DERMA SCIENCES, INC.
Form S-1/A
February 16, 2010

**As filed with the Securities and Exchange Commission on February 16, 2010**

## Registration No. 333-163127

# SECURITIES AND EXCHANGE COMMISSION
# Washington, D.C. 20549

# Form S-1/A-5

# REGISTRATION STATEMENT
# Under
# THE SECURITIES ACT OF 1933

# DERMA SCIENCES, INC.

(Exact Name of Registrant 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 300
## Princeton, NJ 08540
## (609) 514-4744

(Address, Including Zip Code, and Telephone Number,
Including Area Code, of Registrant's Principal Executive Offices)

# Edward J. Quilty, President
# 214 Carnegie Center, Suite 300
# Princeton, NJ 08540
# (609) 514-4744

(Name, Address, Including Zip Code, and Telephone Number,
Including Area Code, of Agent for Service)

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**Approximate date of commencement of proposed sale to public:** From time to time after this registration statement becomes effective.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. x

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

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

| | |
|---|---|
| Large accelerated filer o | Accelerated filer o |
| Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company x |

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# CALCULATION OF REGISTRATION FEE

| Title of Each Class of Securities to Be Registered[1][2] | Proposed Maximum Aggregate Offering Price | Amount of Registration Fee | |
|---|---|---|---|
| Common stock, $.01 par value per share | $ 4,657,500 | $ 332.08 | |
| Warrants to purchase common stock | N/A | N/A | [3] |
| Common stock underlying warrants | $ 1,707,750 | $ 121.76 | |
| Underwriter s warrants to purchase common stock | N/A | N/A | [3] |
| Common stock underlying underwriter s warrants | $ 121,500 | $ 8.66 | |
| Totals | $ 6,486,750 | $ 462.51 | |
| Paid upon initial filing and amendment no. 2 | | $ 617.00 | |
| Registration fee payable | | $ 0 | |

(1) Pursuant to Rule 416 under the Securities Act, this registration statement also relates to an indeterminate number of additional shares of common stock which may be issuable to prevent dilution resulting from stock splits, stock dividends and similar transactions.

(2) Includes shares of common stock which may be issued pursuant to the exercise of a 45-day option granted by the Registrant to the underwriter to cover over-allotments, if any.

(3) In accordance with Rule 457(g) under the Securities Act, by virtue of the fact that the shares of the Registrant s common stock underlying the warrants are registered hereby, no separate registration fee is required with respect to the warrants registered hereby.

**THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON THE DATE OR DATES NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT FILES A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(a) OF THE SECURITIES ACT OF 1933 OR UNTIL THIS REGISTRATION STATEMENT BECOMES EFFECTIVE ON THE DATE THE SECURITIES AND EXCHANGE COMMISSION, ACTING PURSUANT TO SECTION 8(a), MAY DETERMINE.**

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The information in this prospectus is not complete and may be changed. A registration statement relating to these securities has been filed with the Securities and Exchange Commission. These securities may not be sold until the registration statement is effective. This prospectus is not an offer to sell these securities and does not solicit an offer to buy these securities in any state or other jurisdiction where the offer or sale is not permitted.

PRELIMINARY PROSPECTUS **SUBJECT TO COMPLETION, DATED FEBRUARY 16, 2010**

# Derma Sciences, Inc.

# 810,000 Shares of Common Stock
# Warrants to Purchase 270,000 Shares of Common Stock

This is a firm commitment public offering. We are offering for sale 810,000 shares of our common stock and warrants to purchase up to an aggregate of 270,000 shares of our common stock. Each purchaser of a share of our common stock in this offering will receive a warrant exercisable for one-third of a share of our common stock. In this offering, we will sell each share of our common stock and warrant to purchase one-third of a share of common stock for $___. The warrants will have a per share exercise price equal to 110% of the public offering price of a share and a warrant. The warrants are exercisable immediately, non-callable, and will expire five years from the date of this prospectus. For a more detailed description of our common stock and warrants, see Description of Securities on page 51 of this prospectus.

The public offering price of the shares of common stock offered by this prospectus will be determined by negotiation between us and the underwriter based upon market conditions and other factors on the day we price the shares covered by this prospectus, which may not reflect the price at which our common stock trades. The trading price of our common stock is subject to change as a result of market conditions and other factors and we cannot assure you that the shares sold under this prospectus can be resold at or above the offering price or that the shares issuable upon exercise of the warrants can be resold at or above the exercise price of the warrants.

Our common stock currently trades on the NASDAQ Capital Market under the symbol DSCI. On February 12, 2010, our common stock closed at $5.80. The warrants are not currently listed or quoted and we do not expect to seek a listing for them or expected them to be quoted on any market.

**Investing in our securities involves certain risks. See Risk Factors beginning on page 4 of this prospectus for a discussion of information that should be considered in connection with an investment in our securities. Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.**

| | Per Share[1] | Total |
|---|---|---|
| Public offering price | $ | $ |
| Underwriting discounts and commissions[2] | $ | $ |
| Proceeds, before expenses, to us[3] | $ | $ |

(1) Does not include shares of common stock underlying warrants. For every share of common stock purchased, investors will receive a warrant to purchase one-third of a share of common stock.

(2) Does not include a non-accountable expense allowance equal to 0.5% of the gross proceeds of this offering payable to Rodman & Renshaw, LLC, the representative of the underwriters.

(3) We estimate that the total expenses of this offering, exclusive of the underwriters discount and non-accountable expense allowance, will be approximately $_____.

We have granted a 45-day option to the underwriter to purchase additional shares of common stock up to an additional 121,500 shares and warrants to purchase up to 40,500 shares to be offered by us solely to cover over-allotments, if any. The shares and warrants issuable upon exercise of the underwriter option are identical to those offered by this prospectus and have been registered under the registration statement of which this prospectus forms a part.

In connection with this offering, we have agreed to issue to the underwriter a warrant to purchase up to 3% of the shares of common stock constituting the common stock component of the securities sold pursuant to the offering (excluding the over-allotment) at $ per share (125% of the price of the shares sold in the offering), commencing one year from the effective date of the registration statement of which this prospectus is a part and expiring four years thereafter.

The underwriter expects to deliver our shares to purchasers in the offering on or about February , 2010.

**Rodman & Renshaw, LLC**

The date of this prospectus is , 2010.

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**We have not authorized anyone to provide you with information different from that contained or incorporated by reference to this prospectus. Under no circumstances should the delivery to you of this prospectus or any sale made pursuant to this prospectus create any implication that the information contained in this prospectus is correct as of any time after the date of this prospectus. To the extent that any facts or events arising after the date of this prospectus, individually or in the aggregate, represent a fundamental change in the information presented in this prospectus, this prospectus will be updated to the extent required by law.**

**We own or license the following trademarks: DERMA SCIENCES®, DERMAGRAN®, AMERICAN WHITE CROSS®, DUMEX®, MEDIHONEY®, ALGICELL®, XTRASORB™, TCC-EZ™, and BIOGUARD™.**

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# PROSPECTUS SUMMARY

*This summary highlights information contained elsewhere in this prospectus. It does not contain all of the information that you should consider before investing in our securities. You should read the entire prospectus carefully, including the section entitled Risk Factors and our consolidated financial statements and the related notes. The words we , us and our refer to Derma Sciences, Inc. unless the content indicates otherwise.*

## Our Company

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

Derma Sciences, Inc. was organized and incorporated in 1984. In 1994, we completed our initial public offering and our common stock has been publicly held since that time. Derma Sciences, Inc. and our subsidiaries Sunshine Products, Inc., Derma Sciences Canada Inc. and Derma First Aid Products, Inc. are referred to collectively in this prospectus as we or us . Our executive offices are located at 214 Carnegie Center, Suite 300, Princeton, New Jersey and our telephone number is (609) 514-4744.

## Our Website

Our internet address is *http://www.dermasciences.com.* Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge on our website as soon as practicable after these documents are filed with, or furnished to, the Securities and Exchange Commission ( SEC ). Information contained on our website, however, is not part of this prospectus.

