DERMA SCIENCES INC
Form 10KSB40
April 01, 2002

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-KSB

[X] Annual Report under Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2001

[ ] Transition Report under 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 small business 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 100, Princeton, New Jersey	08540
(Address of principal executive offices)	(Zip code)

Registrant's telephone number: (800) 825-4325

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	Boston Stock Exchange
Common Stock, $.01 par value	Pacific Stock Exchange

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

Title of Class

Common Stock, $.01 par value

Check whether the Registrant: (1) filed all reports required to be filed by Sections 13 or 15(d) of the Exchange Act during the past 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 past 90 days.

Yes X No _____

Check if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is not contained in this form, and no disclosure will 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-KSB or any amendment to this Form 10-KSB. [X]

Issuer's revenues for its most recent fiscal year were $8,946,710.

The aggregate market value of the voting stock held by non-affiliates, computed by reference to the average bid and asked prices of such stock as of February 28, 2002, was approximately $855,493.

The number of shares outstanding of each of the issuer's classes of common equity, as of February 28, 2002, was 3,707,109.

Documents Incorporated by Reference: None

Part I

Item 1. Description of Business

Overview

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, pursuant to an Agreement and Plan of Merger dated as of July 8, 1998, Derma Sciences acquired Genetic Laboratories Wound Care, Inc. ("Genetic Labs") by means of a tax-free reorganization whereby Genetic Labs became a wholly-owned subsidiary of Derma Sciences. In December, 1999, pursuant to an Agreement and Plan of Merger dated December 27, 1999, Genetic Labs was merged into Derma Sciences by means of a tax-free reorganization whereby the separate corporate existence of Genetic Labs ceased.

In 1998, Derma Sciences purchased the stock of Sunshine Products, Inc. ("Sunshine Products") in a cash transaction. As a result of the stock purchase, Sunshine Products became a wholly-owned subsidiary of Derma Sciences.

Derma Sciences and its subsidiary Sunshine Products are referred to collectively as the "Company." The Company's executive offices are located at 214 Carnegie Center, Suite 100, Princeton, New Jersey.

The Company engages in the marketing and sale of three dermatological products lines: (1) sprays, ointments and dressings for the management of chronic non-healing skin ulcerations such as pressure, diabetic and venous ulcers, surgical incisions and burns; (2) wound closure strips, specialty fasteners and net dressings; and (3) bathing, skin care products and disinfectants.

The Company's Markets

Chronic Wound Care

The Company markets chronic wound care, incontinent care and related products both to extended care facilities, such as nursing homes, rehabilitation centers, hospitals and home healthcare agencies, and to retail and "closed door" pharmacies. Chronic wounds, unlike acute wounds which heal within a natural timeframe, may linger for weeks, months or years and may defy all traditional attempts at treatment.

The most common chronic wounds are: (1) bedsores (decubitus ulcers) which result from prolonged pressure on the skin impairing the blood supply to the affected area; (2) venous ulcers which result from poorly functioning veins; and (3) diabetic leg ulcers. Traditional techniques for the treatment of chronic wounds have principally involved cleansing and debriding the wound (removing infected and dead tissue), controlling infection with antibiotics and protecting the wound. However, the foregoing treatments are passive in nature and do not stimulate or accelerate wound healing. Many of the Company's chronic wound care products seek to provide an environment conducive to

wound healing by addressing, in addition to healing factors such as protection and infection control, additional healing factors such as vitamins, minerals, zinc, moisture, pH balance and nutrition.

Wound Closure Strips, Fasteners and Net Dressings

The Company markets wound closure strips, nasal tube fasteners and a variety of catheter fasteners to doctors, clinics, nursing homes and hospitals. These wound closure strips eliminate the need for sutures on the surface of many surgical wounds, decrease the incidence of scarring and infection and promote wound healing. In contrast to the characteristics of surgical tapes, these wound closure strips yield to the movement of the skin thereby reducing traction blisters at the wound site. In addition, these wound closure strips provide excellent adherence, optimum surgical wound security and protection from irritation and skin shearing.

The Company's nasal tube and catheter fasteners facilitate attachment of suction tubes, feeding tubes, urinary catheters, gastrostomy tubes, wound drainage systems, IV's and chest tubes. These fasteners incorporate dynamic tape-to-skin adhesion which minimizes irritation, blistering and skin shear. Further, the fasteners' single piece

construction permits adoption of rapid and standardized attachment procedures. The Company's woven elastic net dressings reduce dressing time, allow for proper ventilation of the wound site and hold the dressing in place.

Personal Skin Care

The Company markets general purpose and specialized skin care products to nursing homes, hospitals, home healthcare agencies and other institutions. These products include antibacterial skin cleansers, soaps, hair and body washes, lotions, body oil and moisturizers. The Company's skin care products are designed to enable customers to implement and maintain successful skin care/hygiene programs.

The Company's Products

Descriptions of the Company's products and their intended uses are set forth below:

Wound Prevention and Treatment

Dermagran AF	Topical anti-fungal ointment packaged in tubes. Contains zinc nutrient technology and 2% micronazole nitrate. Used to treat jock itch, ringworm, athlete s foot and other superficial fungal infections.
Dermagran BC	Topical ointment (barrier cream) packaged in tubes. Used to provide protective, long lasting barrier ointment for perineal care associated with incontinency.
Dermagran GP	Topical ointment, packaged in tubes, containing allantoin and aloe vera gel. Used to provide protective, long lasting general skin care protectant for perineal care associated with incontinency.
Dermagran Hydrophilic Wound Dressing	Advanced zinc hydrogel formulation impregnated in gauze pad. Used for the management of stages II through IV pressure sores, diabetic ulcers, venous stasis ulcerations, thermal burns, surgical incisions and superficial lacerations, cuts or abrasions.

Dermagran Hydrogel Dressing	Clear hydrogel packaged in tubes. Used for the management of all stages of pressure sores, surgical incisions, thermal burns, cuts and abrasions and venous stasis ulcerations.
Dermagran-B Hydrophilic Wound Dressing	Advanced zinc hydrogel formulation packaged in tubes. Used for the management of stages II through IV pressure sores, diabetic ulcers, venous stasis ulcerations, thermal burns, surgical incisions and superficial lacerations, cuts or abrasions.
Dermagran Ointment	Topical ointment with a lanolin odor, packaged in both jars and tubes. Active ingredient: aluminum hydroxide gel. Used to manage stage I and II pressure and venous ulcers, incisions, burns and other skin irritations.
Dermagran Spray	Colorless, odorless liquid, packaged in translucent plastic bottles with pump spray nozzles. Active ingredient: zinc acetate. Used to manage stage I pressure and venous ulcers, incisions, burns and other skin irritations.
Dermagran Wound Cleanser	Saline wound cleanser with moisturizing and lubricating properties packaged in a four ounce plastic bottle. Used to cleanse dermal wounds and contribute to the maintenance of a mildly acidic wound environment.
Dermagran Zinc Saline Dressing	Sterile 4" x 8", 12 ply gauze dressing saturated with sterile solution and trace amounts of zinc, packaged in foil envelopes with peel-down tabs. Used for the management of pressure sores, venous ulcers, incisions, burns and skin irritations.

