2,766,964 reflects regularly scheduled debt payments of $1,298,208, pay down of outstanding line of credit borrowings of $1,140,299, capitalization of equity raise expenses in anticipation of charging them off to additional paid in capital upon completion of the planned equity offering in 2010 of $305,715, an increase in restricted cash of $17,742 and costs related to the issuance of stock from a previous offering of $5,000.

Working capital increased $51,950, or 0.8%, at December 31, 2009 to $6,791,601 from $6,739,651 at December 31, 2008. Excluding the reclassification of the $500,000 promissory note from long term to current debt in the second quarter 2009, working capital increased $551,950 in 2009 and increased by $126,457 in the third quarter. Working capital of this magnitude is considered sufficient to support ongoing operations.

Financing Arrangements

With cash on hand of $243,524, together with available revolver capacity of $2,099,055, we have $2,342,579 of available liquidity at December 31, 2009, versus $2,125,840 at September 30, 2009.

On February 22, 2010, we raised $4,537,497 (net of commission and other offering expenses) from the sale in a secondary public offering of shares of our common stock. These proceeds together with $2,032,818 of restricted cash from our balance sheet were used to acquire the worldwide Medihoney licensing rights for $2,250,000, pay off the outstanding U.S. term loan of $3,300,000 and pay off our $500,000 promissory note due April 14, 2010, leaving $520,315 of the net proceeds available for general working capital purposes. Payment of the foregoing indebtedness will have a positive impact on cash flow going forward by eliminating associated debt service. The $520,315 available for working capital was applied to reduce our outstanding line of credit balance, thereby serving to increase the availability of funds under the line.

On March 26, 2010, our U.S. lender modified the terms of our five year revolving credit and security agreement to take into account the payment of the term loan. The existing financial covenants were replaced with twelve month rolling fixed charge coverage and total debt coverage covenants. The lender also reduced the minimum 3 month LIBOR rate from 3.00% to 1.50% and authorized the payment of our $500,000 unsecured promissory note.

The equity raise and modification to our loan covenants in the first quarter 2010, served to further improve our overall liquidity.

Prospective Assessment

Our strategic objective is to in-license, develop and launch novel higher margined advanced wound care products while utilizing our core business (to the extent possible) to fund this objective. In addition, we will continue to evaluate external opportunities to leverage our core capabilities for growth. To the extent we determine that we cannot finance our growth initiatives internally, we will evaluate the feasibility of doing so via the sale of equity.

As a result of these efforts, we launched Algicell in November 2006. We launched our first Medihoney product in October 2007. This product represents the first of its kind and interest in the product has been high. Sales have increased steadily and current indications are that the planned Medihoney based line of products could result in significant incremental sales. We recently launched three new products to complement our existing advanced wound care product line, the MedEfficiency line of Total Contact Cast systems (October 2008), Xtrasorb (November 2008) and Bioguard, our novel anti-microbial infection control product in June 2009. Bioguard, Xtrasorb and MedEfficiency have been well received in the marketplace and have exhibited steady growth. We continue to work on our pipeline and have identified several products that are capable of contributing to future sales growth. We anticipate our overall core business sales will grow modestly over the near term.

Our strategy for growth going forward is:

1. Assuming the existing resources in place are generating the expected return, we will continue to expand our investment in sales and marketing resources in support of our advanced wound care products. We presently have ten direct sales representatives in place and our plan is to hire an additional ten in 2010 and increase the level of marketing and product development support.

2. The FAD business represents a growth opportunity. In addition to its core business opportunities, the FAD business will serve as a platform for introducing our existing advanced and traditional wound care products to new customers and markets, especially the retail market. The FAD continues to work on completion of a cost effective supply chain

for its adhesive bandages and first aid related products. The supply chain is expected to be fully operational within the next nine months, at which time we expect to be able to further reduce our product costs and improve liquidity by reducing the level of inventory required to support the existing level of business.

3. In February 2010, we licensed the worldwide rights to Medihoney. This will serve as the catalyst for the expansion of our international business. Plans are in place to establish a direct presence in Europe immediately and in other areas of the world, employing a direct presence or distributor model as the basis for conducting business, as circumstances dictate.

4. We made a significant investment in DSC 127 beginning in December 2007. While the launch of DSC 127 is several years away, we believe the market potential for this product is considerable. The product began Phase II trials in early 2008 to achieve proof of principle in a human model. The Phase II trials are expected to be completed by the end of 2010. The projected cost to complete the Phase II trials is approximately $1,650,000, including $1,052,884 incurred through December 2009. We plan to continue with this investment and anticipate spending approximately $600,625 to complete the Phase II trial over the next twelve months.

