DERMA SCIENCES INC
Form 10QSB
August 14, 2003

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For Quarter Ended	June 30, 2003
Commission File Number	1-31070

Derma Sciences, Inc.

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

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

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

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

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

Date: June 30, 2003	Class: Common Stock, par value $.01 per share Shares Outstanding: 7,031,256

DERMA SCIENCES, INC.

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Forward Looking Statements

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

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Part I - Financial Information

Item 1. FINANCIAL STATEMENTS

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DERMA SCIENCES, INC.

Consolidated Balance Sheets

	June 30, 2003 Unaudited)	December 31 2002
ASSETS		
Current Assets		
Cash and cash equivalents	1,478,487	$ 1,496,357
Accounts receivable, net	2,390,962	1,975,993
Inventories	3,367,138	2,875,755
Prepaid expenses and other current assets	425,564	281,066
Total current assets	7,662,151	6,629,171
Property and equipment, net	1,097,969	987,891
Goodwill	1,110,967	1,110,967
Patents and trademarks, net	131,956	140,378
Other assets, net	141,469	220,177
Total Assets	$ 10,144,512	$ 9,088,584
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit	1,516,999	$ 1,962,627
Current maturities of long-term debt	173,904	173,493
Accounts payable	804,237	692,259
Accrued expenses and other current liabilities	281,891	445,791
Total current liabilities	2,777,031	3,274,170
Long-term debt	902,412	845,455

Total Liabilities	3,679,443	4,119,625
Shareholders' Equity		
Common stock, $.01 par value, 30,000,000 shares authorized; issued and outstanding: 7,031,256 shares at June 30, 2003 and 4,631,276 shares at December 31, 2002	70,313	46,313
Convertible preferred stock, $.01 par value; 11,750,000 shares authorized; issued and outstanding: 2,526,242 shares (liquidation preference of $4,460,237)	25,262	25,262
Additional paid-in capital	16,723,861	15,588,698
Accumulated other comprehensive income (loss)	225,774	(21,736)
Accumulated deficit	(10,580,141)	(10,669,578)
Total Shareholders' Equity	6,465,069	4,968,959
Total Liabilities and Shareholders' Equity	$ 10,144,512	$ 9,088,584

See accompanying notes.

DERMA SCIENCES, INC.

Consolidated Statement of Operations (Unaudited)

	Three months ended June 30, 2003	2002
Net sales	$ 4,636,189	$ 2,102,207
Cost of sales	2,949,660	926,161
Gross Profit	1,686,529	1,176,046
Operating expenses	1,545,895	1,071,692
Interest expense, net	57,047	6,723
Other (income)/expense, net	2,220	89,244
Total Expenses	1,605,162	1,167,659
Income before provision for income taxes	81,367	8,387
Provision for income taxes	-	-
Net Income	$ 81,367	$ 8,387
Income per common share - basic	$ 0.02	$ 0.00
Income per common share - diluted	$ 0.01	$ 0.00
Shares used in computing income per common share - basic	5,000,507	3,854,609
Shares used in computing income per common share - diluted	10,154,959	7,154,322

See accompanying notes.

DERMA SCIENCES, INC.

Consolidated Statement of Operations (Unaudited)

	Six months ended June 30, 2003	Six months ended June 30, 2002
Net sales	$ 8,852,428	$ 4,242,664
Cost of sales	5,638,889	1,902,081
Gross Profit	3,213,539	2,340,583
Operating expenses	3,000,992	2,057,213
Interest expense	170,486	131,098
Other (income)/expense, net	(47,376)	79,670
Total Expenses	3,124,102	2,267,981
Income before provision for income taxes	89,437	72,602
Provision for income taxes	-	-
Net Income	$ 89,437	$ 72,602
Income per common share - basic	$ 0.02	$ 0.02
Income per common share - diluted	$ 0.01	$ 0.01
Shares used in computing income per common share - basic	4,815,892	3,438,970
Shares used in computing income per common share - diluted	8,664,538	6,814,264

See accompanying notes.

DERMA SCIENCES, INC.

Consolidated Statement of Cash Flows (Unaudited)

	Six months ended June 30, 2003	Six months ended June 30, 2002
Operating Activities		
Net income	$ 89,437	$ 72,60
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation	75,553	35,31
Amortization	98,834	28,52

Deferred financing costs	15,000	120,20
Provision for doubtful accounts and trade rebates	5,000	(3,18
Provision for inventory obsolescence	14,085	19,29
Loss on disposal of property and equipment	2,132	-
Changes in operating assets and liabilities		
Restricted cash	-	(60,00
Accounts receivable	(201,037)	(13,63
Inventories	(232,356)	(8,27
Prepaid expenses and other current assets	(111,451)	(126,07
Other assets	22,341	(3,71
Accounts payable	76,227	301,14
Accrued expenses and other current liabilities	(196,850)	7,25
Net cash (used in) provided by operating activities	(343,085)	369,46
Investing Activities		
Purchases of property and equipment	(55,823)	(46,48
Deferred acquisition costs	-	(132,60
Net cash used in investing activities	(55,823)	(179,08
Financing Activities		
Net change in bank line of credit	(638,348)	-
Deferred financing costs	(26,923)	(85,29
Long-term debt repayments	(108,153)	-
Proceeds from issuance of stock, net of issuance costs	1,154,992	509,40
Net cash provided by financing activities	381,568	424,11
Effect of exchange rate changes on cash	(530)	-
Net (decrease) increase in cash and cash equivalents	(17,870)	614,49
Cash and cash equivalents		
Beginning of period	1,496,357	524,78
End of period	$ 1,478,487	$1,139,27
Supplemental cash flow information		
Conversion of bonds payable and accrued interest to preferred stock	$ -	$595,20
Common stock and warrants issued for debt conversion/extension	$ -	$120,20
Bond conversion reset provision charge to paid-in capital	$ -	$45,00
Stock subscriptions receivable	$ -	$55,00

See accompanying notes.

DERMA SCIENCES, INC.