Wound Closure

Suture Strip	Latex-free, water-resistant, economical wound closure strip. Made of the same non-woven material as Suture Strip Plus®. Used in various surgical and wound care procedures.
Suture Strip Plus®	Latex-free, water-resistant wound closure strip. Made of a macroporous non-woven polyamide with skin friendly adhesive. Used for primary closure and early suture removal.

Catheter Fasteners

NG Strip	Tube fastener made of flexible material designed to maximize adhesion and minimize irritation, blistering and skin shear, packaged in various sizes. Used to secure nasal or feeding tubes to the nose.
Percu-Stay	Sterile, self-adhesive catheter fastener for percutaneous drainage catheters. Made of a combination moisture-absorbent hydrocolloid surrounded by a pressure sensitive adhesive on a non-woven backing. Used to secure percutaneous drainage catheters.
UC Strip/Cath-Strip	Catheter tubing fastener made of a flexible material designed to maximize adhesion and minimize irritation, blistering and skin shear, available in various sizes. Used for securing urinary and gastrostomy catheter tubing to the skin.

Net Dressings

Flexinet/Systenet	Woven elastic net dressing for wounds which reduces dressing time, allows for proper ventilation of the wound site and holds dressings in place. Packaged in various sizes.
Personal Skin Care	
Antibacterial Soap	Antibacterial hand soap with glycerin and aloe vera. Active Ingredient: chloroxylenol. Used as a hand soap for protection against both gram-positive and gram-negative organisms as well as yeasts and fungi.
ApriVera	Odor reducing, non-alkaline body lotion and hair cleanser with aloe vera.
Bathe Away	Body and hair cleanser containing glycerin, coconut oil products and chamomile.
Hydro-Soft	Concentrated blend of skin emollients and gentle skin cleansers for moisturizing and conditioning the skin. Used in whirlpool and hydrotherapy units.
In Between	Perineal spray skin cleanser. Used to remove dry fecal matter and odor resulting from incontinence.
MPH Ointment	Topical ointment, packaged in pumps and jars, containing allantoin and aloe vera gel. Used to provide protective, long lasting barrier ointment for perineal care associated with incontinency.
Mysotrol	Clear gel no-rinse hand sanitizer packaged in squeeze bottles. Used as a hand sanitizer to provide germicidal and virucidal protection. Meets OSHA protocol for a healthcare handwash.
Optima	Bath additive or after-bath moisturizer enhanced with acetylated lanolin alcohol. Used to lubricate and soften the skin.

Skin Care Lotion	Lotion to moisturize and soften the skin.
Soft Wash	No rinse bathing sponge impregnated with cleanser and aloe vera moisturizer.
Swash	Body and hair cleanser.
Therabath	Lotion type body and hair cleanser.
Three to One	Economical concentrated body and hair cleanser.
Whirlpool/Hardsurface Disinfectant	Detergent and disinfectant. Used to clean and disinfect any whirlpool or hardsurface. Effective against a broad range of microorganisms.

Distribution and Sales

Domestic

The Company employs a direct sales force and utilizes drug wholesalers, specialty dealers and medical - surgical distributors to sell and distribute its products in the hospital, home health, nursing home, and physician office markets. The Company's direct sales force consists of an Executive Vice President - Sales and Marketing, a Vice President -

Sales, four direct sales representatives and twenty-eight manufacturer's representatives.

Direct sales representatives receive a base salary together with commissions. Manufacturer's representatives receive commissions based upon sales in their territory and/or market segment. Compensation to wholesalers, dealers and distributors is derived from markups on the Company's products.

International

The Company's wound care products and wound closure strips are distributed and sold internationally pursuant to various licensing and distribution agreements. Sales are made principally to European and Latin American markets. Sales generated from foreign countries are payable in U.S. dollars and approximate $500,000 per year.

eCommerce

The Company launched an eCommerce initiative in early 2000 with a view to generating sales via the Internet. This initiative currently consists of two web-sites one of which is devoted to the Company's institutional markets and one of which is devoted to individuals caring for themselves at home. Sales generated via the Internet are not material.

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 the Company. 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 those of the Company. 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.

The Company's chronic wound care products compete principally with those of Bristol-Myers Squibb-Convatec, Smith & Nephew, Johnson & Johnson and 3M. The Company's largest competitor in the field of wound closure strips is 3M. However, several generic products compete with the Company's specialty fasteners, including hospital and surgical tapes. The Company's personal skin care products compete with those of Provon, Calgon Vestal-Steris and Chester Laboratories.

The ultimate ability of the Company to remain competitive depends upon its ability to acquire, commercialize and market wound and skin care technologies which are superior to those of its competitors. The existence of competing products or treatments, or products or treatments that may be developed in the future by competitors, may adversely affect the marketability of products sold by the Company. However, the Company believes that the quality and performance of its products, together with the skill and dedication of its employees, allow it to successfully compete with larger companies.

Product Sourcing

The Company maintains manufacturing facilities solely for manufacturing its skin care products. The manufacture of all other products is outsourced. The principal manufacturers of the Company's products are: Ambix Laboratories (Dermagran-B Hydrophilic Wound Dressing, Dermagran Wound Cleanser and Dermagran Hydrogel Wound Dressing); Applied Labs (Dermagran Spray); Integrity Medical (Dermagran Zinc-Saline Dressing); Kimberly Clark (Dermagran Hydrophilic Wound Dressing); Topiderm, Inc. (Dermagran Ointment, Dermagran AF, Dermagran BC and Dermagran GP); Trumed Technologies (Cath Strip); Maersk Medical (Percu-Stay) and TapeMark Company

(Suture Strip, Suture Strip Plus(R), NG Strip and UC Strip).

The Company's products utilize readily available components and there are numerous laboratories and production facilities capable of producing these products to the standards required by the FDA, the Company and the pharmaceutical industry. Given the ready availability of other suppliers, the Company does not believe that the loss of one or more of its suppliers would adversely affect its operations.

The Company requires that all of its suppliers conform to the standards set forth in the Good Manufacturing Practice ("GMP") regulations promulgated by the FDA. See "Government Regulation."

Patents, Proprietary and Non-Proprietary Technology

Under the title "Two-Step Procedure for Indolent Would Healing and Aqueous Medium and Topical Ointment Used in Connection therewith," the Company's Dermagran Spray and Dermagran Ointment have received patent protection. Patents have been obtained in: Australia, Canada, European Community (comprised of: Austria, Belgium, France, Germany, Italy, Luxembourg, Netherlands, Sweden, Switzerland and United Kingdom), Ireland, Mexico, Philippines, Spain, and the United States. These patents begin to expire in the year 2003.