The results of the Phase II trial will determine the efficacy and safety of the product and further refine its market potential. The cost of the Phase III trial and bringing the product to market are expected to be significant. Should we decide to proceed with the DSC 127 development plan after completion of Phase II, we plan to fund the additional development costs out of available cash flow or the sale of equity. Alternatively, we may determine to sublicense or sell the rights to the compound.

With the planned improvement in operations and expected working capital requirements, together with the available cash on hand and available borrowing capacity as of December 31, 2009, we anticipate having sufficient liquidity in place to meet our operating needs and debt covenants for the foreseeable future.

Our common stock is traded on the NASDAQ Capital Market under the symbol “DSCI.” We have paid no cash dividends in respect of our common stock and do not intend to pay cash dividends in the near future.

Additional Financial Information

Forward Looking Statements

Statements that are not historical facts, including statements about our 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, sales incentives, discounts and allowances. Significant estimates and assumptions are also required in determining the appropriateness of amortization periods for identifiable intangible assets, the potential impairment of goodwill and the valuation of inventory. Some of these judgments can be subjective and complex and, consequently, actual results may differ from these estimates. For any individual estimate or assumption made by us, there may also be other reasonable estimates or assumptions. We believe, however, that given current facts and circumstances, it is unlikely that applying any such other reasonable judgment would cause a material adverse effect on the consolidated results of operations, financial position or cash flows for the periods presented. Our most critical accounting policies are described below.

Revenue Recognition and Adjustments to Revenue

We sell our products through our own direct sales force and through independent distributors and manufacturers’ representatives. The primary end users of our products are nursing homes, hospitals, clinics and home healthcare agencies. We recognize revenue from the sale of our products when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed and determinable, and collectability is reasonably assured, which is generally at the time of shipment or receipt by our customers, depending on the terms of the related sales or

distribution agreement. When we recognize revenue from the sale of our products, we simultaneously adjust revenue for estimated trade rebates and distribution fees (in Canada), and estimates of returns and allowances, cash discounts and other sales incentives.

A trade rebate represents the difference between the invoice price to the wholesaler/distributor and the end user's contract price. These rebates are estimated monthly based on historical experience, distributor rebate submission trends, estimated distributor inventory levels, and existing contract sales terms with our distributors and end users. We have a contract with our exclusive Canadian distributor and we pay a fixed fee based on sales subject to the fee (as defined) for distribution services in Canada. Because the services performed by the distributor cannot be separated from the purchase of our products by the distributor, we treat this distribution fee as a reduction of revenue. The distribution fee is accrued monthly based on net sales to the distributor multiplied by the ratio of recent historical distributor fee expense to net sales. The percentage of distributor fee expense to net sales is re-evaluated quarterly for reasonableness.

Sales incentives represent credits granted to specific customers based on attainment of pre-determined sales objectives. Sales incentives are accrued monthly in accordance with the terms of the underlying sales incentive agreement and actual customer sales. Sales incentive agreements are generally for a period of one year.

We provide our customers certain limited return rights and we have a formal returned goods policy that guides the disposition of returns with our customers. We accrue for sales returns and allowances and cash discounts monthly based on current sales and historical activity. We do not offer our customers price protection rights or concessions. Returns were approximately 1% of gross sales in both 2009 and 2008.

We continually monitor the factors that influence rebates and fees, returns and allowances, and other discounts and sales incentives and make adjustments as necessary.

Goodwill

At December 31, 2009, we had $7,119,726 of goodwill consisting of $4,679,684 relating to the FAD acquisition in November 2007 and $2,440,042 relating to the Western Medical acquisition in April 2006. We assess the impairment of goodwill annually in the fourth quarter or whenever events or changes in circumstances indicate that the carrying value of goodwill may not be recoverable. The assessment is performed using the two-step process required by FASB accounting guidance relating to goodwill. The first step is a review for potential impairment, while the second step measures the amount of the impairment, if any. The first step of the goodwill impairment test compares the fair value of a reporting unit with its carrying amount, including goodwill. For 2009 and 2008, the first step of our goodwill impairment test reflected a fair value in excess of the carrying value of our reporting units. Accordingly, we did not perform the second step of this test during these periods.

The cash generating unit level or reporting unit at which we test goodwill for impairment is the operating segment level as that term is used in FASB accounting guidance relating to segment reporting. We have three operating segments: wound care, wound closure – specialty securement devices and skin care. Products are allocated to each segment based on the nature and intended use of the product. All of our goodwill has been allocated to the wound care segment as the business acquisitions which gave rise to the goodwill were wound care businesses.