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# The Offering

Securities we are offering pursuant to this prospectus supplement

810,000 shares of common stock. Each purchaser of a share of common stock will also receive a warrant to purchase one-third of a share of common stock, or 270,000 shares in the aggregate. The shares of common stock and the warrants will be issued separately, but can only be purchased together in this offering.

Purchase Price

In this offering, we will sell each share of common stock and warrant to purchase one-third of a share of common stock for $____.

Description of warrants

The warrants will have a per share exercise price equal to 110% of the public offering price of a share and a warrant. The warrants are exercisable immediately, non-callable, and expire five years from the date of issuance. See Description of Warrants.

Common stock to be outstanding after this offering

5,849,480 shares (_____, if the warrants are exercised in full).

Percentage of common stock to be acquired by new investors

___% (___% if all of the warrants are exercised).

Use of proceeds after expenses

We will use the proceeds of this offering, estimated to be $_____, based on an assumed offering price of $_____, to acquire world-wide rights to certain advanced wound care technology and retire a term loan. See Use of Proceeds .

Risk factors

This investment involves a high degree of risk. Investors purchasing our securities should not purchase the securities unless they can afford the loss of their entire investment. See Risk Factors .

Market for our common stock

Our common stock is quoted on The NASDAQ Capital Market under the symbol DSCI. On February 12, 2010, the last reported sale price of our common stock on The NASDAQ Capital Market was $5.80.

Market for the warrants

There is no established public trading market for the offered warrants and we do not expect a market to develop. In addition, we do not intend to apply for listing of the warrants on any national securities exchange.

Underwriter s warrant

In connection with this offering, we have agreed to issue to the underwriter a warrant to purchase up to 3% of the shares sold in this offering (excluding the over-allotment) at $_____ per share (125% of the price of the shares sold in the offering).

Other covenants

We have granted the underwriter a six-month right of first refusal to conduct future offering for us following the date of this prospectus. See Underwriting.

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# Summary Financial Information

In the table below we provide you with historical consolidated financial data for the years ended December 31, 2008 and 2007 and the nine month periods ended September 30, 2009 and 2008, derived from our audited and unaudited consolidated financial statements included elsewhere in this prospectus. Historical results are not necessarily indicative of the results that may be expected for any future period. When you read this historical selected financial data, it is important that you read it along with the appropriate historical consolidated financial statements and related notes and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this prospectus.

**Statement of Operations Data**

| | Nine Months Ended September 30, | | Years Ended December 31, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2008 | 2007 |
| Net sales | $34,877,658 | $37,641,362 | $50,199,428 | $34,135,401 |
| Cost of sales | 24,051,984 | 27,141,628 | 35,289,684 | 22,530,986 |
| Gross profit | 10,825,674 | 10,499,734 | 14,909,744 | 11,604,415 |
| Total operating expenses | 11,532,685 | 13,158,323 | 17,850,189 | 12,878,437 |
| Operating loss | (707,011 ) | (2,658,589 ) | (2,940,445 ) | (1,274,022 ) |
| Total other expense, net | 519,118 | 726,846 | 962,677 | 748,549 |
| Loss before (benefit)/provision for income taxes | (1,226,129 ) | (3,385,435 ) | (3,903,122 ) | (2,022,571 ) |
| (Benefit)/provision for income taxes | (47,151 ) | (3,540 ) | 58,815 | 262,034 |
| Net loss | $(1,178,978 ) | $(3,381,895 ) | $(3,961,937 ) | $(2,284,605 ) |

**Balance Sheet Data**

| | September 30, 2009 | December 31, 2008 | Pro Forma (*) |
|---|---|---|---|
| Current assets | $ 15,410,282 | $ 17,103,720 | $ 17,260,282 |
| Total assets | $ 33,334,583 | $ 36,207,322 | $ 33,184,583 |
| Current liabilities | $ 8,745,138 | $ 10,364,069 | $ 7,545,138 |
| Total liabilities | $ 11,827,456 | $ 14,814,824 | $ 8,427,456 |
| Total shareholders equity | $ 21,507,127 | $ 21,392,498 | $ 24,757,127 |

(*) Pro forma amounts represent September 30, 2009 amounts adjusted to reflect the receipt of net proceeds from the offering estimated to be $3,250,000 (based upon an assumed offering price of $5.00 per share of common stock and warrant), the application of $1.4 million of these proceeds toward the retirement of our term loan and the application of $2.0 million of restricted cash currently collateralizing the term loan for the complete retirement of the loan.

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# RISK FACTORS

*This investment involves a high degree of risk and you should purchase shares only if you can afford a complete loss of your investment. Consider carefully these risk factors and other information in this prospectus.*

# Risks Associated with Our Business

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

We incurred losses of $3,961,937 in 2008, $2,284,605 in 2007, $1,099,990 in 2005, $2,338,693 in 2004, $2,581,337 in 2000, $2,998,919 in 1999 and $1,178,978 for the nine months ended September 30, 2009 (unaudited). At September 30, 2009, we had an accumulated deficit of $20,842,801 (unaudited). We cannot offer any assurance that we will be able to generate sustained or significant future earnings.

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

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

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

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

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

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

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

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

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



The rate of reimbursement for the purchase of our products by governmentand private insurance is subject to chang

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

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

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

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

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

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

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

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

Many of our advanced wound care products utilize technology that we license on an exclusive basis from third parties. These products include *Medihoney* dressings, *Bioguard* dressings and MedEfficiency™ total contact casts. The licensing agreements that we have with the owners of these technologies are of limited duration and renewals of the agreements are in the discretion of the licensors. In addition, the maintenance of the license agreements requires that we meet various minimum sales and minimum royalty requirements. If we fail to meet the minimum sales or

minimum royalty requirements of a given license agreement, there is a possibility that the agreement will be cancelled or not renewed or that our exclusivity under the license agreement will be withdrawn. If any of these events were to occur, our ability to sell the products utilizing the licensed technology could be lost or compromised and our revenues and potential profits could be adversely affected.

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

We operate in an industry where technological developments occur at a rapid pace. We compete with a large number of established companies and institutions many of which have more capital, larger staffs and greater expertise than we do. We also compete with a number of smaller companies. Our competitors

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currently manufacture and distribute a variety of products that are in many respects comparable to our products. While management has no specific knowledge of products under development by our competitors, it is possible that these competitors may develop technologies and products that are more effective than any we currently have. If this occurs, any of our products and technology affected by these developments could become obsolete.

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

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

## Risks Associated with this Offering and Our Capital Structure

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

Up to 2,563,599 shares of our common stock are potentially issuable upon the conversion, exercise or vesting of outstanding convertible preferred stock, warrants and options ( dilutive securities ). The shares of common stock potentially issuable upon conversion, exercise or vesting of dilutive securities are substantial compared to the 5,039,468 shares of common stock currently outstanding.

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

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

Historically, the market price of our common stock has been volatile. The high and low prices for the years 2004 through 2009 are set forth in the table below:

*Derma Sciences, Inc.*
*Trading Range Common Stock*

| Year | Low | High |
|---|---|---|
| 2004 | $ 3.44 | $ 15.20 |

| | | |
|---|---|---|
| 2005 | $ 3.36 | $ 6.24 |
| 2006 | $ 3.60 | $ 7.20 |
| 2007 | $ 4.64 | $ 11.20 |
| 2008 | $ 1.60 | $ 10.80 |
| 2009 | $ 1.92 | $ 6.80 |

Events that may affect our common stock price include:

Quarter to quarter variations in our operating results;
Changes in earnings estimates by securities analysts;
Changes in interest rates or other general economic conditions;
Changes in market conditions in the wound care and skin care industries;
Fluctuations in stock market prices and trading volumes of similar companies;
Discussion of us or our stock price by the financial and scientific press and in online investor communities;

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Additions or departures of key personnel;
Changes in third party reimbursement policies;
The introduction of new products either by us or by our competitors; and
The loss of a major customer.