Notes To Consolidated Financial Statements

1. Organization and Summary of Significant Accounting Policies

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

Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-QSB and Item 310(b) of Regulation S-B. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the six month period ended June 30, 2003, are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2002, included in Form 10-KSB filed with the Securities and Exchange Commission.

Summary of Significant Accounting Policies:

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

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 (loss).

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.

Allowance for Doubtful Accounts The Company provides an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make required payments. The allowance is determined by analyzing historical data and trends. Past due or delinquency status is based on contractual terms. Charges for doubtful accounts are recorded in operating expenses.

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.

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. Leasehold improvements are depreciated over the lesser of their useful lives or the remaining lease term.

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

Goodwill On January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142 (SFAS No. 142), Goodwill and Other Intangible Assets. In accordance with SFAS No. 142, goodwill is deemed to have an indefinite life and is no longer to be amortized but is subject to an annual impairment test.

Stock Based Compensation The Company grants stock options 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 Opinion No. 25, Accounting for Stock Issued to Employees , and, accordingly recognizes no compensation expense for the stock option grants.

Pro forma information regarding net income (loss) and earnings (loss) per share is required by SFAS No. 123, which also requires that the information be determined as if the Company has accounted for its stock options granted under the fair value method of that Statement. For purposes of pro forma disclosures, the estimated fair value of stock options is amortized to expense over the options vesting period. Therefore, future pro forma compensation expense may be greater as additional options are granted. The Company s pro forma information follows:

	Three Months Ended June 30,		Six Months Ended June	
	2003	2002	2003	2002
Net income - as reported	$ 81,367	$ 8,387	$ 89,437	$ 72,6
Pro forma compensation expense	(320,335)	(28,743)	(401,582)	(49,5
Pro forma net (loss) income	$(238,968)	$(20,356)	$(312,145)	$ 23,0
Income (loss) per common share - basic				
As reported	$0.02	$0.00	$0.02	$0.0
Pro forma	$(0.05)	$(0.01)	$(0.06)	$0.0
Income (loss) per common share - diluted				
As reported	$0.01	$0.00	$0.01	$0.0
Pro forma	$(0.05)	$(0.01)	$(0.06)	$0.0

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. Freight costs billed to and reimbursed by customers are recorded as a component of net sales.

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

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

2. Dumex Medical Inc. Acquisition

On August 26, 2002, the Company acquired substantially all 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 the Company s wholly owned Canadian subsidiary, Dumex Medical Canada Inc. The results of operations of Dumex Medical Canada Inc. have been included in the Company s consolidated financial statements since the acquisition date.

3. Accounts Receivable

Accounts receivable include the following:

	June 30, 2003	Dece
Trade accounts receivable	$2,516,514	$1
Less: Allowance for doubtful accounts	(25,000)	
Allowance for trade rebates	(116,000)	
Net trade receivables	2,375,514	1
Other receivables	15,448	
Total receivables	$2,390,962	$1

4. Inventories

Inventories include the following:

	June 30, 2003	Dece
Finished goods	$2,477,088	$2,
Work in process	130,342	
Packaging materials	278,287	
Raw materials	481,421	
Total inventory	$3,367,138	$2,

5. Property and Equipment

Property and equipment include the following:

	June 30, 2003	Dece
Machinery and equipment	$1,222,131	$1,

Furniture and fixtures	174,169	
Leasehold improvements	47,666	
Gross property and equipment	1,443,966	1,
Less: Accumulated depreciation	(345,997)	(
Net property and equipment	$1,097,969	$

6. Goodwill

Goodwill of $1,110,967 relates to the 1998 acquisition of Sunshine Products, Inc. Effective January 1, 2002, in accordance with SFAS No. 142, the Company discontinued the amortization of goodwill and conducted the first of the required annual tests of goodwill impairment. An impairment charge would be recognized if the fair value of Sunshine Products, Inc. s goodwill is less than its carrying value. The results of the initial and subsequent tests which the Company completed in the fourth quarter, 2002 indicate that the goodwill carrying value is not impaired.

7. Patents and Trademarks

Patents and trademarks include the following:

	June 30, 2003	Dece
Patents and trademarks	$ 444,067	$
Less: Accumulated amortization	(312,111)	(
Net patents and trademarks	$ 131,956	$

8. Other Assets

Other assets include the following:

	June 30, 2003	Dece
Deferred financing costs	$ 84,642	$
Deposits	56,827	
Total other assets	$141,469	$

9. Short Term Borrowings

Short term borrowings include the following:

	June 30, 2003	Dece
Canadian line of credit	$1,516,999	$
U.S. line of credit	-	1,
Total short term borrowings	$1,516,999	$1,

Canadian Line of Credit

Effective August 26, 2002, in connection with the acquisition of Dumex Medical Inc., the Company entered into a sixteen month revolving credit facility agreement (the Dumex Agreement) for a maximum principal amount of $1,855,000 with a Canadian bank.

The Company s wholly owned Canadian subsidiary, Dumex Medical Canada Inc., may request advances under the Dumex Agreement up to the value of seventy-five percent (75%) of its eligible receivables (as defined) and fifty percent (50%) of its eligible inventory (as defined) up to a maximum of $705,000. Interest on outstanding advances is payable monthly at the Canadian prime rate (as defined) plus 1.0%, or 6.0% for advances outstanding at June 30, 2003. Outstanding advances are secured by all tangible and intangible assets of Dumex Medical Canada Inc. In addition, the Canadian bank has a second lien security interest in the assets of the Company s U.S. operations. The Company has also guaranteed payment of amounts due under the Dumex Agreement.

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Over the term of the Dumex Agreement, the Company has agreed to comply with a number of financial covenants governing minimum working capital, current ratios, tangible net worth, interest coverage, total indebtedness to tangible net worth and total indebtedness to adjusted pre-tax earnings. These covenants are measured at the end of each month. Additional covenants governing permitted indebtedness, liens, payments of dividends and protection of collateral are included in the Dumex Agreement. In the event of a margin deficiency (as defined) or covenant violation, the Company is required to advance up to an additional $370,000 of working capital to Dumex Medical Canada Inc. in order to correct the deficiency. This additional working capital may be repaid to the Company 45 days after the margin deficiency or covenant violation has been cured upon the condition that such repayment not result in a margin deficiency, covenant violation or any other event of default.