For 2009 and 2008 and consistent with prior periods, we estimated the fair value of our wound care segment, using the "income approach," where we use a discounted cash flow model ("DCF") in preparing our goodwill impairment assessment. This approach calculates fair value by estimating the after-tax cash flows attributable to a reporting unit and then discounting these after-tax cash flows to a present value using a risk-adjusted discount rate. We selected this method as being the most meaningful in preparing our goodwill assessments because we believe the income approach most appropriately measures our income producing assets.

Significant estimates used in the fair value calculation include: (i) estimates of future revenue and expense growth, (ii) future estimated effective tax rates, (iii) future estimated capital expenditures, (iv) future required investments in

working capital, (v) average cost of capital, and (vi) the terminal value of the reporting unit.

The amount and timing of future cash flows within our DCF analysis is based on our five year forecast. Beyond our five year forecast we assumed a terminal value to calculate the value of cash flows beyond the last projected period in our DCF analysis. Annual revenue growth rates in our DCF model reflect expected growth in our advanced wound care products as well as growth in the products which we gained access to when we acquired FAD in November of 2007 as we introduce these products across our existing customer base. The weighted average cost of capital used to discount cash flows for the annual 2009 goodwill impairment test was estimated to be 17%.

Over time, our wound care segment has become an increasingly significant portion of our overall business. For the year ended December 31, 2009, our wound care segment accounted for approximately 95% of our consolidated revenue. Given the significance of this segment to our overall results, we also look to our publicly traded market value, which we may adjust in consideration of an appropriate control premium, as an indicator of the fair value of our wound care segment and the reasonableness of our DCF model.

There have been no substantial changes to the methodology employed, significant assumptions or calculations applied in the first step of the goodwill impairment test over the past several years.

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.

Stock-Based Compensation

We record compensation expense associated with stock options and other equity-based compensation based on their fair value at the grant date and recognized over the requisite service periods. We estimate the fair value of stock options as of the date of grant using the Black-Scholes for service and performance based awards or binomial/lattice pricing model for market based awards and restricted stock based on the quoted market price. Significant judgment and the use of estimates to value the equity-based compensation, particularly surrounding Black-Scholes or binomial/lattice pricing model assumptions such as stock price volatility and expected option lives, as well as expected option forfeiture rates, are made by the Company.

Item 8. Financial Statements and Supplementary Data

Index

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors
of Derma Sciences, Inc.

We have audited the accompanying consolidated balance sheets of Derma Sciences, Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the two years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Derma Sciences, Inc. and subsidiaries at December 31, 2009 and 2008, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Philadelphia, Pennsylvania
March 31, 2010

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

	December 31,	
	2009	2008
ASSETS		
Current Assets		
Cash and cash equivalents	$ 243,524	$ 391,038
Accounts receivable, net	3,372,712	3,892,523
Inventories	11,489,724	12,423,042
Prepaid expenses and other current assets	456,675	397,117
Total current assets	15,562,635	17,103,720
Cash – restricted	2,032,164	2,014,422
Equipment and improvements, net	3,741,347	3,977,853
Goodwill	7,119,726	7,119,726
Other intangible assets, net	3,994,250	5,310,129
Other assets, net	849,753	681,472
Total Assets	$ 33,299,875	$ 36,207,322
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit borrowings	2,306,306	3,446,605
Current maturities of long-term debt	1,759,185	1,298,207
Accounts payable	3,363,096	3,614,764
Accrued expenses and other current liabilities	1,342,467	2,004,493
Total current liabilities	8,771,054	10,364,069
Long-term debt	2,305,851	4,065,036
Other long-term liabilities	96,564	44,848
Deferred tax liability	355,349	340,871
Total Liabilities	11,528,818	14,814,824
Shareholders' Equity		
Convertible preferred stock, $.01 par value; 1,468,750 shares authorized; issued and outstanding: 285,051 (liquidation preference of $4,210,231 at December 31, 2009)	2,851	2,851
Common stock, $.01 par value: 18,750,000 authorized ; issued andoutstanding shares: 5,039,468 at December 31, 2009 and 5,017,593 atDecember 31, 2008	50,395	50,176
Additional paid-in capital	41,221,613	40,398,829
Accumulated other comprehensive income – cumulative translation adjustments	1,303,293	604,465
Accumulated deficit	(20,807,095)	(19,663,823)
Total Shareholders' Equity	21,771,057	21,392,498
Total Liabilities and Shareholders' Equity	$ 33,299,875	$ 36,207,322