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

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

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

## If members of our management and their affiliates were to exercise all warrants and options held by them, and if substantially all of the authorized but unissued restricted stock awards that were granted to members of management and were to vest, members of management and their affiliates could acquire effective control of us.

The executive officers and directors, together with institutions with which they are affiliated, own substantial amounts of our common stock, together with outstanding options and warrants to purchase our common stock. In addition, we have adopted, and our shareholders have approved, a restricted stock plan pursuant to which our outside directors and executive officers may be awarded up to 312,500 shares of restricted stock. Outside directors have been awarded to date 21,875 shares of restricted common stock. Depending upon the warrants and options exercised by outside investors, if directors, executive officers and affiliates were to exercise their options and warrants, and if additional shares of restricted stock are awarded to our directors and executive officers and such awards vest, members of management and their affiliates could obtain effective control of us. As a result, these officers, directors and affiliates would be in a position to significantly influence our strategic direction, the composition of our board of directors and the outcome of fundamental transactions requiring shareholder approval.

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

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

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

The listing standards of the NASDAQ Capital Market (referred to as the NASDAQ Market ) provide that a company,

in order to qualify for continued listing, must maintain a minimum stock price of $1.00 and satisfy standards relative to minimum shareholders equity, minimum market value of publicly held shares and various additional requirements. If we fail to comply with all listing standards applicable to issuers listed on the NASDAQ Market, our common stock may be delisted. If our common stock is delisted, it could reduce the price of our common stock and the levels of liquidity available to our shareholders. In addition, the delisting of our common stock could materially adversely affect our access to the capital markets and any limitation on liquidity or reduction in the price of our common stock could materially adversely affect our ability to raise capital. Delisting from the NASDAQ Market could also result in other negative consequences, including the potential loss of confidence by suppliers, customers and employees, the loss of institutional investor interest and fewer business development opportunities.

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

We implemented a 1-for-8 reverse split of our common and preferred stock on January 28, 2010. A reverse stock split is often viewed negatively by the market and, consequently, can lead to a decrease in our

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price per share and overall market capitalization. If the per share market price does not increase proportionately as a result of the reverse split, then our value as measured by our market capitalization will be reduced, perhaps significantly.

# CAUTION REGARDING FORWARD LOOKING STATEMENTS

*This prospectus contains forward-looking statements. Such forward-looking statements include statements regarding, among other things, (a) our projected sales and profitability, (b) our growth strategies, (c) anticipated trends in our industry, (d) our future financing plans, and (e) our anticipated needs for working capital. Forward-looking statements, which involve assumptions and describe our future plans, strategies, and expectations, are generally identifiable by use of the words may, should, expect, anticipate, estimate, believe, intend, or project or the negative of these words or other variations on these words or comparable terminology. This information may involve known and unknown risks, uncertainties, and other factors that may cause our actual results, performance, or achievements to be materially different from the future results, performance, or achievements expressed or implied by any forward-looking statements. These statements may be found under Prospectus Summary, Management s Discussion and Analysis of Financial Condition and Results of Operations and Description of Business, as well as in this prospectus generally. Actual events or results may differ materially from those discussed in forward-looking statements as a result of various factors, including, without limitation, the risks outlined under Risk Factors and matters described in this prospectus generally. In light of these risks and uncertainties, there can be no assurance that the forward-looking statements contained in this prospectus will in fact occur. In addition to the information expressly required to be included in this filing, we will provide such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.*

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# WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and other reports, proxy statements and other information with the SEC under the Securities Exchange Act of 1934. You may read and copy any materials we file with the SEC at the SEC s public reference room at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public through the SEC s website at *http://www.sec.gov*. General information about us, including our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, as well as any amendments and exhibits to those reports, are available free of charge through our website at *http://www.dermasciences.com* as soon as reasonably practicable after we file them with, or furnish them to, the SEC. Information on our website, other than the above mentioned reports and proxy statements, is not incorporated into, and is not a part of, this prospectus.

# INCORPORATION OF CERTAIN INFORMATION BY REFERENCE

The SEC allows us to incorporate by reference certain information we have filed with it, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is considered to be part of this prospectus. The following documents we filed with the SEC are incorporated herein by reference:

(a) Our registration statement on Form 8-A effective May 13, 1994.

(b) Our annual report on Form 10-K filed March 31, 2009, and amended on November 12, 2009, for the year ended December 31, 2008.

(c) Our notice of annual meeting of shareholders and definitive proxy statement filed April 6, 2009 relative to the election of directors and ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm for the year ending December 31, 2009.

(d) Our current report on Form 8-K filed April 6, 2009 relative to: (i) our execution of a forbearance agreement with Western Medical, Inc. and (ii) our execution of an amendment to our credit and security agreement with GE Business Financial Services Inc.

(e) Our quarterly report on Form 10-Q filed May 15, 2009, and amended on November 12, 2009, for the three-month period ended March 31, 2009.

(f) Our quarterly report on Form 10-Q filed August 14, 2009, and amended on November 12, 2009, for the six-month period ended June 30, 2009.

(g) Our quarterly report on Form 10-Q filed November 13, 2009 for the nine-month period ended September 30, 2009.

(h) Our current report on Form 8-K filed January 29, 2010 relative to: implementation of a 1-for-8 (i) reverse split of common and preferred stock, and (ii) a corresponding reduction in our authorized shares of common and preferred stock.

(i) Our current report on Form 8-K filed February 11, 2010 relative to our listing on the NASDAQ Capital Market.

We will provide without charge to each person, including any beneficial owner, to whom a prospectus is delivered, upon written or oral request, a copy of any or all of the reports or documents that have been incorporated by reference in this prospectus. Requests for these reports or documents should be directed to John E. Yetter, CPA, Vice President and Chief Financial Officer, Derma Sciences, Inc., 214 Carnegie Center, Suite 300, Princeton, NJ 08540. Requests for these reports or documents may be made telephonically to Mr. Yetter at 609-514-4744 and via email to jyetter@dermasciences.com. We will not send exhibits to these filings unless we have specifically incorporated the exhibit by reference into the filing.

We have filed a registration statement with the SEC under the Securities Act that registers the issuance and sale of the securities offered by this prospectus. The registration statement, including the attached exhibits, contains additional relevant information about us. The rules and regulations of the SEC allow us to omit some information included in the registration statement from this prospectus.

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# USE OF PROCEEDS

Assuming the sale of 810,000 shares of common stock and warrants to purchase 270,000 shares of common stock at a public offering price of $5.00 per share of common stock and warrant, we would receive net proceeds of $3,250,000 after deducting $263,250 for underwriting discounts and commissions and estimated expenses of approximately $536,750 for the underwriter s non-accountable expense allowance, legal, accounting, printing costs and various fees associated with the registration and listing of our shares. If the underwriter exercises its right to purchase additional shares of common stock to cover over-allotments, we would receive up to an additional $564,975 after deducting $42,525 for underwriting discounts, commissions and non-accountable expenses. The proceeds from the sale of the shares sold to cover over-allotments will be used for working capital. Assuming no exercise of the underwriter s over-allotment option, we intend to use the net proceeds of the offering as follows:

| | Applied Net Proceeds | Applied Percentage |
|---|---|---|
| Payment against the cash portion of fees in respect of world-wide licensing rights to advanced wound care technology | $1,850,000 | 57 % |
| Retirement of term loan (*) | 1,400,000 | 43 % |
| Total proceeds applied | $3,250,000 | 100 % |

(*) The term loan to be retired is in the amount of $3.4 million, bears interest at a variable rate (6.03% as of September 30, 2009), matures in November, 2012 and is collateralized, in part, by $2.0 million in a restricted cash account. Retirement of the loan will be effected by the combination of $1.4 million of the offering proceeds and $2.0 million from the restricted cash account.