U.S. Line of Credit

In March, 2003 the Company entered into a new one year line of credit agreement (subject to annual renewal) with a U.S. lender (the Agreement) for a maximum principal amount of $2,000,000. No funds have been drawn against the line to date. Estimated maximum potential advances under the Agreement on the date of signing were $1,250,000, less any outstanding standby letters of credit. Advances will be utilized to fund strategic initiatives and for general working capital purposes. The Company terminated its prior U.S. line of credit on February 28, 2003 by repaying the $1,000,000 outstanding indebtedness and paying a $50,000 early termination fee. In addition, the Company charged $66,342 to interest expense for deferred financing costs associated with the prior U.S. line of credit.

The Company may request advances under the Agreement up to the value of 80% of eligible U.S. receivables (as defined) and 50% of eligible U.S. inventory (as defined), excluding work-in-process inventory. Interest on outstanding advances is payable monthly in arrears at the one month LIBOR rate (as published in The Wall Street Journal), plus 3.0%, or 4.1% on June 30, 2003. In addition, the Company will pay an annual line fee of $20,000. This line fee and any one-time lender or legal costs associated with securing the line of credit will be deferred and amortized to interest expense over the line term of one year.

Outstanding advances are secured by all tangible and intangible assets of the Company s U.S. operations. Over the term of the Agreement, the Company has agreed to maintain its fixed charge ratio (as defined) at not less than 1.25:1.0 as measured quarterly on a twelve month trailing basis. Additional covenants governing permitted indebtedness, changes in entity status, purchase of securities and protection of collateral are included in the Agreement.

As security for indebtedness of the Company s subsidiary, Dumex Medical Canada Inc., the Company has accorded a Canadian bank its guarantee of payment together with a second lien security interest in the Company s assets located in the U.S. In connection with the Agreement and in return for a standby letter of credit in the amount of $200,000 against the new line of credit, the Canadian bank has agreed not to exercise its rights under its second lien security interest and guarantee against the Company s U.S. assets without the U.S. lender s approval. The standby letter of credit serves to reduce the Company s potential borrowing capacity under the Agreement by $200,000.

10. Convertible Bonds

Effective January 7, 2002, bondholders of all the Company s issued and outstanding series C and D convertible bonds converted the entirety of the $475,000 principal and $120,200 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 1,309,441 series F warrants.

If prior to July, 2003, the Company offers for sale its common stock at a price per share below $0.50 or its warrants at a per share exercise price of less than $0.57, then the Company has agreed to: (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 recognized an imputed non-cash interest charge of $165,200. A charge of $45,000 was taken to account for the value of the reset concession granted to the bondholders. This charge was amortized over the eighteen-month term of the reset concession. A charge of $120,200 was taken immediately to account for the conversion terms associated with the accrued interest.

11. Long-Term Debt

Long-term debt includes the following:

	June 30, 2003	December 31, 2002
Canadian term loan	$1,071,615	$ 987,576

Capital lease obligations	4,701	31,372
Total debt	$1,076,316	$1,018,948
Less: current maturities	173,904	173,493
Long-term debt	$ 902,412	$ 845,455

Effective August 26, 2002, in connection with the acquisition of substantially all the assets of Dumex Medical Inc., the Company entered into a five-year term loan agreement with a Canadian Bank. The loan is repayable in monthly payments consisting of principal and interest commencing October 1, 2002. Interest on the outstanding principal balance is payable monthly at the bank s prime rate (as defined) plus 1.25%, or 6.25% at June 30, 2003. The term loan is secured by all tangible and intangible assets of Dumex Medical Canada Inc. and subject to the same financial covenants applicable to the operating line of credit (Note 9).

12. Shareholders Equity

Preferred Stock

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

There are 452,504 shares of series B convertible preferred stock outstanding. The series B preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $6.00 per share, votes as a class on matters affecting the series B preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 719,055 shares of series C convertible preferred stock outstanding. The series C preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.71 per share, votes as a class on matters affecting the series C preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 1,204,680 shares of series D convertible preferred stock outstanding. The series D preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.53 per share, votes as a class on matters affecting the series D preferred stock and maintains voting rights identical to the common stock on all other matters.

Stock Purchase Warrants

At June 30, 2003, the Company had warrants outstanding to purchase the Company s common stock as outlined below:

Series	Number of Warrants	Exercise Price	Expiration Date

E	2,200,009	$0.85	July 18, 2005
F	1,309,441	$0.57	January 6, 2007

The Company s 666,673 series B warrants with an exercise price of $6.75 per share expired on June 15, 2002. In connection with the conversion of the Company series C and D convertible bonds on January 7, 2002 described in Note 10, 1,309,441 series F warrants were issued.

Other Equity Transactions

The Company closed in June 2003 a private offering of 4,000,000 shares of its common stock at a price of $0.50 per share initiated in January 2002. Offering proceeds are being used to fund strategic initiatives and for general working capital purposes. From January 2002 through June 30, 2003, 4,000,000 shares of common stock were issued pursuant to the offering and offering proceeds of $1,908,312, net of $91,688 in offering expenses, have been received.

In May 2002, a total of 624,167 shares of series A, B and C preferred stock were converted into 624,167 shares of common stock.

13. Comprehensive Income

The Company s total comprehensive income was as follows:

	Six Months Ended June 30,	
	2003	2002
Net income - as reported	$ 89,437	$72,602
Other comprehensive income:		
Foreign currency translation adjustment	247,510	-
Comprehensive income	$336,947	$72,602

14. Promissory Note

On January 9, 2003 the Company loaned $50,000 to a supplier pursuant to a secured promissory note. The stated maturity date of the note is December 31, 2003. The note may be prepaid without penalty, bears interest at the annual rate of 5% and is secured by the tangible and intangible property of the supplier. The funds advanced are to be used by the supplier for general working capital purposes in the ordinary course of business. The promissory note, together with accrued interest of $1,190, is included in prepaid expenses and other current assets.