Under the title "Topical Barrier Composition Containing Silicone and Bentonite," the Company's Dermagran BC (barrier cream) has received patent protection in the United States. This patent will expire in 2017.

The Company also has patents on its Suture Strip, NG Strip, Cath-Strip and UC Strip products in the United States and United Kingdom. These patents begin to expire in the year 2005.

The Company believes that the foregoing patents and patent applications afford reasonable protection to the Company against the unauthorized copying of the technology embodied in the subject products. However, it must be emphasized that: (1) the means whereby the wound care products may stimulate wound healing are unknown, and (2) the chemical and biological processes bearing upon wound healing are highly complex and subject to a wide variety of influences and stimuli. As such, it is possible that others will develop wound healing products equal or superior to those of the Company without infringing the Company's patents.

Patent law relating to the scope of claims with respect to wound care pharmaceutical products is still evolving and the Company's patent rights are subject to this 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 outcome.

An important component of the Company's 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 the Company will be able to obtain such technology on acceptable terms, if at all. Future inability to acquire or license wound care technology could have a material adverse effect on the Company's business.

Government Regulation

Scope of Regulation

The manufacture, distribution and advertising of the Company and its products are subject to regulation by numerous federal and state governmental agencies in the United States and by similar agencies in foreign countries. 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 the Company's 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 that resemble the FDC Act and the FTC Act.

Medical Devices

The following products are registered with the FDA as Class I "devices" pursuant to the regulations under Section 510(k) of the FDC Act: Dermagran Zinc-Saline Dressing, Dermagran Hydrogel Wound Dressing, Dermagran Hydrophilic Wound Dressing, Dermagran-B Hydrophilic Wound Dressing, Dermagran Wound Cleanser, Suture Strip, NG Strip, Cath-Strip and UC Strip.

The FDC Act requires that all devices for human use marketed in the United States prior to May 28, 1976 ("Preamendment 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, recordkeeping 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 extremely 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 Preamendment Device. Those that are substantially equivalent to a Preamendment Device are given the same classification as the equivalent Preamendment Device. New devices which are not substantially equivalent to Preamendment 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 Preamendment Device. If the FDA determines that the device is not substantially equivalent to a Preamendment 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 the Company have been found by the FDA to be substantially equivalent to a Preamendment Device.

Over-the-Counter Drugs

Prescription drugs may be dispensed only by or 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. Those of the Company's products which are classified as over-the-counter drugs pursuant to the FDC Act are: Dermagran Spray, Dermagran Ointment, Mysotrol, Antibacterial Soap, Dermagran AF and Dermagran BC.

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.

Dermagran Spray, Dermagran Ointment, Dermagran BC and Dermagran AF are currently being marketed as over-the-counter skin protectant drug products. Skin protectant products are the subject of an ongoing FDA rule making procedure which will result in the issuance of a final regulation specifying those active ingredients which are permitted in, and designating labeling requirements for, such products. Preliminary Monographs and Tentative Final Monographs applicable to Dermagran Spray and Dermagran Ointment have been issued by the FDA in 1978 and 1984, respectively.

Dermagran Spray and Dermagran Ointment have been formulated and labeled in accordance with the proposals outlined in the Preliminary Monograph. The Dermagran Spray and Dermagran Ointment labels carry treatment indications of "For symptoms of oozing and weeping due to rubbing or friction" and "For the temporary protection and lubrication of minor skin irritations such as intertrigo, chafing, galling, rubbing or friction," respectively.

Under the Tentative Final Monograph, products formulated and identified in the manner of Dermagran Spray and Dermagran Ointment would be required to carry treatment indications of "Dries the oozing and weeping of poison ivy, poison oak and poison sumac." Thus, if the proposals outlined in the Tentative Final Monograph are adopted without modification in a final regulation, and if no modifications were made to the formulations of Dermagran Spray and Dermagran Ointment, the treatment indications on the current Spray and Ointment labels would have to be revised.

It is currently impossible to predict when the FDA will promulgate a final regulation, what the final regulation will provide or how a final regulation (monograph) will affect either of these products or their labels. Pursuant to the FDA's Compliance Policy Guide, discussed above, Dermagran Spray and Dermagran Ointment may be marketed under their current monographs until one year following the issuance of a Final Monograph. It is the Company's intention to manufacture Dermagran Spray and Dermagran Ointment pursuant to the FDA's Final Monograph relative to "skin protectants" and to make whatever formulation and labeling changes are necessary to fully comply with the final regulation. Given the uncertainty with respect to both the timing and provisions of a Final Monograph relative to Dermagran Spray and Dermagran Ointment, it is not possible to assess the probable impact of this Final Monograph upon these products' manufacture, marketing or sale.

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, the Company is 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.

The Company is 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 the Company is 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 the Company.

Third Party Reimbursement

The Company sells its 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 the Company's products are purchased often are covered by medical insurance. Accordingly, the Company's customers routinely seek reimbursement for the cost of the Company's 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 the Company's 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.

Medicaid reimbursement of the Company's products is dependent upon Company paid rebates to state Medicaid agencies. Effective January 1, 1991, the Omnibus Budget Reconciliation Act of 1990 requires pharmaceutical companies, as a condition of the eligibility of its products for Medicaid reimbursement, to enter into a rebate agreement with the federal government. Only drugs of the pharmaceutical companies having such rebate agreements are covered by state Medicaid programs. Pharmaceutical companies participating in the Medicaid rebate program must remit to state Medicaid agencies a formula-based rebate which varies from quarter to quarter in accordance with the Company's quarterly net sales and the average manufacturer price of the individual products. Medicaid rebates represent approximately 1% of net sales.

Medicare is a federally funded program administered by four 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 the Company's wound care products, together with Cath-Strip and Percu-Stay, are eligible for Medicare reimbursement.

The Prospective Payment Systems (PPS) enacted by Congress as part of the Balanced Budget Act of 1997 places "per capita" (per patient) limits on the amount of Medicare payments for goods and services provided by skilled nursing facilities. PPS has generally had a negative impact on the long-term care industry as well as suppliers to this industry, including the Company.

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 the Company's products will continue to be available. Likewise, there is uncertainty as to the future extent of the Company's rebate obligations.

Product Development

The Company conducts limited product development activities with respect to its skin care line. The Company does not conduct in-house product development activities relative to its wound care and wound closure-fastener product lines and relies for the expansion of these lines upon the purchase or licensing of products from outside sources.

Employees

The Company maintained thirty-nine full-time and three part-time employees at December 31, 2001. The Company considers its employee relations to be satisfactory.