# DETERMINATION OF OFFERING PRICE

The public offering price of the securities offered by this prospectus will be determined by negotiation between us and the underwriter based upon market conditions on the day we price the securities. The offering price may not reflect the price at which the common stock currently trades. That price is subject to change as a result of market conditions and other factors and we cannot assure you that the shares constituting the common stock component of the securities can be resold at or above the public offering price.

# DIVIDEND POLICY

We do not expect to declare or pay any cash dividends on our common stock in the foreseeable future and we currently intend to retain future earnings, if any, to finance the expansion of our business. The decision whether to pay cash dividends on our common stock will be made by our board of directors, in their discretion, and will depend on our financial condition, operating results, capital requirements and other factors that the board of directors considers significant.

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# CAPITALIZATION

The table set forth below depicts our capitalization as of September 30, 2009, on an actual and pro forma basis, as follows:

On an actual basis; and

On a pro forma basis as adjusted to reflect the receipt of net proceeds of $3,250,000 from the sale of 810,000 shares of our common stock and warrants to purchase 270,000 shares of our common stock offered hereby less underwriting discounts and estimated offering expenses and the repayment of $3,400,000 of long term debt.

| | Actual | Pro Forma |
|---|---|---|
| Long-term debt, excluding capital lease obligations | $4,300,000 | $900,000 |
| Common stock, $0.01 par value; authorized: 18,750,000; outstanding: 5,039,468 | 50,395 | 58,495 |
| Convertible preferred stock, $0.01 par value; authorized: 1,468,750; outstanding: 285,051 | 2,851 | 2,851 |
| Additional paid-in capital | 41,082,067 | 44,323,967 |
| Accumulated other comprehensive income | 1,214,615 | 1,214,615 |
| Accumulated deficit | (20,842,801) | (20,842,801) |
| Total capitalization | $25,807,127 | $25,657,127 |

# MARKET FOR COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

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

| Quarter Ended | High | Low |
|---|---|---|
| March 31, 2009 | $ 5.60 | $ 2.80 |
| June 30, 2009 | $ 4.40 | $ 1.92 |
| September 30, 2009 | $ 6.80 | $ 2.64 |
| December 31, 2009 | $ 6.16 | $ 4.32 |
| March 31, 2008 | $ 10.80 | $ 5.92 |
| June 30, 2008 | $ 8.40 | $ 6.40 |
| September 30, 2008 | $ 7.60 | $ 2.16 |
| December 31, 2008 | $ 5.60 | $ 1.60 |
| March 31, 2007 | $ 6.96 | $ 5.28 |
| June 30, 2007 | $ 8.80 | $ 4.72 |
| September 30, 2007 | $ 7.76 | $ 4.80 |
| December 31, 2007 | $ 11.20 | $ 4.64 |

On February 12, 2010 our common stock closed at $5.80. 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 our preferred stock. As of the close of business on February 12, 2010 there were 1,173 holders of record of the

common stock.

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# DILUTION

As of September 30, 2009, we had a net tangible book value of $10,064,651 or $1.89 per share. Net tangible book value represents our total tangible assets, less all liabilities, divided by the number of shares of common and preferred stock issued and outstanding.

Without taking into account any changes in such net tangible book value after September 30, 2009, other than to give effect to the securities offered hereby (excluding the securities covered by the underwriter s over allotment option), the pro forma net tangible book value per share at September 30, 2009 was $2.17. This amount represents an immediate increase in net tangible book value of $0.28 per share to our current shareholders and an immediate decrease in net tangible book value of $2.83 per share to new investors purchasing shares in this offering.

The table set forth below shows the calculation of the increase in book value to current shareholders and the decrease in book value to investors in this offering.

| | | |
|---|---|---|
| Post-offering net tangible book value per share | $ 2.17 | (1) |
| Pre-offering net tangible book value per share | 1.89 | (2) |
| Pro forma increase in book value per share attributable to new investors | $ 0.28 | |
| Offering price per share | $ 5.00 | |
| Post-offering net tangible book value per share | 2.17 | (1) |
| Pro forma decrease in book value per share experienced by new investors | $ 2.83 | |

(1) Determined by adding to our pre-offering net tangible assets of $10,064,651 the amount of $3,250,000 representing the estimated net proceeds of the offering (based upon an estimated public offering price of $5.00 per share and warrant) and dividing the sum of these amounts by the post-offering outstanding common and preferred stock totaling 6,134,519 shares.

(2) Determined by dividing our pre-offering net tangible assets of $10,064,651 by our pre-offering outstanding common and preferred stock totaling 5,324,519 shares.

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# MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## Nine Months Ended September 30, 2009 Compared to Nine Months Ended September 30, 2008

### Overview

The following table highlights the nine months ended September 30, 2009 versus 2008 operating results:

| | Nine Months Ended September 30, | | Variance | |
|---|---|---|---|---|
| | 2009 | 2008 | | |
| Gross Sales | $41,668,350 | $45,524,044 | $(3,855,694) | (8.5%) |
| Sales adjustments | (6,790,692 ) | (7,882,682 ) | (1,091,990) | (13.9%) |
| Net sales | 34,877,658 | 37,641,362 | (2,763,704) | (7.3%) |
| Cost of sales | 24,051,984 | 27,141,628 | (3,089,644) | (11.4%) |
| Gross profit | 10,825,674 | 10,499,734 | 325,940 | 3.1 % |
| Selling, general and administrative expense | 11,244,347 | 12,919,124 | (1,674,777) | (13.0%) |
| Research and development expense | 288,338 | 239,199 | 49,139 | 20.5 % |
| Interest expense | 631,909 | 748,743 | (116,834 ) | (15.6%) |
| Other income, net | (112,791 ) | (21,897 ) | (90,894 ) | |
| Total expenses | 12,051,803 | 13,885,169 | (1,833,366) | (13.2%) |
| Loss before income taxes | (1,226,129 ) | (3,385,435 ) | 2,159,306 | 63.8 % |
| Provision for income taxes | (47,151 ) | (3,540 ) | (43,611 ) | |
| Net loss | $(1,178,978 ) | $(3,381,895 ) | $2,202,917 | 65.1 % |

**Gross to Net Sales Adjustments**

Gross to net sales adjustments comprise the following:

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2009 | 2008 |
| Gross Sales | $41,668,350 | $45,524,044 |
| Trade rebates | (4,934,121 ) | (5,831,141 ) |
| Distributor fees | (711,980 ) | (887,655 ) |
| Sales incentives | (453,411 ) | (359,581 ) |
| Returns and allowances | (384,403 ) | (452,702 ) |
| Cash discounts | (306,777 ) | (351,603 ) |
| Total adjustments | 6,790,692 | 7,882,682 |

| | | |
|---|---|---|
| Net sales | $34,877,658 | $37,641,362 |

Trade rebates decreased in 2009 versus 2008 due principally to lower Canadian sales subject to rebate which, in turn, resulted from lower demand as a result of the exclusive Canadian distributor reducing its inventory, unfavorable exchange, and a slight increase in sales not subject to rebate. U.S. rebates increased due to an increase in regular and private label sales subject to rebate, coupled with an increase in the percentage of rebates to sales due to list price increases (without a commensurate increase in contract pricing). The decrease in distribution fee expense is commensurate with the change in Canadian net sales upon which it is based. The increase in sales incentive expense relates principally to an expansion of the FAD sales incentive program together with an increase in the level of sales subject to incentives. The sales returns and allowances decrease is principally due to the non-recurrence of higher FAD integration related returns and allowances in 2008. The decrease in cash discounts reflects lower U.S. sales subject to cash discount.

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### Rebate Reserve Roll Forward

A nine month roll forward of the trade rebate accruals at September 30, 2009 and 2008 is outlined below:

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2009 | 2008 |
| Beginning balance January 1 | $2,660,086 | $2,407,709 |
| Rebates paid | (5,223,401) | (5,364,269) |
| Rebates accrued | 4,934,121 | 5,831,141 |
| Ending balance September 30 | $2,370,806 | $2,874,581 |

The $289,280 decrease in the trade rebate reserve balance for the nine months ended September 30, 2009 reflects the timing of payment of U.S. private label rebates coupled with a reduction in the Canadian reserve due to lower sales to the exclusive Canadian distributor in response to the distributors plan to reduce its investment in inventory. There has been no other discernable change in the nature of our business year-to-date as it relates to the accrual and subsequent payment of rebates.