15. Income taxes

No provision for income taxes has been made in the three or the six months ended June 30, 2003 or 2002 given the Company s available net operating loss carryforwards.

At December 31, 2002, the Company has net operating loss carryforwards of approximately $7,000,000 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 approximately $7,000,000 that expire in years 2004 through 2010. As of December 31, 2002, the Company has foreign net operating loss carryforwards of approximately $182,000 which begin to expire in 2009. Based on transactions occurring in periods prior to 2001, the Company may have had a change in control as defined in Internal Revenue Code Section 382. Consequently, certain limitations may apply to the timing and amount of the utilization of the federal operating loss carryforwards.

16. Operating Segments

The Company consists of three operating segments: wound care, wound closure-fasteners and skin care. Products in the wound care segment consist of basic and advanced dressings, ointments and sprays designed to treat wounds. Wound closure-fasteners products include wound closure strips, nasal tube fasteners, a variety of catheter fasteners and net dressings. The skin care segment consists of bath sponges, antibacterial skin cleansers, hair and body soaps, lotions and moisturizers designed to enable customers to implement and maintain successful skin care/hygiene programs. As of August 26, 2002, Dumex Medical Canada Inc. s operating results have been included in the wound care segment.

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

Segment sales and gross profit for the three months and six months ended June 30, 2003 and 2002 are as follows:

Three Months Ended June 30, 2003

	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company
Net sales	$3,395,393	$723,108	$517,688	-	$ 4,636,189
Gross profit	1,187,213	354,441	144,875	-	1,686,529
Total expenses	-	-	-	$(1,605,162)	(1,605,162
Net income					$ 81,367
Net long-lived assets	$1,008,985	-	$1,300,487	$31,420	$ 2,340,892

Three Months Ended June 30, 2002

	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company
Net sales	$ 785,519	$660,642	$656,046	-	$ 2,102,207
Gross profit	616,345	324,193	235,508	-	1,176,046
Total expenses	-	-	-	$(1,167,659)	(1,167,659
Net income					$ 8,387
Net long-lived assets	$ 156,155	$295	$1,229,690	$54,777	$ 1,440,917

Six Months Ended June 30, 2003

	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company
Net sales	$6,206,378	$1,568,364	$1,077,686	-	$ 8,852,428
Gross profit	2,152,334	748,875	312,330	-	3,213,539
Total expenses	-	-	-	$(3,124,102)	(3,124,102
Net income					$ 89,437
Net long-lived assets	$1,008,985	-	$1,300,487	$31,420	$ 2,340,892

Six Months Ended June 30, 2002

	Wound Care	Wound Closure-Fasteners	Skin Care	Other Costs	Total Company
Net sales	$1,536,896	$1,431,892	$1,273,876	-	$ 4,242,664
Gross profit	1,187,859	717,136	435,588	-	2,340,583
Total expenses	-	-	-	$(2,267,981)	(2,267,981
Net income					$ 72,602
Net long-lived assets	$156,155	$295	$1,229,690	$54,777	$1,440,917

Long-lived assets consist of property and equipment, patents and trademarks and goodwill. Wound care long-lived assets consist principally of Dumex Medical Canada Inc. property and equipment in the first six months ended June 30, 2003 and patents and trademarks in the first six months of 2003 and 2002. Wound closure-fastener products are for the most part outsourced, and accordingly, are not appreciably supported internally by long-lived assets. Skin care long-lived assets consist of goodwill associated with the acquisition of Sunshine Products, Inc. and associated property and equipment.

International sales (excluding Canada) were $444,063 and $328,500 in 2003 and 2002, respectively. Wound closure-fasteners sales represent the majority of international sales.

17. Subsequent Event

On August 5, 2003, the Company purchased for cash all right, title and interest to Genesis Ointment for $112,000 from Gericare Providers, Inc. Genesis Ointment is a vitamin enriched moisture barrier and skin protectant that both competes with and complements the Company s existing wound care product line. Sales of Genesis Ointment approximate $150,000 to $200,000 per year.

The asset purchase agreement further provides that Gericare Providers, Inc. not enter into any business that competes in any way with Genesis Ointment or Derma Sciences Dermagran line of wound care products for a period of five years from the date of the agreement.

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

QUARTER ENDED JUNE 30, 2003 COMPARED TO QUARTER ENDED JUNE 30, 2002.

Results of Operations

Net sales increased $2,533,982, or 120.5%, to $4,636,189 in the second quarter 2003 from $2,102,207 in the second quarter 2002. Gross profit increased $510,483, or 43.4%, to $1,686,529 in the second quarter 2003 from $1,176,046 in the second quarter 2002. Gross profit margins decreased to 36.4% in the second quarter 2003 from 55.9% in the second quarter 2002. Operating expenses increased $474,203, or 44.3%, in the second quarter 2003 to $1,545,895 from $1,071,692 in the second quarter 2002. Interest expense increased $50,324 in the second quarter 2003 to $57,047 from $6,723 in the second quarter 2002. Other expense decreased $87,024 in the second quarter 2003 to $2,220 from $89,244 in the second quarter 2002. Net income of $81,367 and $8,387 was generated in the second quarters of 2003 and 2002, respectively.

The following table highlights the impact on second quarter 2003 operating results of the August 26, 2002 acquisition by the Company s subsidiary, Dumex Medical Canada Inc., of substantially all of the assets of Dumex Medical Inc.

	Quarter Ended June 30, 2003			Quarter June 30
	Consolidated	Dumex	Derma	(Derma

Net sales	$4,636,189	$2,650,985	$1,985,204	$2,10
Gross profit	1,686,529	636,094	1,050,435	1,17
Operating expenses	1,545,895	500,117	1,045,778	1,07
Interest expense, net	57,047	42,432	14,615	
Other expenses (income), net	2,220	(14,479)	16,699	8
Total expenses	1,605,162	528,070	1,077,092	1,16
Income (loss) before income taxes	81,367	108,024	(26,657)	
Provision for taxes	-	-	-	-
Net income (loss)	$ 81,367	$ 108,024	$ (26,657)	$

Derma Business Overview

Excluding the Dumex acquisition, second quarter 2003 net sales decreased $117,003, or 5.6% to $1,985,204 versus $2,102,207 in the second quarter 2002. Net sales were lower in the wound and skin care lines primarily due to competitive pricing pressure. The wound closure-fasteners line experienced a 9.5% increase in sales due to stronger suture strip and catheter fastener sales.