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

	Year ended December 31,	
	2009	2008
Net Sales	$ 48,526,158	$ 50,199,428
Cost of sales	33,468,440	35,289,684
Gross Profit	15,057,718	14,909,744
Operating expenses		
Selling, general and administrative	15,135,233	17,196,863
Research and development	399,558	653,326
Total operating expenses	15,534,791	17,850,189
Operating loss	(477,073)	(2,940,445)
Other expense, net:		
Interest expense	842,132	940,148
Other (income) expense, net	(244,596)	22,529
Total other expense, net	597,536	962,677
Loss before provision for income taxes	(1,074,609)	(3,903,122)
Provision for income taxes	68,663	58,815
Net Loss	$ (1,143,272)	$ (3,961,937)
Net loss per common share – basic and diluted	$ (0.23)	$ (0.82)
Shares used in computing loss per common share – basic and diluted	5,031,557	4,825,847

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Shareholders' Equity

	Preferred Shares Issued	Convertible Preferred Stock	Common Shares Issued	Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Shareholders' Equity
Balance, January 1, 2008	285,051	$ 2,851	4,228,719	$ 42,287	$ 33,856,916	$ 1,854,787	$ (15,701,886)	$ 20,054,955
Net loss							(3,961,937)	(3,961,937)
Foreign currency translation adjustment						(1,250,322)		(1,250,322)
Comprehensive loss – total								(5,212,259)
Issuance of common stock in private placement, net of issuance costs of $389,079			762,500	7,625	5,603,246			5,610,871
Cashless exercise of warrants			11,399	114	(114)			-
Exercise of common stock warrants			12,500	125	104,875			105,000
Exercise of common stock options			2,475	25	12,350			12,375
Stock based charges					821,556			821,556
Balance, December 31, 2008	285,051	$ 2,851	5,017,593	$ 50,176	$ 40,398,829	$ 604,465	$ (19,663,823)	$ 21,392,498
Net loss							(1,143,272)	(1,143,272)
Foreign currency translation adjustment						698,828		698,828
Comprehensive loss – total								(444,444)

Issuance of common stock			21,875	219	(219)			-
Stock issuance costs					(5,000)			(5,000)
Stock based charges					828,003			828,003
Balance, December 31, 2009	285,051	$ 2,851	5,039,468	$ 50,395	$ 41,221,613	$ 1,303,293	$ (20,807,095)	$ 21,771,057

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

	Year Ended December 31,	
	2009	2008
Operating Activities		
Net loss	$ (1,143,272)	$ (3,961,937)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation of equipment and improvements	882,598	855,609
Amortization of intangible assets	1,315,879	1,427,524
Amortization of deferred financing costs	144,565	129,519
Provision for bad debts	(92,827)	247,000
Allowance for sales adjustments	702,999	690,625
Provision for inventory obsolescence	363,170	349,303
Gain on disposal of equipment	(59,031)	–
Deferred rent expense	46,318	(60,115)
Compensation charge for employee stock options	800,945	773,136
Compensation charge for restricted stock	18,148	48,420
Interest charge for stock warrants	8,910	–
Deferred tax provision	(35,822)	(5,008)
Changes in operating assets and liabilities:		
Accounts receivable	(151,126)	(476,106)
Inventories	1,002,031	(3,570,840)
Prepaid expenses and other current assets	19,203	7,724
Other assets	(440)	(46,291)
Accounts payable	(367,404)	(241,634)
Accrued expenses and other current liabilities	(800,640)	(910,896)
Net cash provided by (used in) operating activities	2,654,204	(4,743,967)
Investing Activities		
Costs of acquiring businesses	–	(120,484)
Refund of acquired business escrow funds	–	1,193,187
Purchase of equipment and improvements	(265,726)	(471,357)
Proceeds from sale of equipment	61,000	–
Net cash (used in) provided by investing activities	(204,726)	601,346
Financing Activities		
Cash restricted	(17,742)	(2,014,422)
Net change in bank line of credit	(1,140,299)	2,227,408
Deferred financing costs	–	(269,235)
Deferred issuance costs	(305,715)	–
Long-term debt repayments	(1,298,208)	(1,313,749)
Proceeds from issuance of common stock, net of costs	(5,000)	5,728,246
Net cash (used in) provided by financing activities	(2,766,964)	4,358,248
Effect of exchange rate changes on cash	169,972	(401,684)
Net decrease in cash and cash equivalents	(147,514)	(186,058)
Cash and cash equivalents		
Beginning of year	391,038	577,096
End of year	$ 243,524	$ 391,038
Supplemental disclosures of cash flow information:		

Equipment obtained with capital leases	$ -	$ 96,324
Cash paid during the year for:		
Interest	$ 723,339	$ 809,808

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

1. Description of Business

Derma Sciences, Inc. and its subsidiaries (the "Company") is a full line provider of wound care, wound closure and specialty securement devices and skin care products. The Company markets its products principally through independent distributors servicing the long-term care, home health and acute care markets in the United States, Canada and other select international markets. The Company's U.S. distribution facilities are located in St. Louis, Missouri, and Houston, Texas, while the Company's Canadian distribution facility is located in Toronto. The Company has manufacturing facilities in Toronto, Canada and Nantong, China.