### Net Sales and Gross Margin

The following table highlights the September 30, 2009 versus 2008 product line net sales and gross profit:

| | Nine Months Ended September 30, | | Variance | |
|---|---|---|---|---|
| | 2009 | 2008 | | |
| Net Sales | $34,877,658 | $37,641,362 | $(2,763,704) | (7.3%) |
| Cost of sales | 24,051,984 | 27,141,628 | (3,089,644) | (11.4%) |
| Gross Profit | $10,825,674 | $10,499,734 | $325,940 | 3.1 % |
| Gross Profit % | 31.0 % | 27.9 % | | |

Consolidated net sales decreased $2,763,704, or 7.3% (4.1% adjusted for exchange), in 2009 versus 2008. Canadian net sales decreased $1,730,747, or 18.1%, to $7,843,218 in 2009 from $9,573,965 in 2008. This decrease was driven by unfavorable exchange of $1,231,370 associated with a 14.8% weakening of the Canadian dollar and lower sales of $499,377. Inventory rationalization on the part of our Company s exclusive Canadian distributor is principally responsible for the lower sales. Real growth as measured by sales of our Company s products reported by our exclusive distributor, unadjusted for foreign exchange, approximated 7.1%. U.S. net sales decreased $1,032,957, or 3.7%, to $27,034,440 in 2009 from $28,067,397 in 2008. The decrease was driven by lower FAD sales of $3,527,817, or 27.4%, and traditional wound care sales of $358,331, or 7.2%, partially offset by higher advanced wound care sales of $1,965,451, or 60.5%, and private label sales of $961,105, or 19.3%. Specialty fixation, burn care and skin care and bathing sales were down $73,365, or 3.8%, period to period. The lower FAD sales reflect the non-recurrence of higher sales in 2008 due to integration related backorder fulfillment, lower demand and customers rationalizing their inventory in 2009 in response to the economy and lost business. The lower traditional wound care sales reflect the non-recurrence of a spot sale (customer s normal supplier was unable to supply) realized in 2008 and lower demand. The higher advanced wound care sales reflect continued growth of *Medihoney* together with the balance of the product line in response to our focused sales and marketing effort. Gross U.S. *Medihoney* sales increased $928,433, or 95.9%, to $1,896,503 in 2009 versus $968,070 in 2008. *Bioguard*, our new novel anti-microbial advanced wound care product launched in June, recorded gross sales of $397,871 in its first four months. *Algicell*, *Xtrasorb* and MedEfficiency have also exhibited strong growth in 2009. The increase in private label sales reflects improved demand from a number of

our core customers, coupled with some modest new business that is expected to contribute to the private label segments future growth. Excluding FAD, U.S. sales increased $2,494,860, or 16.4%.

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Consolidated gross profit increased $325,940, or 3.1%, in 2009 versus 2008. The consolidated gross profit margin percentage increased to 31.0% in 2009 from 27.9% in 2008. Canadian gross profit decreased $766,008, or 26.7%, to $2,104,664 in 2009 from $2,870,672 in 2008. The Canadian gross profit margin percentage decreased to 26.8% in 2009 from 30.0% in 2008. The decrease in Canadian 2009 gross profit dollars reflects the lower sales and gross profit margin percentage decrease. The change in Canadian gross profit margin percentage principally reflects the adverse effect of price erosion coupled with higher product costs, partially offset by the favorable impact of higher production volumes on labor efficiency and overhead absorption and lower overhead spending in 2009 versus 2008. U.S. gross profit increased $1,091,947, or 14.3%, to $8,721,010 in 2009 from $7,629,063 in 2008. The U.S. gross profit margin percentage increased to 32.3% in 2009 from 27.2% in 2008. The increase in U.S. gross profit dollars reflects the increase in gross profit margin percentage, partially offset by the lower sales. The increase in gross profit margin percentage is principally attributable to the improvement in FAD margin due to the discontinuation of higher cost domestic manufacturing in the fourth quarter 2008, growth of the higher margined advanced wound care business and lower freight costs, partially offset by higher product costs. Excluding FAD, favorable product mix partially offset by higher product costs served to increase U.S. margin dollars $1,150,340, or 22.5%, and the gross profit percentage to 35.4% from 33.6%.

## *Selling, General and Administrative Expenses*

The following table highlights September 30, 2009 versus 2008 selling, general and administrative expenses by type:

| | Nine Months Ended September 30, | | Variance | |
|---|---|---|---|---|
| | 2009 | 2008 | | |
| Distribution | $1,331,067 | $1,450,481 | $(119,414) | (8.2%) |
| Marketing | 1,201,411 | 1,414,977 | (213,566) | (15.1%) |
| Sales | 3,743,003 | 4,284,762 | (541,759) | (12.6%) |
| General and administrative | 4,968,866 | 5,768,904 | (800,038) | (13.9%) |
| Total | $11,244,347 | $12,919,124 | $(1,674,777) | (13.0%) |

Selling, general and administrative expenses decreased $1,674,777, or 13.0%, in 2009 versus 2008, including a decrease of $285,941 in Canadian selling, general and administrative expenses attributable to exchange.

Distribution expense decreased $119,414, or 8.2%, in 2009 versus 2008. Expenses in Canada decreased $102,164 (including a $34,806 benefit related to exchange) while expenses in the U.S decreased $17,250. The decrease in Canada was driven by the non-recurrence of incremental expense related to the buy out of the former distribution center lease in the second quarter 2008. The U.S. decrease was driven by the non-recurrence of incremental FAD related integration expenses in Houston incurred in 2008, partially offset by higher lease costs in Houston and St. Louis together with higher personnel and operating costs in St. Louis in support of the growing non-FAD business.

Marketing expense decreased $213,566, or 15.1%, in 2009 versus 2008. The decrease is attributable to a U.S. decrease of $196,177 coupled with a decrease in Canada of $17,389 (including a $12,012 benefit related to exchange). The U.S. decrease stems from a planned reduction in advanced wound care clinical personnel, consulting, travel and trade show and promotion expense, partially offset by higher product development expense in 2009 in order to align costs with available financial resources, coupled with an increase in FAD related marketing reflecting implementation of a full marketing plan in 2009 versus a partial transition related plan in 2008. The Canada expense decrease reflects lower advanced wound care promotion expense, partially offset by higher product sampling expenses.

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Sales expense decreased $541,759, or 12.6%, in 2009 versus 2008. Expenses in Canada decreased $118,493 (including a $79,314 benefit related to exchange) while expenses in the U.S. decreased $423,269. Expenses in Canada decreased principally due to lower sales commission due to a change in the sales commission program in 2009, direct representative commission due to lower sales and lower travel costs due to cost reduction initiatives, partially offset by higher increased rate related group purchasing organization fees. The U.S. decrease was attributable to lower compensation and commission expenses associated with open (timing related) sales representative positions and the non-recurrence of incremental integration related compensation expenses in customer service, lower FAD broker commissions due to lower sales, lower travel expenses due to cost reduction initiatives, lower recruiting expenses together with the non-recurrence in 2009 of FAD integration related expenses. Offsetting these decreases were higher equity based compensation, regional show and sales tracing expenses associated with the implementation of a more structured sales tracing program in 2008.