Gross profit in the second quarter of 2003 decreased $125,611, or 10.7%, to $1,050,435 versus $1,176,046 in the second quarter 2002. This decrease is attributable to decreases in the skin and wound care lines due to competitive pricing pressures, partially offset by an increase in the wound closure-fasteners line gross profit due to higher sales volume.

Total expenses in the second quarter 2003 decreased $90,567, or 7.8%, to $1,077,092 from $1,167,659 in the second quarter of 2002. The decrease in expenses is primarily attributable to the 2002 write off of $94,900 of acquisition costs associated with a cancelled acquisition initiative. In the second quarter of 2003, the Derma business generated a $26,657 loss versus net income of $8,387 in the second quarter of 2002.

Dumex Business Overview

The Dumex business acquired on August 26, 2002, generated second quarter 2003 net sales of $2,650,985. Net sales were slightly higher than plan in local currency and benefited approximately 11% in translation due to a stronger Canadian to U.S. dollar exchange rate. Canadian sales exceeded plan due to the sale of face masks, which are outside the core Dumex business, in response to the Sudden Acute Respiratory Syndrome (SARS) epidemic and the positive impact of renewed and expanded long-term supply contracts, partially offset by lower than anticipated sales of traditional wound care products to hospitals due to the SARS epidemic and lower than expected private label sales.

Gross profit of $636,094 and a gross profit percentage of 24% met expectations. Gross profit improved as a result of higher gross margins on masks in response to the SARS epidemic, favorable exchange rates on U.S. dollar inventory related purchases, partially offset by lower margins on the renewal of long-term supply contracts.

Operating expenses of $500,117 were higher than plan due primarily to a stronger than anticipated Canadian versus U.S. dollar, along with higher than anticipated employee benefit costs and sample expense due to increased marketing efforts.

Dumex returned to profitability in the second quarter of 2003 generating net income of $108,024.

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, hydrophilic wound dressings and the Dumex product line. Wound closure-fasteners sales consist primarily of wound closure strips and catheter fasteners. Skin care sales consist of bath sponges, body washes, shampoos, incontinent care products, skin conditioners, disinfectants and deodorizers.

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

	Quarter Ended June 30, 2003	Quarter Ended June 30, 2002
Gross Sales	$4,860,098	$2,354,183
Trade rebates	(178,136)	(188,540)
Cash discounts	(34,817)	(44,686)
Medicaid rebates	(10,956)	(18,750)
Net Sales	$4,636,189	$2,102,207

Gross sales increased $2,505,915, or 106.5%, from the same quarter of the prior year due to inclusion of Dumex sales for the entire second quarter of 2003, along with higher wound closure-fasteners sales, slightly offset by lower skin care and Derma related wound care sales. Gross to net sales adjustments relate primarily to the Derma business and are not significantly impacted by Dumex activity. Trade rebates were lower due to lower Derma skin care sales in the second quarter 2003 versus 2002. Cash discounts decreased on a quarter-to-quarter basis principally due to a reduction in the Derma cash discount rate to general industry terms for several customers, effective January 1, 2003. Medicaid rebates declined as a result of lower Derma related wound care sales.

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

Product Line	Quarter Ended June 30, 2003	Quarter Ended June 30, 2002	Variance	
Wound care	$3,395,393	$ 785,519	$2,609,874	332.2%
Wound closure-fasteners	723,108	660,642	62,466	9.5%
Skin care	517,688	656,046	(138,358)	(21.1)%
Total	$4,636,189	$2,102,207	$2,533,982	120.5%

Net sales increased $2,533,982, or 120.5%, in the second quarter 2003 versus the second quarter 2002. Wound care net sales increased due to the acquisition of Dumex in August 2002. Excluding Dumex net sales, quarter-to-quarter wound care net sales decreased $117,003, or 5.6%, largely due to competitive pricing pressures. Wound closure-fasteners sales increased $62,466, or 9.5%, due principally to an increase in suture strip and catheter fastener sales. Net sales of skin care products were down $138,358, or 21.1%, from the same quarter of the prior year due to increased competition.

Net Sales, Cost of Sales and Gross Profit

The Company s net sales, cost of sales, gross profit and gross profit margins for the second quarter of 2003 and 2002 are outlined in the table below:

	Quarter Ended June 30,					
	2003		2002		Variance	
Net sales	$4,636,189	100.0%	$2,102,207	100.0%	$2,533,982	120.5%
Cost of sales	2,949,660	63.6%	926,161	44.1%	2,023,499	218.5%
Gross profit	$1,686,529	36.4%	$1,176,046	55.9%	$ 510,483	43.4%

Gross profit increased 43.4% in the second quarter of 2003 to $1,686,529 from $1,176,046 in the second quarter of 2002 due to higher sales volume arising from the Dumex acquisition. Excluding Dumex sales, the second quarter 2003 gross profit was lower than the second quarter 2002 gross profit as a result of pricing pressures in the wound and skin care lines.

The second quarter 2003 and 2002 gross profit percentages were 36.4% and 55.9%, respectively. The decrease in the 2003 second quarter versus the 2002 second quarter gross profit percentage is primarily attributable to the inclusion of lower margin Dumex product sales and a decline in the gross profit margin of the Derma business on a stand-alone basis of 3.0% from 55.9% in 2002 to 52.9% in 2003. The Derma business gross profit margin decline was attributable to pricing pressures in the wound and skin care lines. The Dumex business on a stand-alone basis generated a 24% gross profit which met second quarter 2003 expectations.

Operating Expenses

Operating expenses increased $474,203, or 44.2%, to $1,545,895 in the second quarter of 2003 from $1,071,692 in the second quarter of 2002. A summary of selling, marketing and general administrative expenses for the second quarter 2003 and 2002 are outlined in the table below.

