DERMA SCIENCES, INC.
Form 10-Q
August 08, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2016

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

For the transition period from ____________ to ____________

Commission file number 1-31070

**Derma Sciences, Inc.**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 23-2328753 |
| (State or other jurisdiction of Incorporation) | (IRS employer identification number) |

214 Carnegie Center, Suite 300

Princeton, NJ 08540

(Address of principal executive offices)

(609) 514-4744

(Issuer's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| | | |
|---|---|---|
| Date: August 5, 2016 | Class: | Common Stock, par value $.01 per share |
| | | Shares Outstanding: 28,305,591 |

PART I – FINANCIAL INFORMATION

**DERMA SCIENCES, INC.**

**FORM 10-Q**

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Part II - Other Information

**Part I – Financial Information**

**Item 1. Financial Statements.**

DERMA SCIENCES, INC. AND SUBSIDIARIES

**Consolidated Balance Sheets (Unaudited)**

| | **June 30, 2016** | December 31, 2015 |
|---|---|---|
| **ASSETS** | | |
| Current Assets | | |
| Cash and cash equivalents | $18,998,616 | $15,814,205 |
| Short-term investments | 25,000,000 | 25,003,990 |
| Accounts receivable, net of allowances of $606,218 and $704,527, respectively | 9,332,223 | 8,145,589 |
| Inventories | 18,286,773 | 20,690,706 |
| Prepaid expenses and other current assets | 1,014,749 | 1,449,407 |
| Total current assets | 72,632,361 | 71,103,897 |
| Long-term equity investment | 15,776,448 | 16,110,178 |
| Equipment and improvements, net of accumulated depreciation and amortization of $8,426,608 and $7,634,541, respectively | 3,951,851 | 4,129,208 |
| Identifiable intangible assets, net of accumulated amortization of $15,064,010 and $13,615,631, respectively | 8,382,866 | 9,831,245 |
| Goodwill | 13,457,693 | 13,457,693 |
| Other assets | 150,348 | 147,934 |
| Total assets | $114,351,567 | $114,780,155 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Accounts payable | $2,285,434 | $2,473,056 |
| Accrued expenses and other current liabilities | 4,951,112 | 6,691,340 |
| Liabilities of discontinued operations | 1,477,511 | 4,371,010 |
| Total current liabilities | 8,714,057 | 13,535,406 |
| Long-term liabilities | 684,441 | 1,014,378 |
| Deferred tax liability | 2,819,509 | 1,804,516 |
| Total liabilities | 12,218,007 | 16,354,300 |

| | | |
|---|---|---|
| Commitments and contingencies (Note 11) | | |
| | | |
| Stockholders' Equity | | |
| Convertible preferred stock, $.01 par value; shares authorized 1,468,750; issued and outstanding 73,332 at June 30, 2016 and December 31, 2015 (liquidation preference of $3,222,368 at June 30, 2016) | 733 | 733 |
| Common stock, $.01 par value; shares authorized 50,000,000; issued and outstanding 25,963,801 at June 30, 2016 and 25,876,870 at December 31, 2015 | 259,638 | 258,769 |
| Additional paid-in capital | 236,303,495 | 234,943,291 |
| Accumulated other comprehensive income | 7,394,757 | 5,272,908 |
| Accumulated deficit | (141,825,063) | (142,049,846) |
| Total stockholders' equity | 102,133,560 | 98,425,855 |
| Total liabilities and stockholders' equity | $114,351,567 | $114,780,155 |

See accompanying notes to consolidated financial statements.