Item 2. Description of Property

The Company's executive offices are located in Princeton, New Jersey. The Company has a lease for its executive office space, at a rate of $9,200 per month, that expires in August, 2002. The Company has a month-to-month lease for offices located in Wilkes Barre, Pennsylvania, at a rate of $1,542 per month. The Company has a month-to-month lease for 8,200 square feet of warehouse space in Old Forge, Pennsylvania, at a rate of $1,925 per month. The Company has a lease for 24,000 square feet of office and warehouse space in St. Louis, Missouri, at a rate $7,298 per month that expires in August, 2002 and a month-to-month lease for 2,000 square feet of warehouse space, also in St. Louis, at a rate of $1,000 per month.

Item 3. Legal Proceedings

The Company is not a party to any material litigation.

Item 4. Submission of Matters to a Vote of Security Holders

The Company did not submit any matter to a vote of shareholders during the fourth quarter, 2001.

Part II

Item 5. Market for Common Equity and Related Shareholder Matters

The Common Stock of the Company is traded on the OTC Bulletin Board under the symbol "DSCI.OB." The Common Stock is also traded on the Boston and Pacific Stock Exchanges under the symbol "DMS." The Company's Common Stock commenced trading on May 13, 1994. The following table sets forth the high and low bid prices for the Company's Common Stock:

Quarter Ended	High	Low
March 31, 2000	$4.56	$1.81
June 30, 2000	$2.00	$0.56
September 30, 2000	$1.50	$0.50
December 31, 2000	$1.25	$0.44
March 31, 2001	$0.59	$0.22
June 30, 2001	$0.65	$0.23
September 30, 2001	$0.71	$0.38
December 31, 2001	$0.80	$0.25

The stock prices reflect inter-dealer prices without retail mark-up, mark-down or commission and may not necessarily represent actual transactions. There is no public market for the Company's preferred stock.

As of the close of business on February 28, 2002, there were 1,217 holders of record of the Common Stock.

The Company has paid no cash dividends in respect of its Common Stock and does not intend to pay cash dividends in the near future.

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations

Reference to Consolidated Financial Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Company's consolidated financial statements and notes to consolidated financial statements set forth below under Item 7.

Results of Operations

Net sales decreased $619,424, or 6.5%, in 2001 to $8,946,710 from $ 9,566,134 in 2000. Gross profit margins increased to 49.8% in 2001 from 48.5% in 2000. Operating expenses decreased $1,872,767, or 31.1%, in 2001 to $4,144,923 from $6,017,690 in 2000. Interest expense decreased $1,037,763 in 2001 to $187,476 from $1,225,239 in 2000. Net income of $192,398 was generated in 2001 versus a loss of $2,581,337 in 2000.

Sales Overview

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

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

Year Ended December 31,

	2001	2000
Gross sales	$9,970,255	$10,879,234
Trade rebates	(763,683)	(1,054,042)
Cash discounts	(194,985)	(191,040)
Medicaid rebates	(64,877)	(68,018)
Net Sales	$8,946,710	$ 9,566,134

Gross sales decreased $908,979, or 8.4%, in 2001 versus 2000 reflecting lower skin care sales associated principally with the loss of the Beverly supply agreement and lower second half wound closure-fastener sales related to lower Percu-Stay sales, partially offset by stronger wound care sales. Trade rebates were down due principally to the reduction in rebate intensive Beverly skin care sales. Cash discounts are up due to more customers taking advantage of terms. Medicaid rebates declined slightly due to lower sales.

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

	Year Ended December 31,			
Product Line	2001	2000	Variance	
Wound care	$2,957,487	$2,593,160	$364,327	14.0%
Wound closure-fasteners	2,889,092	2,989,137	(100,045)	(3.3)%
Skin care	3,100,131	3,983,837	(883,706)	(22.2)%
Total	$8,946,710	$9,566,134	($619,424)	(6.5)%

Net sales declined $619,424, or 6.5%, in 2001 versus 2000. Wound care sales reversed a trend of declining year-on-year sales in 2001, growing 14.0%. Momentum created by renewal of clinical education programs and focused sales efforts were the primary contributors to this growth. Wound closure-fastener sales were down due principally to lower second half Percu-Stay sales as a major customer worked off excess inventory. Excluding Percu-Stay, wound closure-fastener sales were up 2%. Skin care sales were down significantly versus the prior year. The decrease, which began in the second quarter, is principally due to the loss of the Beverly supply agreement effective May 31, 2001. To a lesser extent, skin care sales were adversely impacted by supply interruptions in late 2000 that continued into the first quarter 2001 and a competitive marketplace.

Net Sales, Cost of Sales and Gross Profit

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

	Year Ended December 31,					
	2001		2000		Variance	
Net sales	$8,946,710	100.0%	$9,566,134	100.0%	($619,424)	(6.5)%
Cost of sales	4,488,990	50.2%	4,922,318	51.5%	433,328	8.8%
Gross profit	$4,457,720	49.8%	$4,643,816	48.5%	($186,096)	(4.0)%

==========	=====	==========	=====	==========

Gross profit decreased in 2001 versus 2000 due to lower sales, partially offset by improving margins. The increase in gross profit margin principally reflects increasing sales of higher margined wound care products coupled with decreasing sales of lower margined wound closure-fastener (Percu-Stay) and skin care (Beverly contract)

products versus the prior year. Product line net sales as a percentage of total net sales, together with the gross profit percentages attributable to each line, are outlined below:

		Percentage of Total Net Sales	
Product Line	Gross Profit Percentage	2001	2000
Wound care	60% - 80%	33.1%	27.1%
Wound closure-fasteners	40% - 60%	32.3%	31.2%
Skin care	20% - 40%	34.6%	41.7%
Total		100.0%	100.0%

Lower freight and obsolescence costs in 2001 also contributed. Freight costs as a percentage of sales were down in 2001 due to resolution in early 2001 of the inefficiencies associated with the skin care backorder situation prevalent in the later half of 2000, together with the successful renegotiation of lower freight rates. Partially offsetting this favorable contribution to margin improvement were slightly higher product costs.

On average, contract manufactured wound care and wound closure-fastener line cost increases approximated 1% to 2%. Skin care line material costs were up 1% to 2%, while labor and overhead costs were adversely impacted during the Beverly contract termination transition period and subsequently by the resultant significant decrease in production volume which, in turn, had an adverse impact on fixed overhead absorption.