	Quarter Ended June 30,			
	2003	2002	Variance	
Selling	$ 459,875	$ 314,426	$145,449	46.3%
Marketing	58,851	157,351	(98,500)	(62.6%)
General administrative	1,027,169	599,915	427,254	71.2%

Total	$1,545,895	$1,071,692	$474,203	44.2%

Selling expenses increased from the same quarter of the prior year due principally to incremental Dumex selling expenses of $117,058 and an increase in Derma selling expenses of $28,391. The increase in Derma selling expenses is attributable to an upgrade and expansion of the sales organization. Marketing expenses, which relate primarily to the Derma business, decreased due to lower outside consulting expenses and promotional activities. General administrative expenses increased from the same quarter of the prior year as a result of incremental Dumex expenses, along with the Derma business incurring higher compensation, travel, insurance, public relations and accounting expense, partially offset by lower bad debt, regulatory and depreciation expenses.

Excluding Dumex related operating expenses of $500,117, operating expenses decreased $25,914, or 2.4%, to $1,045,778 versus $1,071,692 on a quarter-to-quarter basis.

Interest Expense, net

Interest expense, net increased $50,324 to $57,047 in the second quarter 2003 from $6,723 in the second quarter 2002. Interest expense, net in the second quarter of 2003 is principally comprised of U.S. line of credit costs of $10,500 and Dumex interest expense related to its line of credit and long-term indebtedness of $42,500, while the second quarter of 2002 primarily relates to amortization of deferred financing costs associated with the U.S. line of credit of $4,750.

Other Expense, net

Other expense, net decreased $87,024 to $2,220 in the second quarter of 2003 from $89,244 in the second quarter of 2002. Other expense, net in the second quarter of 2003 is primarily comprised of the write-off of a cancelled acquisition initiative of $22,500, temporary storage and demurrage of containers of $21,900, exchange losses of $12,300, and one-time ISO consulting expenses of $9,700, partially offset by the sale and/or conversion of previously reserved, discontinued and slow moving inventory of $54,400. Other expense in the second quarter of 2002 is principally related to the write-off of deferred costs related to a cancelled acquisition initiative of $94,900.

Provision for Income Taxes

Given available net operating loss carryforwards, no provision for income taxes has been made in the second quarter 2003 and 2002.

Net Income

The Company generated net income of $81,367, or $0.02 per share (basic) and $0.01 per share (diluted), in the second quarter 2003 compared to net income of $8,387, or $0.00 per share (basic) and $0.00 per share (diluted), in the second quarter 2002.

SIX MONTHS ENDED JUNE 30, 2003 COMPARED TO SIX MONTHS ENDED JUNE 30, 2002.

Results of Operations

Net sales increased $4,609,764, or 108.7%, to $8,852,428 in the six months ended June 2003 from $4,242,664 in the six months ended June 2002. Gross profit increased $872,956, or 37.3%, to $3,213,539 from $2,340,583. Gross profit margins decreased to 36.3% from 55.2%. Operating expenses increased $943,779, or 45.9%, from $2,057,213 to $3,000,992. Interest expense, net increased $39,388 to $170,486 from $131,098. Other income, net increased $127,046 to $47,376 income from $79,670 expense. Net income of $89,437 and $72,602 was generated in the six months ended June 2003 and 2002, respectively.

The following table highlights the impact on the first six months of 2003 operating results of the August 26, 2002 acquisition by the Company s subsidiary, Dumex Medical Canada Inc., of substantially all of the assets of Dumex Medical Inc.

	Six Months Ended June 30, 2003			Six Months Ended June 30, 2002
	Consolidated	Dumex	Derma	(Derma Only)
Net sales	$8,852,428	$4,730,697	$4,121,731	$4,242,664
Gross profit	3,213,539	1,068,744	2,144,795	2,340,583
Operating expenses	3,000,992	954,381	2,046,611	2,057,213
Interest expense, net	170,486	75,220	95,266	131,098
Other (income) expense, net	(47,376)	(25,049)	(22,327)	79,670
Total expenses	3,124,102	1,004,552	2,119,550	2,267,981
Income before income taxes	89,437	64,192	25,245	72,602
Provision for taxes	-	-	-	-
Net income	$ 89,437	$ 64,192	$ 25,245	$ 72,602

Derma Business Overview

Excluding the Dumex acquisition, the first six months of 2003 net sales decreased $120,933, or 2.9%, to $4,121,731 versus $4,242,664 in the first six months of 2002. The Derma business net sales were lower in both the wound and skin care lines primarily due to competitive pricing pressure. The wound closure-fasteners line experienced a 9.5% increase in sales due to stronger catheter fasteners sales.

The Derma business gross profit in the first six months of 2003 decreased $195,788, or 8.4%, to $2,144,795 in the first six months of 2003 from $2,340,583 in the first six months of 2002. The decrease is attributable to lower profitability in the wound and skin care lines due to competitive pricing pressure, partially offset by a gross profit increase in the wound closure fasteners line resulting from higher sales of catheter fasteners.

The Derma business total expenses in the first six months of 2003 decreased $148,431, or 6.5%, to $2,119,550 from $2,267,981 in the first six months of 2002. The first six months of 2003 were favorably impacted by the settlement of an Internal Revenue Service claim of $88,000, lower acquisition related costs of $72,400, lower non-cash interest changes of $120,200 associated with the conversion of the Company s Series C and D bonds and accrued interest outstanding in January 2002, partially offset by interest costs, one-time early termination fee and write-off of deferred financing costs associated with the previous U.S. line of credit of $136,000. Net income in the first six months of 2003 decreased $47,357 to $25,245 from $72,602 in the first six months of 2002.

Dumex Business Overview

The Dumex business for the first six months of 2003 generated net sales of $4,730,697. Net sales were lower than plan in local currency, but benefited approximately 8% in translation due to a stronger Canadian to U.S. dollar exchange rate. Canadian sales were benefited by the sale of face masks, which are outside the core Dumex business, in response to the SARS epidemic and the positive impact of the renewal, and in some cases expansion, of long-term supply agreements, partially offset by lower than anticipated sales of traditional wound care products to hospitals due to the SARS epidemic and lower than expected private label sales.