2. 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.

Reverse Stock Split – The accompanying financial statements reflect a 1-for-8 reverse split of the Company's common and preferred stock approved by the board of directors and stockholders of the Company and made effective by an amendment to the Company's articles of incorporation on January 28, 2010. All share and per share information herein that relates to the Company's common and preferred stock has been retroactively restated to reflect the reverse stock split.

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

Foreign Currency Translation – Assets and liabilities are translated using the exchange rates in effect at the balance sheet date, while income and expenses are translated using average rates. Translation adjustments are reported as a component of shareholders' equity in accumulated other comprehensive income. For the Company's Canadian subsidiary, whose functional currency is the Canadian dollar, exchange rate fluctuations on foreign currency denominated assets and liabilities other than the functional currency resulted in income of $84,423 and $128,470 for the years ended December 31, 2009 and 2008 which is included in the consolidated statement of operations as follows:

	2009	2008
Cost of sales	$ 152,853	$ (311,949)
Other (income) expense, net	(237,276)	183,479
	$ (84,423)	$ (128,470)

Exchange rate fluctuations of foreign currency denominated assets and liabilities associated with inventory are included in cost of sales.

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

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

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 $250,000. 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.

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 term nature. The fair value of the Company's long-term debt approximates book value as the debt is 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 or fair value as determined as of the date of acquisition. 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, non-compete and other agreements are amortized over 4 to 13 years on a straight-line basis.

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 – The Company tests goodwill for impairment using a two-step process. 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. If the first step indicates an impairment, i.e. when the carrying value exceeds the fair value, then the second step is required to determine the implied fair value of goodwill. The implied fair value of goodwill is calculated in the same manner that goodwill is calculated in a business combination. The allocation is to be performed as if the reporting unit had just been acquired and the fair value of the unit was the purchase price. The goodwill impairment equals the carrying value of goodwill less the implied fair value of goodwill. The Company performs its goodwill impairment test as of December 31 of each year, or more frequently if impairment indicators are present.

Stock-Based Compensation – Financial Accounting Standards Board (FASB) guidance for stock compensation requires that new, modified and unvested share-based payment transactions with employees, such as grants of stock options

and restricted stock, be recognized in the financial statements based on their fair value at the grant date and recognized as compensation expense over their requisite service periods. The Company estimates the fair value of stock options as of the date of grant using the Black-Scholes for service and performance based awards or binomial/lattice pricing model for market based awards and restricted stock based on the quoted market price.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

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.

The Company measures and recognizes the tax implications of positions taken or expected to be taken in its tax returns on an ongoing basis. In 2009 and 2008, the Company had no unrecognized tax benefits or liabilities, and no adjustment to its financial position, results of operations or cash flows were required. The Company records interest and penalties related to tax matters within other expense on the accompanying Consolidated Statements of Operations. These amounts are not material to the consolidated financial statements for the periods presented. The Company's U.S. tax returns are subject to examination by federal and state taxing authorities. Tax years prior to 2006 are no longer subject to federal or state examination. Tax years prior to 2006 are also no longer subject to examination in Canada.

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

Advertising and Promotion Costs – Advertising and promotion costs are expensed as incurred and were $1,131,909 and $1,276,368 in 2009 and 2008, respectively.

Royalties – The Company recognizes royalty expenses associated with the products sold at the time the related sale occurs and records them as a component of cost of sales. Royalty expense for the years ended December 31, 2009 and 2008 was $447,291 and $346,260, respectively.

Net Loss per Share – Net loss per common share – basic is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Net loss per common share – diluted reflects the potential dilution of earnings by including the effects of the assumed exercise, conversion or issuance of potentially issuable shares of common stock ("potentially dilutive securities"), including those attributable to stock options, warrants, convertible preferred stock and restricted common stock in the weighted average number of common shares outstanding for a period, if dilutive. The effects of the assumed exercise of warrants and stock options are determined using the treasury stock method. Potentially dilutive securities have not been included in the computation of diluted loss per share for the years ended December 31, 2009 and 2008 as the effect would be anti-dilutive.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

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

	Year Ended December 31,	
	2009	2008
Excluded dilutive shares:		
Preferred stock	285,051	285,051
Restricted common stock	-	21,875
Stock options	1,066,328	1,002,828
Warrants	1,099,407	1,093,157
Total dilutive shares	2,450,786	2,402,911

Recently Issued Accounting Pronouncements – Effective January 1, 2009, the Financial Accounting Standards Board ("FASB") issued new guidance related to assessing whether an equity-linked financial instrument (or embedded feature) is indexed to an entity's own stock for the purposes of determining whether such equity-linked financial instrument (or embedded feature) is subject to derivative accounting. We adopted this new guidance effective January 1, 2009 which had no impact on the consolidated financial statements.