Operating Expenses

Operating expenses decreased $1,872,767, or 31.1%, to $4,144,923 in 2001 from $6,017,690 in 2000. A summary of selling, marketing and general administrative expenses for 2001and 2000 are outlined in the table below:

	Year Ended December 31,			
Operating Expense	2001	2000	Variance	
Selling	$1,402,935	$2,544,637	($1,141,702)	(44.9)%
Marketing	343,200	640,141	(296,941)	(46.4)%
General and administrative	2,398,788	2,832,912	(434,124)	(15.3)%
Total	$4,144,923	$6,017,690	($1,872,767)	(31.1)%

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

Interest Expense, net

Interest expense, net decreased $1,037,763 to $187,476 in 2001 from $1,225,239 in 2000. Interest expense, net consists of interest income on the Company's investment account balance, interest expense on the Company's bank line of credit (secured by the investment account), convertible bond interest and debt refinancing costs. The decrease is attributable to the absence in 2001 of $1,143,866 of debt refinancing costs incurred in 2000 associated with the Company's Series C and D convertible bonds, lower outstanding 2001 line of credit and convertible bond balances and lower interest rates. These reductions were partially offset by $160,000 of non-cash interest associated with amortizing the consideration granted in January 2001 to extend the maturity date of the outstanding Series C and D convertible bonds.

Other Income, net

Other income, net increased $57,801 to $75,577 in 2001 from $17,776 in 2000. One-time Medicaid adjustments of $31,320, reversal of the $19,468 excess restructuring reserve and higher recurring profit sharing and royalty income were responsible for the increase.

Provision for Income Taxes

A provision for federal and state income taxes of $8,500 has been established in 2001 coincident with the Company's return to profitability. The provision is at less than corresponding statutory rates due to available net operating losses.

Net Income (Loss)

The Company generated net income of $192,398, or $0.08 per share (basic) and $0.04 per share (diluted), in 2001 compared to a net loss of $2,581,337, or $1.48 per share (basic and diluted), in 2000. Included in the 2000 net loss were restructuring costs of $250,000 and write-downs or write-offs totaling $450,000. These latter charges related primarily to doubtful accounts, inventory obsolescence and impaired property, plant and equipment. In addition, non-cash related debt refinancing costs of $1,143,866 were included in the net loss for 2000.

Liquidity and Capital Resources

Operating results for 2001 versus 2000 were significantly improved. Sales, gross margin and operating expenses were in line with expectations, cash flow was positive and the Company achieved four consecutive quarters of profitability.

At December 31, 2001 and December 31, 2000, the Company had unrestricted cash and cash equivalents on hand of $524,783 and $424,165, respectively. Cash flow provided by and used in operating activities (excluding restricted cash) was $178,367 in 2001 versus a negative $582,655 in 2000. The Company's return to profitability and a significant improvement in the accounts receivable aging are principally responsible for the 2001 cash flow improvement. The positive cash flow was achieved despite a significant utilization of cash to fund a $568,398 increase in inventory and a $425,652 reduction in accounts payable. Principal drivers behind the inventory increase were timing of receipt for contract manufactured products that are ordered on a semi-annual/annual basis, new products and the need to increase the unit quantity carried for certain products that had fallen below normal safety stock levels at year end 2000. The decrease in accounts payable reflects a clean-up of aged payables and the re-establishment of customer payments more in line with terms, as cash flow permitted.

At December 31, 2001 and 2000, the Company had working capital of $1,862,072 and $1,390,082 (adjusted for reclass of $475,000 of convertible bonds from long term to current), respectively. This $471,990 improvement is attributable to the Company's return to profitability and positive cash flow.

At December 31, 2001 and 2000, $475,000 of the Company's convertible bonds were outstanding. Interest is payable on these bonds at prime rate. This interest rate was 4.75% at December 31, 2001. Interest on the convertible bonds accrues and is payable upon maturity thereof. Convertible bond interest was $39,925 in 2001. At December 31, 2001 accrued and unpaid convertible bond interest was $119,563. The convertible bonds matured on January 7, 2002 (see below).

As of January 5, 2001 bondholders owning the convertible bonds extended the maturity date of the bonds one year to January 7, 2002 in return for non-cash consideration valued at $160,000. This $160,000 debt refinancing cost was recorded as bond discount and amortized to interest expense over the one-year maturity extension.

In November 2001, the Company closed out its $1,000,000 bank line of credit facility that was fully secured with cash deposited with the bank and paid off its $580,455 outstanding loan balance.

The Company's 450,002 Series A warrants with an exercise price of $4.50 expired on November 15, 2001. Other warrants consisting of 10,000 warrants with an exercise price of $15.63 expired on August 2, 2001. In February

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

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

Prospectively, the Company expects to build on the momentum created in 2001 in a competitive market place. Modest sales and profitability growth are projected in 2002. Sales are projected to grow based upon identified new customers, new products and expanded sales and marketing efforts. Steps are planned to better control our product costs and minimize year-to-year cost increases. Operating expenses will continue to be properly balanced with revenues. Cash flow is projected to improve in concert with the Company's operating performance.

Strategically, the Company's plan is to stay focused on its base business while considering external opportunities to leverage its core capabilities and grow the business.

Conversion of Convertible Bonds and Accrued Interest

Effective January 7, 2002, bondholders of all the Company's issued and outstanding Series C and D convertible bonds entered into an agreement to convert the entirety of the $475,000 principal and $120,200 accrued interest outstanding. The agreement provides for conversion of the principal and accrued interest into units at a rate of one unit for each $0.50 of principal and interest converted. Each unit consists of one share of Series C or Series D Preferred Stock and one and one tenth warrants to purchase one share of common stock at a per share exercise price of $0.57 ("Series F Warrants"). Each share of preferred stock is convertible into common stock on a one-for-one basis. Principal and accrued interest under the bonds totaling $595,200 were converted into 1,190,400 shares of convertible preferred stock and 1,309,440 warrants.

The agreement further provides that if, prior to July, 2003, the Company offers for sale its common stock at a price per share below $0.50 or its warrants with a per share exercise price of less than $0.57, then the Company shall: (1) issue to the bondholders such additional shares of preferred stock and warrants as, when added to the preferred stock and warrants previously issued, equal the shares of preferred stock and warrants that would have been issued using the lower common stock price as the conversion rate, and (2) lower the per share exercise price of the Series F Warrants to the lower per share exercise price.

In connection with the conversion, the Company will recognize imputed non-cash interest charges of $165,200. A charge of $45,000 will be taken to account for the value of the reset concession granted the bondholders. This charge will be amortized over the eighteen-month term of the reset provision. A charge of $120,200 will be taken immediately to account for the beneficial reduction in conversion terms associated with the accrued interest.

Common Stock Private Offering

The Company initiated in January 2002 a private offering of 2,000,000 shares of its common stock at a price of $0.50 per share. At February 28, 2002, the Company had concluded subscription agreements with its President, together with 15 other individual and institutional investors for the sale of 1,300,000 shares of common stock for a total investment of $650,000. At February 28, 2002, subscriptions totaling $565,000 have been funded. The Company expects the balance of the subscriptions to be funded on or about March 31, 2002. The Company has agreed to file a registration statement with the Securities and Exchange Commission relative to the common stock issued in its private offering.