General and administrative expense decreased $800,038, or 13.9%, in 2009 versus 2008. Expenses in Canada decreased $165,765 (including a $159,809 benefit related to exchange) while expenses in the U.S. decreased $634,273. Adjusted for exchange, the $5,956 decrease in Canada reflects lower compensation due a change in staffing, travel, recruiting and operating expenses, partially offset by higher equity based compensation, benefits, insurance and accounting expenses. The U.S. decrease principally reflects lower bad debt expense of $247,400 due to the non-recurrence of a significant provision for bad debts in the third quarter of 2008, lower travel of $156,200, investor relations of $134,200 and compensation of $27,400 expenses due to cost reduction initiatives, non-recurring and lower legal expenses of $95,600 and non-recurring recruiting expense of $45,700, together with lower other professional service fees of $27,700 due principally to timing and other net operating costs of $65,300 due to non-recurrence and cost savings initiatives, partially offset by incremental intangible asset amortization expense of $165,300 related to the FAD acquisition.

### Research and Development Expense

Research and development expense increased $49,139 to $288,338 in 2009 from $239,199 in 2008. The increase reflects higher ongoing patent related legal and development costs associated with the DSC127 Phase II clinical trial initiated in the first quarter 2008, partially offset by lower consulting expenses.

### Interest Expense

Interest expense decreased $116,834 to $631,909 in 2009 from $748,743 in 2008. The decrease is principally attributable to lower interest rates coupled with lower line of credit and term loan borrowing levels, partially offset by higher loan related fees and lower interest income in 2009 versus 2008.

### Other Income

Other income increased $90,894 to $112,791 in 2009 from $21,897 in 2008. The main drivers for the increase were $66,500 of gains on miscellaneous asset sales associated with the closure of the FAD manufacturing operation together with lower exchange losses, partially offset by lower royalty income and other miscellaneous income in 2009 versus 2008.

### Income Taxes

We recorded a $47,151 tax benefit for 2009 consisting of a $25,788 current foreign tax benefit and a $21,363 deferred foreign tax benefit based on our Canadian subsidiary s operating results. No tax benefit was recorded for our U.S. operations in 2009 due to uncertainty surrounding our ability to use available net operating loss carry forwards and net

deferred tax assets. We recorded a $3,540 deferred foreign tax benefit in 2008 related to our Canadian subsidiary s operating results.

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

**Net Loss**

We generated a net loss of $1,178,978, or $0.23 per share (basic and diluted), in 2009 compared to a net loss of $3,381,895, or $0.71 per share (basic and diluted), in 2008.

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Liquidity and Capital Resources

## Cash Flow and Working Capital

Quarterly financial performance has improved steadily in 2009 culminating with net income of $139,603 in the third quarter after losses in the first and second quarters. We reported a $1,178,978 net loss for the first nine months of 2009 versus a $3,381,895 net loss in the first nine months of 2008. While sales are lower in 2009, gross profit dollars and margin percentage increased due to a favorable sales mix (principally reflecting the growth of the higher margined advanced wound care business), the elimination of higher cost FAD domestic manufacturing in the fourth quarter 2008 and improved manufacturing performance in Canada, partially offset by higher product costs. Operating expenses were reduced as planned, to better align costs with revenues.

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

Improving financial performance and other steps taken to improve cash management have served to improve our liquidity. Operating cash flow has improved in the first nine months of 2009 versus the full year 2008. This is attributable to a significant reduction in net operating assets and liabilities employed, together with a lower net loss. In 2008, we increased our investment in inventory approximately $3,600,000. In 2009 this trend was reversed. Through September 2009 inventories have been reduced approximately $1,630,000. Operating cash flow is expected to continue to improve over the next twelve months given the expected improvement in financial performance and continuation of our inventory reduction initiative.

At September 30, 2009 and December 31, 2008, we had cash and cash equivalents on hand of $399,998 and $391,038, respectively. The $8,960 increase in cash reflects net cash provided by operating activities of $1,605,607 and cash provided as a result of exchange rate changes of $138,362. These increases were essentially offset by cash used in financing activities of $1,610,787 and cash used in investing activities of $124,222.

Net cash provided by operating activities of $1,605,607 stems from $1,998,363 cash provided from operations (net loss plus non-cash items), together with $392,756 cash used from the net change in operating assets and liabilities. The increase in cash provided from operations reflects the non-cash items, partially offset by the operating loss. Lower accounts payable, accrued liabilities and higher accounts receivable, partially offset by lower inventory were the main drivers behind the net change in operating assets and liabilities. The decrease in accounts payable reflects a significant reduction in payables related to inventory purchases (consistent with the plan to reduce inventory), lower overall spending levels and timing. The decrease in accrued expenses and other current liabilities principally reflects payment of 2008 year end accruals and timing related changes. The increase in accounts receivable reflects higher third quarter sales. The reduced investment in inventory reflects our plan to reduce inventory levels whenever possible, without compromising customer service requirements.

Net cash used in investing activities of $124,222 reflects capital expenditures of $185,222, less receipt of $61,000 cash from the sale of assets associated with the discontinuation of FAD domestic manufacturing. Capital expenditures are down in 2009 versus 2008 and no significant non discretionary expenditures are anticipated over the next twelve months.

Net cash used in financing activities of $1,610,787 reflects regularly scheduled debt payments of $975,339, pay down of outstanding line of credit borrowings of $611,016, an increase in restricted cash of $15,142 and costs related to the issuance of stock of $9,290.

Working capital decreased $74,507, or 1.1%, at September 30, 2009 to $6,665,144 from $6,739,651 at December 31, 2008. Excluding the reclassification of the $500,000 promissory note from long term to current debt in the second quarter 2009, working capital increased $425,493 in the first nine months of 2009 and increased by $702,812 in the third quarter. Working capital of this magnitude is considered sufficient to support ongoing operations.

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## Financing Arrangements

On March 31, 2009, our U.S. lender agreed to amend the credit and security agreement to allow us to enter into a forbearance agreement with Western Medical to postpone payment of our $500,000 promissory note due April 2009, for one year until April 2010 and to allow subsequent payments on the subordinate debt beginning in April 2010. The Western Medical note payments are conditioned on our achieving predetermined liquidity and free cash flow (as defined) objectives and Western Medical s further extending for one year the payment of the principle balance, if any, remaining on the promissory note after giving effect to the April 2010 payment. In return for the amendment, we agreed to change our base rate for interest charged to a three month LIBOR rate from a one month LIBOR rate (an estimated increase of approximately 50 basis points) and increase our base rate margin by 150 basis points effective April 1, 2009. Using market rates as of the date of the amendment, the estimated cost of the change in interest rates is approximately $15,000 per month.

In August 2008, we and our U.S. lender modified the terms of our five-year revolving credit and security agreement. The modified terms amend the existing minimum EBITDA, fixed charge coverage, senior debt coverage and total debt coverage covenants. Amendment of the covenants was predicated on our depositing $2,000,000 in a blocked account controlled by the U.S. lender. Our maximum revolver borrowing capacity remained unchanged at the lesser of (a) the revolver loan commitment ($8,000,000) or (b) the borrowing base (as defined), less $1,500,000.

With cash on hand of $399,998, together with available revolver capacity of $1,725,641, we have $2,125,639 of available liquidity at September 30, 2009, versus $662,806 at June 30, 2009.

## Prospective Assessment

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

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

In recognition of our financial condition in the fourth quarter of 2008, we initiated the following actions:

1. While not compromising the overall integrity of the advanced wound care growth strategy, prospective plans in terms of sales and marketing resources were scaled back to more affordable levels resulting in an immediate reduction of expense. We have implemented a process to better measure the ongoing return on sales and marketing resources deployed. Assuming the existing resources in place are generating the expected return, we will prospectively expand our investment in sales and marketing resources in support of our advanced wound care growth strategy, as financial conditions allow. We presently have ten direct sales representatives in place and have hired several independent representatives on a commission only

basis to cover open territories.

2. The FAD business represents a growth opportunity. In addition to its core business opportunities, the FAD business will serve as a platform for introducing our existing advanced and traditional wound care products to new customers and markets, especially the retail market. The FAD is presently working on a number of opportunities for sales growth. We began to realize the savings associated with discontinuing the FAD s higher cost U.S. production in the fourth quarter 2008. In addition, the

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

3. Steps were taken to identify and eliminate all non-essential operating costs. No salary increases or bonuses are planned until our performance and liquidity improves.