In April 2009, the FASB issued additional guidance requiring fair value disclosures in both interim as well as annual financial statements in order to provide more timely information about the effects of current market conditions on financial instruments. The guidance is effective for interim and annual periods ending after June 15, 2009, and we adopted this guidance commencing with our June 30, 2009 consolidated financial statements. The implementation of this standard did not have a material impact on our consolidated balance sheet and operating results.

In May 2009, the FASB issued new guidance on the reporting of subsequent events which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This statement sets forth the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements. We adopted this standard during the quarter ended June 30, 2009.

On July 1, 2009, the FASB issued the FASB Accounting Standards Codification (the "Codification"). The Codification became the single source of authoritative nongovernmental U.S. GAAP, superseding existing literature of the FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force and other sources. The Codification was effective for interim and annual periods ending after September 15, 2009. We adopted the Codification for the quarter ended September 30, 2009. There was no impact on our consolidated balance sheet and results of operations as this change is disclosure-only in nature.

In September 2009, the FASB issued amendments to the accounting and disclosure for revenue recognition. These amendments, effective for fiscal years beginning on or after June 15, 2010 (early adoption is permitted), modify the criteria for recognizing revenue in multiple element arrangements and the scope of what constitutes a non-software deliverable. The impact of the adoption of these amendments will depend on the nature of the arrangements that we enter into subsequent to the date we adopt the amendments.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

3. Accounts Receivable

Accounts receivable include the following:

	December 31, 2009	2008
Accounts receivable	$ 4,216,147	$ 5,213,167
Less: Allowance for doubtful accounts	(73,318)	(370,000)
Allowance for trade rebates	(642,789)	(709,244)
Allowance for cash discounts and returns	(127,328)	(241,400)
Accounts receivable, net	$ 3,372,712	$ 3,892,523

4. Inventories

Inventories include the following:

	December 31, 2009	2008
Finished goods	$ 7,804,339	$ 9,001,269
Work in process	466,365	443,511
Packaging materials	722,148	700,948
Raw materials	2,496,872	2,277,314
Total inventory	$ 11,489,724	$ 12,423,042

5. Equipment and Improvements, net

Equipment and improvements include the following:

	December 31, 2009	2008
Machinery and equipment	$ 5,677,389	$ 5,110,112
Furniture and fixtures	609,694	569,617
Leasehold improvements	1,473,920	1,229,168
Gross equipment and improvements	7,761,003	6,908,897
Less: accumulated depreciation	(4,019,656)	(2,931,044)
Total equipment and improvements, net	$ 3,741,347	$ 3,977,853

Included in equipment and improvements at December 31, 2009 were leased machinery and equipment with a cost of $161,381 and accumulated amortization of $92,795 and furniture and fixtures with a cost of $260,069 and accumulated amortization of $118,315. Amortization of assets under capital leases is included in depreciation expense.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

6. Other Intangible Assets, net

Other intangible assets, net include the following:

	December 31, 2009	December 31, 2008
Patents and trademarks	$ 444,067	$ 444,067
Other intangible assets	7,842,797	7,842,797
	8,286,864	8,286,864
Less accumulated amortization	(4,292,614)	(2,976,735)
Other intangible assets, net	$ 3,994,250	$ 5,310,129

In connection with the acquisition of certain assets and assumption of trade payables in 2007 and 2006, the Company allocated $7,500,000 to identifiable intangible assets as outlined below:

	Fair Value	Annual Amortization	Amortization Period
Customer list	$ 3,300,000	$ 600,000	4-10 years
Trademarks and trade names	1,600,000	135,000	10-13 years
Non-compete agreement	1,200,000	240,000	5 years
Other agreements	1,200,000	300,000	4 years
Certification and product designs	200,000	39,000	5 years
Total	$ 7,500,000	$ 1,314,000	

The weighted average useful life of patent and trademarks and other intangibles as of December 31, 2009 and 2008 is 3.0 and 3.8 years, respectively. Actual amortization expense for 2009 and 2008 and estimated thereafter by year is outlined below:

	Patents and Trademarks	Other Intangibles	Total
Actual amortization expense for year ended December 31, 2009	$ -	$ 1,315,879	$ 1,315,879
Actual amortization expense for year ended December 31, 2008	$ 36,012	$ 1,391,511	$ 1,427,524
Estimated amortization expense for years ending December 31,			
2010	$ -	$ 1,314,000	$ 1,314,000
2011	-	1,050,375	1,050,375
2012	-	323,000	323,000
2013	-	285,000	285,000

2014	-	285,000	285,000
Thereafter	-	736,875	736,875
Total	$ -	$ 3,994,250	$ 3,994,250

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

7. Other Assets, net

Other assets, net include the following:

	December 31, 2009	2008
Deferred financing costs, net	$ 414,647	$ 559,212
Deferred issuance costs	305,715	-
Deposits	129,391	122,260
Total other assets, net	$ 849,753	$ 681,472

Deferred financing costs related to the U.S. credit facility are being amortized over the five-year term of the related facility. Costs incurred through December 31, 2009 in connection with the February, 2010 equity raise (see note 15) are included in deferred issuance costs and will be reclassified to additional paid in capital upon the close of the equity offering.

8. Line of Credit Borrowings

In November, 2007, the Company entered into a new five-year revolving credit agreement providing for maximum borrowings of $8,000,000 with a U.S. lender. Advances under the revolving credit agreement may be drawn, from time to time, up to the amount of 85% of eligible receivables (as defined) and 44% of eligible inventory (as defined). Interest on outstanding advances under the revolving credit agreement as amended is payable at the three month LIBOR monthly rate (the “Base Rate”) plus 4.25% (the “Base Rate Margin”) (6.00% at December 31, 2009). In addition, the Company pays a monthly unused line fee of 0.5% per annum on the difference between the daily average amount of advances outstanding under the agreement and $8,000,000 together with a monthly collateral management fee of $2,000. Outstanding balances under the agreement are secured by all of the Company’s and its subsidiaries’ existing and after-acquired tangible and intangible assets located in the United States and Canada. At December 31, 2009 the Company had an outstanding balance of $2,306,306 under this agreement.

The revolving credit agreement is subject to financial covenants which require maintaining a minimum cumulative EBITDA level and certain ratios of fixed charge coverage, senior debt leverage and total debt leverage as defined in the agreement. Additional covenants governing permitted investments, indebtedness and liens, together with payments of dividends and protection of collateral, are also included in the agreement. The revolving credit agreement contains a subjective acceleration provision whereby the lender can declare a default upon a material adverse change in the Company’s business operations.

On March 31, 2009, the Company’s U.S. lender agreed to amend the credit and security agreement to allow the Company to enter into a forbearance agreement with Western Medical to postpone payment of its promissory note due April 18, 2009 and to allow subsequent payments on the subordinated debt beginning in April 2010 provided the Company achieves predetermined liquidity and free cash flow (as defined) objectives and provided Western Medical further extends for one year the payment of the principal balance, if any, remaining on the promissory note after giving effect to the April, 2010 payment. In return for the amendment, the Company agreed to change its base rate for interest charged to a three month LIBOR rate from a one month LIBOR rate. Further, the base rate margin was

increased 150 basis points on the revolving line of credit from 2.75% to 4.25%, on the term loan from 4.25% to 5.75% and on the portion of the term loan secured by restricted cash from 2.25% to 3.75%. In addition, the Company is obligated to increase the revolving loan availability on its revolving line of credit to a minimum of $3,000,000 by December 31, 2009. Failure to achieve the minimum revolving loan availability amount will result in the base rate changing to the greater of 3.00% or the actual rate in effect. The Company did not increase the availability of its line of credit to a minimum of $3,000,000 by December 31, 2009. Accordingly, effective January 1, 2010 the base rate changed from the three month LIBOR rate to the greater of 3.00% or the actual rate in effect.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Effective August 13, 2008, the Company's lender agreed to waive all prior financial and reporting covenant defaults and amend the existing minimum EBITDA, fixed charge coverage, senior debt leverage and total debt leverage covenants to allow the Company to continue to implement its growth strategy in line with the lender's minimum liquidity terms. Amendment of the covenants was predicated upon the Company segregating $2,000,000 in a restricted account the use of which is subject to the approval of the lender. The Company's maximum revolver borrowing capacity remained unchanged. The Company incurred fees of $25,000 associated with the granting of the covenant amendment.