Forward Looking Statements

Statements that are not historical facts, including statements about the Company's confidence, strategies, expectations about new or existing products, technologies, opportunities, market demand or acceptance of new or existing products are forward-looking statements that involve risks and uncertainties. These uncertainties include, but

are not limited to, product demand and market acceptance risk, impact of competitive products and prices, product development, commercialization or technological delays or difficulties, and trade, legal, social, financial and economic risks.

Critical Accounting Policies

The preparation of the financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts in the financial statements and the accompanying notes. Actual results could differ from those estimates. We believe the following accounting policies are the most critical to the Company.

Revenue Recognition and Allowance for Trade Rebates

Revenue is recognized when product is shipped and title passes to the customer. Sales are adjusted for cash discounts, Medicaid rebates and trade rebates to derive net sales. The Company establishes an allowance for trade and Medicaid rebates based on past experience. If the estimate of trade and Medicaid rebates is not sufficient to cover actual rebates, additional allowances may be required.

Reserve for Obsolete Inventory

The Company establishes a reserve for obsolete inventory based on quantities of the inventory on hand, expected future sales and inventory expiration dates. If the estimated reserve for obsolete inventory is not sufficient to cover actual obsolete inventory, additions to the reserve may be required.

Item 7. Financial Statements

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Report of Independent Auditors

Board of Directors
Derma Sciences, Inc.

We have audited the accompanying consolidated balance sheets of Derma Sciences, Inc., as of December 31, 2001 and 2000 and the related consolidated statements of operations, cash flows and shareholders' equity for the years then ended. 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 auditing standards generally accepted in the 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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., at December 31, 2001 and 2000, and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

/s/ ERNST & YOUNG LLP

Philadelphia, Pennsylvania
February 22, 2002

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DERMA SCIENCES, INC.

Consolidated Balance Sheets

ASSETS	December 31, 2001	2000
Current Assets		
Cash and cash equivalents	$ 524,783	$ 424,165
Restricted cash	–	640,000
Accounts receivable, net	914,458	1,561,633
Inventories, net	1,787,247	1,282,370
Prepaid expenses and other current assets	54,661	75,916
Total current assets	3,281,149	3,984,084
Property and equipment, net	169,708	204,029
Goodwill, patents and trademarks	1,268,827	1,392,495
Total Assets	$ 4,719,684	$ 5,580,608
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Bank line of credit	$ –	$ 640,000
Accounts payable	551,428	977,080
Accrued expenses and other current liabilities	392,649	501,922
Convertible bonds	475,000	
Total current liabilities	1,419,077	2,119,002
Long-term liabilities		

Convertible bonds	-	475,000
Total Liabilities	1,419,077	2,594,002
Shareholders' Equity		
Common stock, $.01 par value, 30,000,000 shares authorized; issued and outstanding: 2,407,109 shares in 2001; 2,120,940 shares in 2000	24,071	21,209
Convertible preferred stock, $.01 par value; 11,750,000 shares authorized; issued and outstanding: 1,960,009 shares in 2001; 2,189,178 shares in 2000 (liquidation preference of $5,650,000 at December 31, 2001)	19,600	21,892
Additional paid-in capital	13,987,882	13,866,849
Accumulated deficit	(10,730,946)	(10,923,344)
Total Shareholders' Equity	3,300,607	2,986,606
Total Liabilities and Shareholders' Equity	$ 4,719,684	$ 5,580,608

See accompanying notes.

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DERMA SCIENCES, INC.

Consolidated Statements of Operations

	Year ended December 31 2001	2000
Net sales	$8,946,710	$ 9,566,134
Cost of sales	4,488,990	4,922,318
Gross Profit	4,457,720	4,643,816
Operating expenses	4,144,923	6,017,690
Interest expense, net	187,476	1,225,239
Other income, net	(75,577)	(17,776)
Total Expenses	4,256,822	7,225,153
Income (loss) before provision for income taxes	200,898	(2,581,337)
Provision for income taxes	8,500	-
Net Income (Loss)	$ 192,398	$(2,581,337)
Income (loss) per common share - basic	$ 0.08	$ (1.48)
Income (loss) per common share - diluted	$ 0.04	$ (1.48)
Shares used in computing income (loss) per common share - basic	2,375,299	1,743,717
Shares used in computing income (loss) per common share - diluted	4,398,131	1,743,717

See accompanying notes.

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DERMA SCIENCES, INC.

Consolidated Statements of Cash Flows

	Year Ended December 31	
	2001	2000
Operating Activities		
Net income (loss)	$ 192,398	$(2,581,337)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	197,341	356,758
Non-cash financing costs	160,000	1,143,866
Provision for bad debts and rebates	110,717	530,324
Provision for inventory obsolescence	63,521	118,000
Changes in operating assets and liabilities		
Restricted cash	640,000	10,000
Accounts receivable	536,458	44,506
Inventories	(568,398)	(111,232)
Prepaid expenses and other current assets	21,255	148,042
Accounts payable	(425,652)	(239,540)
Accrued expenses and other current liabilities	(109,273)	7,958
Net cash provided by (used in) operating activities	818,367	(572,655)
Investing Activities		
Purchases of property and equipment	(39,352)	(22,494)
Net cash used in investing activities	(39,352)	(22,494)
Financing Activities		
Net change in bank line of credit	(640,000)	(10,000)
Proceeds from issuance of convertible securities	-	150,000
Proceeds from the issuance of stock, net of issuance costs	(38,397)	307,623
Net cash (used in) provided by financing activities	(678,397)	447,623
Net increase (decrease) in cash and cash equivalents	100,618	(147,526)
Cash and cash equivalents		
Beginning of year	424,165	571,691
End of year	$ 524,783	$ 424,165
Supplemental cash flow information		
Warrants issued in payment of debt refinancing	-	$ 411,479
Conversion of bonds payable to preferred stock	-	$ 1,000,000
Conversion of accounts payable to common stock	-	$ 45,000
Common stock and warrants issued for debt extension	$ 160,000	-

See accompanying notes.

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DERMA SCIENCES, INC.

Consolidated Statements of Shareholders' Equity

	Common Shares Issued	Preferred Shares Issued	Common Stock	Convertible Preferred Stock	Ad P C
Balance, December 31, 1999	1,325,938	939,176	$13,259	$ 9,392	$12,
Conversion of preferred shares	83,334	(83,334)	833	(833)	
Issuance of Common Stock in $500,000 private placement, net of issuance costs	666,668	-	6,667	-	
Issuance of Common Stock in payment of trade debt	45,000	-	450	-	
Conversion of $850,000 of Series C Convertible Bonds into Preferred Stock	-	1,133,335	-	11,333	
Conversion of $150,000 of Series D Convertible Bonds into Preferred Stock	-	200,001	-	2,000	
Warrants issued in payment of debt refinancing	-	-	-	-	
Net loss	-	-	-	-	
Balance, December 31, 2000	2,120,940	2,189,178	$21,209	$21,892	$13,
Common stock issued in consideration for Series C and Series D Convertible Bonds maturity date extension	57,000	-	570	-	
Conversion of preferred shares	229,169	(229,169)	2,292	(2,292)	
Common stock issuance costs	-	-	-	-	
Net income	-	-	-	-	
Balance, December 31, 2001	2,407,109	1,960,009	$24,071	$19,600	$13,

See accompanying notes.