4. We made a significant investment in DSC 127 beginning in December 2007. While the launch of DSC 127 is several years away, we believe the market potential for this product is considerable. The product began Phase II trials in early 2008 to achieve proof of principle in a human model. The Phase II trials are expected to be completed by the fourth quarter of 2010. The projected cost to complete the Phase II trials is approximately $1,800,000, including $1,072,010 incurred through September 2009. We plan to continue with this investment and anticipate spending approximately $727,990 to complete the Phase II trial over the next fifteen months.

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

With the planned improvement in operations and modest expected working capital requirements, together with the available cash on hand and available borrowing capacity as of September 30, 2009, we anticipate having sufficient liquidity in place to meet our operating needs and debt covenants for the foreseeable future.

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

Additional Financial Information

## Forward Looking Statements

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

## Critical Accounting Policies

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

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### Revenue Recognition and Adjustments to Revenue

We sell our products through our own direct sales force and through independent distributors and manufacturers representatives. The primary end users of our products are nursing homes, hospitals, clinics and home healthcare agencies. We recognize revenue from the sale of our products when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed and determinable, and collectability is reasonably assured, which is generally at the time of shipment or receipt by our customers, depending on the terms of the related sales or distribution agreement. When we recognize revenue from the sale of our products, we simultaneously adjust revenue for estimated trade rebates and distribution fees (in Canada), and estimates of returns and allowances, cash discounts and other sales incentives.

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

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

We provide our customers certain limited return rights and we have a formal returned goods policy that guides the disposition of returns with our customers. We follow the accounting guidance outlined in paragraph 605-15-25 of the FASB Accounting Standards Codification as it relates to the recognition of revenue at the time of sale when the right of return exists. We accrue for sales returns and allowances and cash discounts monthly based on current sales and historical activity. We do not offer our customers price protection rights or concessions. Returns were approximately 1% of gross sales in both 2009 and 2008.

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

### Goodwill

At September 30, 2009, we had $7,119,726 of goodwill consisting of $4,679,684 relating to the FAD acquisition in November 2007 and $2,440,042 relating to the Western Medical acquisition in April 2006. We assess the impairment of goodwill annually in the fourth quarter or whenever events or changes in circumstances indicate that the carrying value of goodwill may not be recoverable. The assessment is performed using the two-step process required by FASB accounting guidance relating to goodwill. The first step is a review for potential impairment, while the second step measures the amount of the impairment, if any. The first step of the goodwill impairment test compares the fair value of a reporting unit with its carrying amount, including goodwill. For 2008 and 2007, the first step of our goodwill impairment test reflected a fair value in excess of the carrying value of our reporting units. Accordingly, we did not perform the second step of this test during these periods.

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

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For 2008 and 2007 and consistent with prior periods, we estimated the fair value of our wound care segment, using the income approach, where we use a discounted cash flow model ( DCF ) in preparing our goodwill impairment assessment. This approach calculates fair value by estimating the after-tax cash flows attributable to a reporting unit and then discounting these after-tax cash flows to a present value using a risk-adjusted discount rate. We selected this method as being the most meaningful in preparing our goodwill assessments because we believe the income approach most appropriately measures our income producing assets.

Significant estimates used in the fair value calculation include: (i) estimates of future revenue and expense growth, (ii) future estimated effective tax rates, (iii) future estimated capital expenditures, (iv) future required investments in working capital, (v) average cost of capital, and (vi) the terminal value of the reporting unit.

The amount and timing of future cash flows within our DCF analysis is based on our five year forecast. Beyond our five year forecast we assumed a terminal value to calculate the value of cash flows beyond the last projected period in our DCF analysis. Annual revenue growth rates in our DCF model reflect expected growth in our advanced wound care products as well as growth in the products which we gained access to when we acquired FAD in November of 2007 as we introduce these products across our existing customer base. The weighted average cost of capital used to discount cash flows for the annual 2008 goodwill impairment test was estimated to be 17%.

Over time, our wound care segment has become an increasingly significant portion of our overall business. For the year ended December 31, 2008, our wound care segment accounted for approximately 95% of our consolidated revenue which is consistent with the results we are experiencing in 2009. Given the significance of this segment to our overall results, we also look to our publicly traded market value, which we may adjust in consideration of an appropriate control premium, as an indicator of the fair value of our wound care segment and the reasonableness of our DCF model.

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

### Inventory

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

### Stock-Based Compensation

We record compensation expense associated with stock options and other equity-based compensation in accordance with the provisions of ASC Topic 718, Stock Compensation (formerly SFAS 123R) which requires that share-based payment transactions with employees, such as grants of stock options and restricted stock, be recognized in the financial statements based on their fair value at the grant date and recognized as compensation expense over their vesting periods. We estimate the fair value of stock options as of the date of grant using the Black-Scholes or binomial/lattice pricing model (as applicable) and restricted stock based on the quoted market price. ASC Topic 718 requires significant judgment and the use of estimates to value equity-based compensation, particularly surrounding Black-Scholes or binomial/lattice pricing model assumptions such as stock price volatility and expected option lives, as well as expected option forfeiture rates.

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# Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Results of Operations

### Consolidated Operating Results

The following table highlights the year ended December 31, 2008 versus 2007 operating results:

| | Year Ended December 31, | | Variance | |
|---|---|---|---|---|
| | 2008 | 2007 | | |
| Gross Sales | $60,431,835 | $42,712,304 | $17,719,531 | 41.5 % |
| Sales adjustments | (10,232,407) | (8,576,903 ) | (1,655,504 ) | 19.3 % |
| Net sales | 50,199,428 | 34,135,401 | 16,064,027 | 47.1 % |
| Cost of sales | 35,289,684 | 22,530,986 | 12,758,698 | 56.6 % |
| Gross profit | 14,909,744 | 11,604,415 | 3,305,329 | 28.5 % |
| Selling, general and administrative expense | 17,196,863 | 11,885,368 | 5,311,495 | 44.7 % |
| Research and development expense | 653,326 | 993,069 | (339,743 ) | (34.2%) |
| Interest expense | 940,148 | 413,992 | 526,156 | 127.1 % |
| Loss on debt extinguishment | | 256,628 | (256,628 ) | |
| Other expense, net | 22,529 | 77,929 | (55,400 ) | (71.1%) |
| Total expenses | 18,812,866 | 13,626,986 | 5,185,880 | 38.1 % |
| (Loss) income before income taxes | (3,903,122 ) | (2,022,571 ) | (1,880,551 ) | 93.0 % |
| Provision for income taxes | 58,815 | 262,034 | 203,219 | (77.6%) |
| Net loss | $(3,961,937 ) | $(2,284,605 ) | $(1,677,332 ) | 73.4 % |

### Gross to Net Sales Adjustments

Gross sales are adjusted for trade rebates, distributor fees (in Canada), sales incentives, returns and allowances and cash discounts to derive net sales. Trade rebates are trued-up monthly based upon an analysis of historical sales subject to rebate and actual rebates received from distributors. The normal rebate cycle is one month. Non-exclusive distributors generally carry one month s inventory. Our exclusive distributor in Canada normally carries three to four months inventory. As distributor inventory is depleted via sales, it is replenished via purchases from us. Rebates are processed and submitted for credit on a timely basis consistent with distributor sales. If the normal rebate cycle were one-half month less than estimated at December 31, 2008, the trade rebate reserve would be overstated by approximately $240,000. If the normal rebate cycle were one month greater than estimated at December 31, 2008, the trade rebate reserve would be understated by approximately $480,000. To minimize their cash outflow invested in rebates, distributors generally strive to optimize the rebate credit submission process.

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

We currently pay our exclusive Canadian distributor a fixed fee of 10% on net sales subject to the fee (as defined) for distribution services in Canada. The distributor fee is accrued each month based on net sales to the distributor times the ratio of estimated percentage of distributor fee expense to net sales based on past history. The percentage of distributor fee expense to net sales is re-evaluated quarterly for reasonableness.