For the first six months of 2003, Dumex generated a gross profit of $1,068,744 and a gross profit percentage of 24%. Gross profit benefited from the sale of higher margin face masks, favorable exchange rates on U.S. dollar inventory related purchases, partially offset by lower gross margins on new or expanded long-term supply contracts.

Operating expenses of $954,381 exceeded plan principally due to the strengthening of the Canadian dollar versus the U.S. dollar, along with higher than plan costs for utilities, employee benefits and samples.

Net income for the first six months of 2003 was $64,192.

Sales Overview

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

	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
Gross Sales	$9,314,330	$4,681,050
Trade rebates	(368,217)	(312,912)
Cash discounts	(69,422)	(88,099)
Medicaid rebates	(24,263)	(37,375)
Net Sales	$8,852,428	$4,242,664

Gross sales increased $4,633,280, or 99.0%, period to period principally reflecting the inclusion of Dumex sales for the six months of 2003, along with higher wound closure-fasteners sales, slightly offset by lower skin care and Derma related wound care sales. Gross to net sales adjustments relate primarily to the Derma business and are not significantly impacted by Dumex activity. Trade rebates were higher due to more aggressive pricing and a higher percentage of contract price related business. Cash discounts decreased on a period to period basis principally due to a reduction in the Derma cash discount rate to general industry terms for several customers, effective January 1, 2003. The Medicaid rebates decrease is attributable to lower Derma related wound care sales.

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

Six Months Ended June 30, 2003	Six Months Ended June 30, 2002	Variance

Product Line				
Wound care	$6,206,378	$1,536,896	$4,669,482	303.8%
Wound closure-fasteners	1,568,364	1,431,892	136,472	9.5%
Skin care	1,077,686	1,273,876	(196,190)	(15.4%)
Total	$8,852,428	$4,242,664	$4,609,764	108.7%

Net sales increased $4,609,764, or 108.7%, in the six months ended June 30, 2003 versus 2002. Wound care sales increased due to the acquisition of Dumex in August 2002. Excluding Dumex net sales, period to period wound care sales decreased $61,215, or 4.0%, largely due to competitive pricing pressures. Wound closure-fasteners sales increased $136,472, or 9.5%, due principally to an increase in sales of catheter fasteners. Net sales of skin care products decreased $196,190, or 15.4%, due to lower sales volumes associated with a competitive market place.

Net Sales, Cost of Sales and Gross Profit

The Company s net sales, cost of sales, gross profit and gross profit margins for the six months ended 2003 and 2002 are outlined in the table below:

	Six Months Ended June 30,					
	2003		2002		Variance	
Net sales	$8,852,428	100.0%	$4,242,664	100.0%	$4,609,764	108.7%
Cost of sales	5,638,889	63.7%	1,902,081	44.8%	3,736,808	196.5%
Gross profit	$3,213,539	36.3%	$2,340,583	55.2%	$ 872,956	37.3%

Gross profit increased 37.3% in the first six months of 2003 to $3,213,539 from $2,340,583 in the first six months of 2002 due to higher sales volume arising from the Dumex acquisition. Excluding Dumex sales, the first six months of 2003 gross profit was lower than the first six months of 2002 gross profit as a result of competitive pricing pressure in the wound and skin care businesses.

The first six months of 2003 and 2002 gross profit percentages were 36.3% and 55.2%, respectively. The decrease in the 2003 six month gross profit percentage is primarily attributable to the inclusion of lower margin Dumex product sales and a decline in the gross profit margin of the Derma business on a stand-alone basis of 3.3% from 55.2% in 2002 to 51.9% in 2003. The Derma business gross profit decline was attributable to pricing pressure in the wound and skin care lines. The Dumex business on a stand-alone basis generated a 22.6% gross profit in line with expectations.

Operating Expenses

A summary of selling, marketing and general administrative expenses for the first six months of 2003 and 2002 are outlined in the table below:

	Six Months Ended June 30, 2003	2002	Variance	
Selling	$ 862,965	$ 663,129	$199,836	30.1%
Marketing	105,583	221,925	(116,342)	(52.4%)
General administrative	2,032,444	1,172,159	860,285	73.4%
Total	$3,000,992	$2,057,213	$943,779	45.9%

Selling expenses increased from the same six months of the prior year due principally to incremental Dumex selling expenses of $209,305, partially offset by a modest decline in Derma business selling expenses of $9,469. Marketing expenses, which relate primarily to the Derma business, decreased primarily due to lower promotional and outside consulting expense. General administrative expenses increased as a result of incremental Dumex expenses, along with the Derma business incurring higher compensation, accounting, insurance, travel, consulting and public relations expenses, partially offset by lower regulatory, bad debt and depreciation expense.

Excluding Dumex related operating expenses of $954,381, operating expenses decreased $10,602, or 0.5%, to $2,046,611 versus $2,057,213 for the first six months of 2003 versus 2002.

Interest Expense, net

Interest expense, net increased $39,388 to $170,486 in the first six months of 2003 from $131,098 in the first six months of 2002. Interest expense, net in the first six months of 2003 is principally comprised of Dumex interest expense of $75,200 related to its line of credit and long-term indebtedness, the February 28, 2003 termination of the Company s previous U.S. line of credit facility resulting in the write-off of $66,342 of deferred financing costs, $19,700 interest incurred on the U.S. line of credit prior to termination, non-cash interest charges of $15,000 and $10,480 related to financing costs associated with the new U.S. line of credit, partially offset by interest income of $16,050. Prior year interest expense, net of $131,098, related principally to non-cash interest charges of $137,700 associated with the conversion of the Company s Series C and D bonds and accrued interest outstanding in January 2002.

Other Income, net

Other income, net increased $127,046 to $47,376 income in the first six months of 2003 from $79,670 expense in 2002. Other income in 2003 is principally comprised of $88,000 resulting from the favorable settlement of an Internal Revenue Service claim, sale and/or conversion of previously reserved, discontinued and slow-moving inventory of $87,100, partially offset by the payment of a $50,000 fee associated with the early termination of the Company s previous U.S. line of credit, exchange losses of $23,200, storage and demurrage for containers of $25,000 and one-time ISO consulting and audit expenses of $18,100. Other expense, net in the first six months of 2002 relates to cancelled initiative costs of $94,900.