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

1. Organization and Summary of Significant Accounting Policies

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

Summary of Significant Accounting Policies

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

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

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

Net Income and Loss per Share - Net income (loss) per common share - basic is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Net income (loss) per common share - diluted reflects the potential dilution of earnings by including other common stock equivalents, including stock options, warrants, convertible preferred stock and convertible bonds in the weighted average number of common shares outstanding for a period, if dilutive.

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

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

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

Goodwill relates to the acquisition of Sunshine Products, Inc. in 1998. The Company does not believe that the goodwill is impaired. However, an impairment charge would be recognized if the Company expected that the present value of future earnings from Sunshine Products, Inc. did not exceed the unamortized goodwill.

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill will no longer be amortized, but will be subject to

an annual impairment test in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

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

Cash Flow Information - Interest paid during 2001 and 2000 amounted to $31,280 and $70,419, respectively. Income taxes paid in 2001 and 200 were $1,090 and $1,355, respectively.

Non cash transactions in 2001 include the issuance of 57,000 shares of Common Stock at $0.50 per share together with other equity valued at $160,000 in the aggregate in consideration for extending the maturity date of the Convertible Bonds. Non cash transactions in 2000 include the conversion of $1,000,000 of aggregate principal amount of convertible bonds into Preferred Stock and issuance of 45,000 shares of Common Stock, valued at $1.00 per share, in settlement of trade debt, as well as equity issued in payment of debt financing of $411,479.

Stock Based Compensation - The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date of grant. The Company accounts for stock option grants in accordance with APB Option No. 25, "Accounting for Stock Issued to Employees", and, accordingly recognizes no compensation expense for the stock option grants.

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

Advertising and Promotion Costs - Advertising and promotion costs are expensed in the year incurred.

Reclassifications - Certain reclassifications have been made to prior year amounts and balances to conform with the 2001 presentation.

2. Accounts Receivable

Accounts Receivable comprise the following:

	December 31,	
	2001	2000
Trade accounts receivable	$1,051,283	$1,725,001
Less: Allowance for doubtful accounts	(50,000)	(175,000)
Allowance for trade rebates	(100,000)	(135,000)
Net trade receivables	901,283	1,415,001
Other receivables	13,175	146,632

Total receivables	$ 914,458	$1,561,633

Trade receivable write-offs were $270,717 and $275,845 in 2001 and 2000, respectively. The allowance for trade rebates reflects estimated rebates embedded in outstanding trade receivables.

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

3. Inventories

Inventories comprise the following:

	December 31,	
	2001	2000
Finished goods	$1,617,449	$ 994,258
Packaging materials	268,001	234,859
Raw materials	96,797	201,253
Gross inventory	1,982,247	1,430,370
Reserve for obsolescence	(195,000)	(148,000)
Net inventory	$1,787,247	$1,282,370

4. Property and Equipment

Property and equipment comprise the following:

	December 31,	
	2001	2000
Machinery and equipment	$ 360,188	$320,836
Furniture and fixtures	668,336	668,336
Gross property and equipment	1,028,524	989,172
Less: Accumulated depreciation	(858,816)	(785,143)
Net property and equipment	$ 169,708	$204,029

Depreciation expense was $73,673 and $201,007 in 2001 and 2000, respectively. Depreciation expense for the year ended December 31, 2000 included $86,957 for the write-down of impaired property and equipment.

5. Goodwill, Patents and Trademarks

Goodwill, patents and trademarks comprise the following:

	December 31,	
	2001	2000
Goodwill	$1,497,364	$1,497,364
Less: Accumulated amortization	(386,397)	(280,397)
Net goodwill	1,110,967	1,216,967
Patents and trademarks	451,417	451,417
Less: Accumulated amortization	(293,557)	(275,889)
Net patents and trademarks	157,860	175,528
Net goodwill, patents and trademarks	$1,268,827	$1,392,495

Goodwill amortization expense was $106,000 and $137,720 in 2001 and 2000, respectively. Patent and trademark amortization expense was $17,668 and $18,031 in 2001 and 2000, respectively.

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DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

6. Bank Line of Credit

The Company previously had a $1,000,000 bank line of credit facility fully secured with cash deposited with the bank. On November 5, 2001, the Company paid off its outstanding loan balance of $580,455 and did not renew the line of credit facility. The former line of credit agreement required monthly interest payments at prime minus 1%, or 3.75%. At December 31, 2000, $640,000 of the line of credit facility was outstanding. Interest expense for the years 2001 and 2000 was $31,280 and $70,419, respectively.

7. Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities comprise the following:

	December 31,	
	2001	2000

Accrued compensation	$ 59,251	$ 52,000
Reserve for restructuring costs	-	71,623
Convertible bond interest	119,563	105,553
Medicaid rebates	17,800	32,000
Accrued customer service fees	49,750	31,176
Other	146,285	128,875
Total accrued liabilities	392,649	421,227
Deferred revenue	-	80,695
Total accrued expenses and other current liabilities	$392,649	$501,922

In connection with an agreement for the distribution of catheter fasteners with a third party, the Company received an advance payment of $250,000 in 2000 against the first 83,333 units sold which it recorded as deferred revenue. The advance was amortized to revenue at a rate of $3.00 per unit sold. The advance was fully amortized in the first quarter of 2001.

8. Convertible Bonds

Convertible bonds comprise the following:

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

On August 16, 1999, the Company completed a private placement of its Series C Convertible Bonds ("Series C Bonds") in which an aggregate of $875,000 was raised. The Series C Bonds pay interest only at the prime rate, as defined, until maturity and were originally convertible into Series C Units described below.

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

In July 2000, bondholders owning $375,000 in aggregate principal amount of the Series C Bonds converted the principal of their Series C Bonds into "modified" Series E Units at the rate $0.75 per Unit. Each "modified"

Series E Unit consists of one share of Series C Preferred Stock and one and one tenth warrants to purchase one share of Common Stock at $0.85 per share. Investors who converted their bonds in March 2000 have had their conversions adjusted so as to receive conversion terms equivalent to those of the July 2000 conversion.

In December 1999, the Company received $450,000 of a total of $600,000 in subscriptions for its Series D Convertible Bonds ("Series D Bonds"). Payments of $50,000 and $100,000 representing the balance of these subscriptions were received in January and February, 2000, respectively. The Series D Bonds pay interest only at the prime rate, as defined, until maturity and were originally convertible into Series D units described below.