Effective March 28, 2008, the Company's U.S. lender agreed to waive all prior financial and reporting covenant defaults and amend the existing minimum EBITDA, fixed charge coverage, senior debt leverage and total debt leverage covenants, to be measured on a quarterly basis, to allow the Company to implement its growth strategy. Amendment of the covenants was predicated upon the Company's commitment to raise a minimum of $3,000,000 by May 1, 2008 from the sale of equity and agreement to limit its maximum revolver borrowing to the lesser of (a) the revolver loan commitment ($8,000,000) or (b) the borrowing base (as defined), less $1,500,000. Not less than $3,000,000 of the equity infusion was required to be applied to the then existing revolver balance which amount will be credited as a component of EBITDA for covenant compliance purposes. The Company incurred fees of $250,000 associated with the granting of the covenant amendment, together with related expenses of $10,829 which are included as additions to deferred financing costs. In March, 2008 the equity infusion requirement was met (see Note 11).

9. Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities include the following:

	December 31,	
	2009	2008
Accrued Canadian sales rebate, net (see note 15)	$ 369,197	$ 1,257,273
Accrued compensation and related taxes	317,230	177,133
Accrued sales incentives and administrative fees	260,985	347,841
Other	395,055	222,246
Total accrued expenses and other current liabilities	$ 1,342,467	$ 2,004,493

At December 31, 2009 and 2008, the value of the Canadian accrued sales rebate and other reserves exceeded the value of the underlying trade receivables outstanding. The net credit balance in trade receivables was reclassified for financial reporting purposes to accrued expense to recognize it as a net liability.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

10. Long-Term Debt

Long-term debt and capital leases includes the following:

	December 31, 2009	2008
U.S. term loan	$ 3,500,000	$ 4,700,000
Promissory note	500,000	500,000
Capital lease obligations	65,036	163,243
Total debt	4,065,036	5,363,243
Less: current maturities	1,759,185	1,298,207
Long-term debt	$ 2,305,851	$ 4,065,036

The following are term loan and promissory note maturities over the next five years:

Year Ending December 31,	Term Loan and Promissory Note
2010	$ 1,700,000
2011	1,200,000
2012	1,100,000
2013	-
Total term loan obligations	4,000,000
Less: current maturities	1,700,000
Long-term loan obligations	$ 2,300,000

U.S. Term Loan

In November, 2007, the Company entered into a five-year $6,000,000 term loan agreement with a U.S. lender. Interest on the term loan as amended is payable at the three month LIBOR monthly rate plus 5.75%, (7.50% at December 31, 2009). Monthly payments of principal in the amount of $100,000 together with interest are due under the agreement. The agreement is secured by all of the Company's and its subsidiaries' existing and after-acquired tangible and intangible assets located in the United States and Canada.

The term loan agreement is subject to financial covenants which require maintaining a minimum cumulative EBITDA level and certain ratios of fixed charge coverage, senior debt leverage and total debt leverage as defined in the agreement. Additional covenants governing permitted investments, indebtedness and liens, together with payments of dividends and protection of collateral, are also included in the agreement. The term loan agreement contains a subjective acceleration provision whereby the lender can declare a default upon a material adverse change in the

Company’s business operations.

Effective March 31, 2009, August 13, 2008 and March 28, 2008, the foregoing financial covenants were amended as described in the third, fourth and fifth paragraphs under the heading Line of Credit Borrowings (see Note 8).

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Promissory Note

In connection with the acquisition of Western Medical in April 2006, a portion of the purchase price was paid via a three-year unsecured promissory note issued to the seller. The principal amount of the promissory note, together with simple interest of 12%, is payable in 11 quarterly installments of interest only in the amount of $15,000 and a final payment of accrued interest of $15,000 and the principal balance of $500,000 on April 18, 2009. The promissory note may be prepaid in part or in full at any time without penalty.

On March 31, 2009, the Company entered into a Forbearance Agreement (the "Agreement") with Western Medical to postpone payment of its $500,000 promissory note due April 18, 2009. The Company will continue to make interest payments when due and a final payment of the principal plus accrued interest through the date of payment on April 14, 2010. In consideration for the postponement, the Company granted Western Medical warrants to purchase 6,250 shares of the Company's common stock at the market price on the date of execution of the Agreement and agreed to pay Western Medical's legal fees associated with the preparation and subsequent enforcement of the Agreement. In 2009 the Company recorded an interest charge of $8,910 for the fair value of the warrants.

Capital Lease Obligations

The Company has two capital lease obligations for office furniture totaling $65,036 as of December 31, 2009. The capital lease obligations bear interest at annual rates ranging from 6.8% to 9.6% expiring through February 2011.

The future minimum lease payments required under the capital leases and the present value of the minimum lease payments as of December 31, 2009 are as follows:

Year Ending December 31	Capital Lease Obligations
2010	$ 61,463
2011	5,901