Provision for Income Taxes

No provision for income taxes has been provided in the first six months of 2003 and 2002 given available net operating loss carry forwards.

Net Income

The Company generated net income of $89,437, or $0.02 per share (basic) and $0.01 per share (diluted), in the first six months of 2003 compared to net income of $72,602, or $0.02 per share (basic) or $0.01 per share (diluted), in 2002.

Liquidity and Capital Resources

Sales in the first six months of 2003 increased significantly over the prior year due to the inclusion of Dumex sales in 2003. Excluding Dumex, sales were down approximately 3%. Dumex sales in Canada are growing modestly in line with expectations on a local currency basis and have benefited from a stronger Canadian dollar. Dumex sales in the United States are growing in response to focused sales and marketing efforts. Dumex s private label business is off versus historical levels due to the loss of several customers. Derma sales are softer than expected and down slightly versus the prior year due principally to lower wound and skin care sales associated with a competitive marketplace. Gross profit is higher in 2003 versus 2002 due to inclusion of the Dumex sales. Overall gross profit margin percentages are lower in 2003 versus 2002 reflecting inclusion of the lower margin Dumex business in 2003. On a stand-alone basis, Dumex gross margins have remained relatively stable as the unfavorable impact of price erosion has been offset by lower product costs and favorable exchange. Derma s gross margin percentage in 2003 versus 2002 is lower due to pricing pressures in the wound and skin care lines. Operating expenses continue to be closely monitored and are in line with expected revenues. Net income improved in the second quarter over the first, bolstered by the improving performance of the Dumex Canadian operations.

At June 30, 2003, and December 31, 2002, the Company had cash and cash equivalents of $1,478,487 and $1,496,357, respectively. The slight decrease in cash is attributable to cash used in operating activities of $343,085, cash used for the purchase of equipment of $55,823 and cash provided by financing activities of $381,568. Cash used in operating activities was driven by increases in accounts receivable and inventory in support of existing and anticipated sales growth, prepayment of normal operating expenses, a $50,000 advance in the form of a promissory note to a supplier and the pay down of accrued liabilities. Cash provided by financing activities relates to net proceeds of $1,154,992 from the sale of common stock and an increase in the draw down of Dumex s line of credit of $361,652, offset by repayment of Derma s previous U.S. line of credit of $1,000,000 in February 2003 and scheduled debt repayments. Working capital increased $1,530,119 to $4,885,120 at June 30, 2003 from $3,355,001 at December 31, 2002.

In connection with the Dumex acquisition, the Company entered into a sixteen month $1,855,000 revolving credit facility expiring December 31, 2003 to fund day-to-day operations. Maximum potential advances under the agreement at June 30, 2003 were $1,740,000. Advances outstanding against the credit facility were $1,516,999 at June 30, 2003, leaving an additional $223,001 available for borrowing.

In March 2003 the Company entered into a new one year line of credit agreement (subject to annual renewal) with a U.S. lender (the Agreement) for a maximum principal amount of $2,000,000. No funds have been drawn against the line to date. Estimated maximum potential advances under the Agreement on the date of signing were $1,250,000, less any outstanding standby letters of credit. Advances will be utilized to fund strategic initiatives and for general working capital purposes.

As security for indebtedness of the Company s subsidiary, Dumex Medical Canada Inc., the Company has accorded a Canadian bank its guarantee of payment together with a second lien security interest in the Company s assets located in the U.S. In connection with the Agreement and in return for a standby letter of credit in the amount of $200,000 against the new line of credit, the Canadian bank has agreed not to exercise its rights under its second lien security interest and guarantee against the Company s U.S. assets without the U.S. lender s approval. The standby letter of credit serves to reduce the Company s potential borrowing capacity under the Agreement by $200,000.

For 2003, the Company seeks to increase sales and profits by, among other initiatives, launching sale of the Dumex product line in the U.S., driving organic growth of its core product lines both in the U.S. and Canada and integrating the Dumex business more fully into Derma. Steps are planned to minimize year-to-year product cost increases and improve overall supply chain efficiency and cost effectiveness. Plans are also in place to invest in upgrading sales and marketing resources. Operating expenses will continue to be properly balanced with revenues.

Among the potential sources of capital the Company expects to utilize to finance its growth plans in 2003 are anticipated improved profitability and prudent utilization of available lines of credit.

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

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

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.

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.

Goodwill Impairment

At June 30, 2003, the Company s skin care segment had $1,110,967 of goodwill. The Company tests goodwill for impairment on a periodic basis. The process of evaluating the potential impairment of goodwill is highly subjective and requires significant judgments at many points during the analysis. In estimating the fair value of the skin care segment with recognized goodwill, the Company makes estimates and judgments about the future cash flows of this segment. The Company s cash flow forecasts are based on assumptions that are consistent with the plans and estimates used to manage the underlying business. In addition, the Company makes certain judgments about allocating shared assets to the balance sheet for this segment. Changes in these estimates would cause the skin care segment to be valued differently in the future.

Item 3. CONTROLS AND PROCEDURES

The Company s management, including the Chief Executive Officer and Chief Financial Officer, have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this quarterly report has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation.

Part II Other Information

Item 1. Legal Proceedings

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits. All exhibits required by Item 601 of Regulation S-B and required hereunder, as filed with the Securities and Exchange Commission in Form 10-KSB on March 31, 2003, are incorporated herein by reference.

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

32.2 Certification of Principal Financial Officer pursuant to U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) **Reports on Form 8-K.** Forms 8-K were filed on April 4, 2003 relative to the Registrant s, financial results for the fourth quarter and year ended December 31, 2002, on May 2, 2003 relative to the Registrant s initiation of a $2,000,000 revolving credit facility and on June 12, 2003 relative to completion of the Registrant s private placement of 4,000,000 shares of its common stock.

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

DERMA SCIENCES, INC.

By: /s/ John E. Yetter
John E. Yetter, CPA
Chief Financial Officer

Dated: August 13, 2003