Each Series D Unit consists of one share of Series D Preferred Stock convertible into one share of Common Stock and one warrant to purchase one share of common stock at $1.01 per share. In March 2000, bondholders owning $150,000 in aggregate principal amount of the Series D Bonds converted the principal of their Series D Bonds into Series D Units at the rate of $1.0125 per Unit. In March, 2000, the bondholders extended the maturity of the Series D Bonds from the original maturity date of December 31, 2000 until January 7, 2001. Investors who converted their bonds in March, 2000 have had their conversions adjusted so as to receive conversion terms equivalent to those of the July, 2000 conversion of Series C Bonds.

The expense recognized for the beneficial conversion features and other consideration given in connection with the reset of the conversion terms of the Series C and Series D convertible bonds in 2000 was $1,143,866.

As of January 5, 2001, bondholders owning an aggregate of $475,000 of the Company's Series C and Series D Convertible Bonds extended the maturity date of their bonds from January 7, 2001 to January 7, 2002. In consideration for this maturity postponement, the Company accorded the bondholders the following: (1) 57,000 shares of the Company's Common Stock with registration rights, (2) reduction in the "per unit" conversion rate of the Series C and Series D Convertible Bonds remaining outstanding from $0.75 to $0.50, (3) increase in the ratio of preferred stock to warrants comprising the units from one share of preferred stock and one warrant to one share of preferred stock and one and one tenth warrants, and (4) reduction of the exercise price of the warrants from $0.85 per share to $0.57 per share. The $160,000 value of the foregoing was recorded as bond discount and amortized to interest expense over the one-year bond maturity extension. The warrants issuable pursuant to items (3) and (4), in total aggregating 1,045,000, have been redesignated as the Company's Series F Warrants.

9. Shareholders' Equity

Preferred Stock

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

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

There are 1,000,001 shares of Series C Convertible Preferred Stock ("Series C Preferred") outstanding. The Company's directors, on February 10, 2000, designated 795,457 shares of the Company's non-designated preferred stock as Series C Preferred. The directors, on July 17, 2000, designated an additional 437,878 shares of non-designated preferred stock as Series C Preferred. The Series C Preferred is a component of the Company's Series

C Units described above under Convertible Bonds. The Series C Preferred is convertible into Common Stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $1.10 per share, votes as a class on matters affecting the Series C Preferred and maintains voting rights identical to the Common Stock on all other matters.

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

Series E Financing

On August 11, 2000, the Company completed a private placement of its Series E Units in which an aggregate of $500,000 was raised. The Series E Units each consist of one share of Common Stock and one and one tenth warrants to purchase one share of Common Sock at $0.85 per share ("Series E Warrants"). The Series E Warrants will expire on July 18, 2005. A total of 733,333 Series E Warrants were issued in connection with the Series E Common Stock private placement.

Stock Purchase Warrants

At December 31, 2001, the Company had 2,866,682 warrants outstanding to purchase the Company's common stock as outlined below:

Series	Number of Warrants	Exercise Price	Expiration Date
B	666,673	$6.75	June 15, 2002
E	2,200,009	$0.85	July 18, 2005

The Company's 450,002 Series A warrants with an exercise price of $4.50 per share expired on November 15, 2001. Other warrants consisting of 10,000 warrants with an exercise price of $15.63 per share expired on August 2, 2001. In connection with the July 2000 Convertible Bond modification as described in Note 8, all Series C and D warrants were redesignated as Series E warrants.

Other Equity Transactions

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

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10. Income Taxes

Significant components of the Company's deferred tax assets and liabilities are as follows:

	December 31,	
	2001	2000
Deferred tax liabilities:		
Prepaid insurance	$ (6,155)	$ (16,086)
Patent amortization	(45,957)	(53,129)
Total deferred liabilities	(52,112)	(69,215)
Deferred tax assets:		
Net operating loss carryforwards	2,775,333	2,872,881
Depreciation	146,454	105,860
Amortization of intangibles	79,794	109,230
Accrued expenses	281,469	261,596
Allowance for bad debts	20,297	71,038
Other	9,728	-
Gross deferred tax assets	3,313,075	3,420,605
Valuation allowance	(3,260,963)	(3,351,390)
Total deferred tax assets	52,112	69,215
Net deferred tax assets	$ -	$ -

The majority of the current year valuation allowance relates to net operating loss carryforwards for which realization is not assured.

The reconciliation of income tax attributable to continuing operations computed at the U.S. federal statutory tax rates to income tax expense (benefit) is:

	December 31,	
	2001	2000
Tax expense (benefit) at U.S. statutory rates	$ 68,305	$(877,655)
State income taxes, net of Federal benefit	16,268	(116,363)
(Decrease) increase in valuation allowance	(90,427)	559,971
Nondeductible expenses	14,354	434,047
Provision for income taxes	$ 8,500	$ -

The provision for income taxes of $8,500 represents an increase in a deferred federal income tax liability for 2001.

At December 31, 2001, the Company has net operating loss carryforwards of approximately $6,800,000 for federal income tax purposes that begin to expire in years 2012 through 2020. For state income tax purposes, the Company has net operating loss carryforwards of $6,800,000 that expire in years 2004 through 2010. During 1998 the Company had a change in control as defined by the Internal Revenue Code Section 382. Consequently, certain limitations may apply to the timing and amount of the utilization of such net operating loss carryforwards.

11. Operating Segments

The Company consists of three operating segments, wound care, wound closure-fasteners and skin care. Products in the wound care segment consist of dressings, ointments and sprays designed to treat chronic wounds.

Wound closure-fasteners products include wound closure strips, nasal tube fasteners, a variety of catheter fasteners and net dressings. The skin care segment consists of antibacterial skin cleansers, hair and body soaps, lotions and moisturizers designed to enable customers to implement and maintain successful skin care / hygiene programs.

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

Segment sales and gross profit for 2001 and 2000 are as follows:

	Year Ended December 31, 2001				
	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company
Net sales	$2,957,487	$2,889,092	$3,100,131	---	$8,946,710
Gross profit	2,278,555	1,411,447	767,718	---	4,457,720
Total expenses	---	---	---	(4,256,822)	(4,256,822)
Income taxes	---	---	---	(8,500)	(8,500)
Net income					$ 192,398

	Year Ended December 31, 2000				
	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company

Net sales	$2,593,160	$2,989,137	$3,983,837	---	$9,566,134
Gross profit	1,740,980	1,643,936	1,258,900	---	4,643,816
Total expenses	---	---	---	($7,225,153)	(7,225,153)
Income taxes	---	---	---	---	---
Net loss					($ 2,581,337)

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

International sales were $602,000 in 2001 and $524,000 in 2000. Wound closure-fastener sales represent the majority of international sales.

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12. Operating Leases

The Company has operating