Sales incentives are credits granted to specific customers based upon attainment of pre-determined sales objectives. The agreements are generally for a period of one year.

Returns and allowances and cash discounts are accrued monthly based on recent historical activity.

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Gross to net sales adjustments comprise the following:

| | Year Ended December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Gross Sales | $60,431,835 | $42,712,304 |
| Trade rebates | (7,446,780) | (6,636,302) |
| Distributor fees | (1,135,901) | (1,135,072) |
| Sales incentives | (481,803) | (225,386) |
| Returns and allowances | (694,765) | (300,042) |
| Cash discounts | (473,158) | (280,101) |
| Total adjustments | (10,232,407) | (8,576,903) |
| Net sales | $50,199,428 | $34,135,401 |

Trade rebates increased in 2008 versus 2007 due principally to an increase in the overall Canadian rebate percentage due to renewal of buying group contracts at lower selling prices and continuing growth of rebate intensive U.S. private label sales. The change in distribution fee expense is commensurate with the change in Canadian net sales upon which it is based. The increase in sales incentive expense relates principally to a full year of FAD incentives. The sales returns and allowances increase is due principally to a full year of FAD sales and a higher level of FAD returns and allowances associated with the integration of this business during 2008 coupled with a large private label return, partially offset by lower Canadian returns. Cash discounts increased commensurate with an increase in the U.S. sales subject to discount.

### Rebate Reserve Roll Forward

A twelve month roll forward of the trade rebate accruals at December 31, 2008 and 2007 is outlined below:

| | Year Ended December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Beginning balance January 1 | $2,407,709 | $1,819,558 |
| Rebates paid | (7,194,403) | (6,048,151) |
| Rebates accrued | 7,446,780 | 6,636,302 |
| Ending balance December 31 | $2,660,086 | $2,407,709 |

The $252,377 increase in the trade rebate reserve balance in 2008 reflects continued growth of the rebate intensive U.S. private label business coupled with a timing related delay in the payment of the corresponding rebates together with an increase in the Canadian rebate reserve (in local currency) due to higher sales, an increase in the overall rebate percentage due to renewal of buying group contracts at lower selling prices coupled with an increase in the exclusive distributor s inventory level. These increases were partially offset by an overall reduction in the Canadian reserve due to the weakening of the Canadian dollar in the fourth quarter of 2008. There has been no other discernable change in the nature of our business as it relates to the accrual and subsequent payment of rebates.

### Net Sales and Gross Margin

The following table highlights the December 31, 2008 versus 2007 product line net sales and gross profit:

| | Year Ended December 31, | | Variance |
|---|---|---|---|
| | 2008 | 2007 | |

| | | | | |
|---|---|---|---|---|
| Net Sales | $50,199,428 | $34,135,401 | $16,064,027 | 47.1% |
| Cost of sales | 35,289,684 | 22,530,986 | 12,758,698 | 56.6% |
| Gross Profit | $14,909,744 | $11,604,415 | $3,305,329 | 28.5% |
| Gross Profit % | 29.7 % | 34.0 % | | |

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Consolidated net sales increased $16,064,027, or 47.1%, in 2008 versus 2007. Canadian net sales decreased $232,253, or 1.9%, to $12,091,858 in 2008 from $12,324,111 in 2007. This decrease was driven by lower sales of $228,888 and unfavorable exchange of $3,365. Price erosion and some softness in demand in the fourth quarter, partially offset by a modest distributor inventory build and gross *Medihoney* sales of $152,267 are principally responsible for the sales decrease. U.S. net sales increased $16,296,280, or 74.7%, to $38,107,570 in 2008 from $21,811,290 in 2007. The increase was driven by the addition of incremental FAD sales of $15,654,910 coupled with higher advanced wound care sales of $1,546,584, offset by lower traditional wound care, private label, specialty fixation device and skin care sales. The higher advanced wound care sales reflect continued growth of *Medihoney* together with the balance of the line in response to increased sales and marketing support. Gross U.S. *Medihoney* sales in 2008 were $1,361,624. The decrease in private label sales reflects softening demand from several customers partially offset by strengthened demand from others. Specialty fixation device sales declined due to the discontinuation of a private label agreement in 2007. Excluding FAD sales, U.S. sales increased $641,368, or 3.2%.

Consolidated gross profit increased $3,305,329, or 28.5%, in 2008 versus 2007. The consolidated gross profit margin percentage decreased to 29.7% in 2008 from 34.0% in 2007. Canadian gross profit decreased $104,625, or 2.6%, to $3,947,185 in 2008 from $4,051,810 in 2007. The Canadian gross profit margin percentage decreased to 32.6% in 2008 from 32.9% in 2007. The decrease in Canadian 2008 gross profit dollars reflects the lower gross profit margin percentage. The decline in Canadian gross profit margin percentage principally reflects the adverse impact of lower production volumes on overhead absorption and unfavorable labor efficiency (smaller than normal production runs) together with unfavorable purchase price variances in the fourth quarter associated with higher China product costs. U.S. gross profit increased $3,409,954, or 45.2%, to $10,962,559 in 2008 from $7,552,605 in 2007. The U.S. gross profit margin percentage decreased to 28.8% in 2008 from 34.6% in 2007. The increase in U.S. gross profit dollars reflects higher sales, partially offset by the decline in gross profit margin percentage. The decrease in gross profit margin percentage is principally attributable to the addition of lower margined FAD sales. FAD gross profit margin percentage in 2008 was lower than normal due principally to the need to continue higher cost domestic manufacturing to meet customer demand. Excluding FAD, U.S. gross profit decreased $118,246, or 1.6%, and the gross profit margin percentage would have been 34.0%, versus 35.2% in 2007. The decrease in the U.S. gross profit margin dollars (excluding FAD), reflects the lower gross profit margin percentage. The decrease in the U.S. gross profit margin percentage (excluding FAD) is attributable to the loss of the higher margined specialty fixation private label agreement in 2007, unfavorable product sales mix and higher transportation and product costs.

### Selling, General and Administrative Expenses

The following table highlights December 31, 2008 versus 2007 operating expenses by type:

| | Year Ended December 31, | | Variance | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | | | |
| Distribution | $ 1,893,146 | $ 1,062,766 | $ 830,380 | 78.1 | % |
| Marketing | 1,781,128 | 1,512,338 | 268,790 | 17.8 | % |
| Sales | 5,714,899 | 3,088,052 | 2,626,847 | 85.1 | % |
| General administrative | 7,807,690 | 6,222,212 | 1,585,478 | 25.5 | % |
| Total | $ 17,196,863 | $ 11,885,368 | $ 5,311,495 | 44.7 | % |

Selling, general and administrative expenses increased $5,311,495, or 44.7%, in 2008 versus 2007, including a decrease of $2,542 in Canadian selling, general and administrative expenses attributable to exchange.

Distribution expense increased $830,830, or 78.1%, in 2008 versus 2007. Expenses in Canada decreased $41,127 (including a $1,168 benefit related to exchange) while expenses in the U.S increased $871,507. The decrease in

Canada relates to lower utility and maintenance expense, partially offset by lease settlement costs associated with our former Canadian distribution center. The U.S. increase was driven by the addition of

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incremental FAD expense of $822,852 (including one-time transition related costs that are not expected to recur) coupled with incremental personnel and operating costs in St. Louis in support of the non-FAD business.

Marketing expense increased $268,790, or 17.8%, in 2008 versus 2007. The increase is principally attributable to U.S. increases of $234,779 to $1,649,044 in 2008 from $1,414,264 in 2007. These increases related to $74,856 in clinical personnel, trade show and promotion expense principally in support of our advanced wound care growth initiatives, partially offset by the absence of any bonus payout in 2008 and $159,924 in incremental FAD expenses reflecting a full year of activity and the addition of a graphic artist. Canada expense increased $34,010 (including a $2,032 benefit related to exchange), or 34.7%, reflecting a higher level of advanced wound care marketing effort, principally for *Medihoney*.