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Operations (Unaudited)**

| | Three Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2016 | | | 2015* | | |
| Net Sales | $ | 22,208,061 | | $ | 22,556,364 | |
| Cost of sales | | 13,948,215 | | | 14,185,116 | |
| Gross Profit | | 8,259,846 | | | 8,371,248 | |
| Operating Expenses | | | | | | |
| Selling, general and administrative | | 10,284,886 | | | 13,701,728 | |
| Research and development | | - | | | 230,942 | |
| Total operating expenses | | 10,284,886 | | | 13,932,670 | |
| Operating loss | | (2,025,040 | ) | | (5,561,422 | ) |
| Other income, net | | (4,535,101 | ) | | (880,514 | ) |
| Income (loss) from continuing operations before income taxes | | 2,510,061 | | | (4,680,908 | ) |
| Income tax provision | | 527,525 | | | 344,857 | |
| Net Income (Loss) from Continuing Operations | | 1,982,536 | | | (5,025,765 | ) |
| Discontinued Operations | | | | | | |
| Loss from discontinued operations, net of taxes | | - | | | (4,259,946 | ) |
| Net Income (Loss) | $ | 1,982,536 | | $ | (9,285,711 | ) |
| Net income (loss) per common share – basic | | | | | | |
| Continuing operations | $ | 0.08 | | $ | (0.19 | ) |
| Discontinued operations | | - | | | (0.17 | ) |
| Total net income (loss) per common share – basic | $ | 0.08 | | $ | (0.36 | ) |

| | | | | | |
|---|---|---|---|---|---|
| Net income (loss) per common share – diluted | | | | | |
| Continuing operations | $ | 0.08 | $ | (0.19 | ) |
| Discontinued operations | | - | | (0.17 | ) |
| Total net income (loss) per common share – diluted | $ | 0.08 | $ | (0.36 | ) |
| Shares used in computing net income (loss) per common share – basic | | 25,915,065 | | 25,759,843 | |
| Shares used in computing net income (loss) per common share – diluted | | 26,058,893 | | 25,759,843 | |

* Reclassified for discontinued operations. See Note 2.

See accompanying notes to consolidated financial statements.

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Operations (Unaudited)**

| | Six Months Ended June 30, | |
|---|---|---|
| | 2016 | 2015* |
| Net Sales | $42,450,618 | $42,055,016 |
| Cost of sales | 26,483,249 | 26,148,642 |
| Gross Profit | 15,967,369 | 15,906,374 |
| Operating Expenses | | |
| Selling, general and administrative | 20,238,000 | 26,960,133 |
| Research and development | - | 583,124 |
| Total operating expenses | 20,238,000 | 27,543,257 |
| Operating loss | (4,270,631 ) | (11,636,883) |
| Other income, net | (4,803,141 ) | (512,726 ) |
| Income (loss) from continuing operations before income taxes | 532,510 | (11,124,157) |
| Income tax provision | 307,727 | 352,908 |
| Net Income (Loss) from Continuing Operations | 224,783 | (11,477,065) |
| Discontinued Operations | | |
| Loss from discontinued operations, net of taxes | - | (8,418,223 ) |
| Net Income (Loss) | $224,783 | $(19,895,288) |
| Net income (loss) per common share – basic | | |
| Continuing operations | $0.01 | $(0.45 ) |
| Discontinued operations | - | (0.33 ) |
| Total net income (loss) per common share - basic | $0.01 | $(0.78 ) |
| Net income (loss) per common share – diluted | | |
| Continuing operations | $0.01 | $(0.45 ) |
| Discontinued operations | - | (0.33 ) |
| Total net income (loss) per common share – diluted | $0.01 | $(0.78 ) |
| Shares used in computing net income (loss) per common share – basic | 25,897,179 | 25,656,875 |
| Shares used in computing net income (loss) per common share – diluted | 26,036,047 | 25,656,875 |

* Reclassified for discontinued operations. See Note 2.

See accompanying notes to consolidated financial statements.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive Income (Loss) (Unaudited)**

| | Three Months Ended June 30, | |
|---|---|---|
| | 2016 | 2015 |
| Net Income (Loss) | $ 1,982,536 | $ (9,285,711 ) |
| Other Comprehensive Income (Loss) | | |
| Foreign currency translation adjustment | 225,219 | (102,652 ) |
| Unrealized gain on equity securities, net of taxes of $1,546,426 and ($2,715), respectively | 2,581,229 | (4,347 ) |
| Less: reclassification of realized gain on equity securities included in net income (loss), net of taxes of $1,782,823 and $0, respectively | (2,975,813 ) | - |
| Total other comprehensive loss | (169,365 ) | (106,999 ) |
| Comprehensive Income (Loss) | $ 1,813,171 | $ (9,392,710 ) |

See accompanying notes to consolidated financial statements.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive Income (Loss) (Unaudited)**

| | Six Months Ended June 30, | |
|---|---|---|
| | 2016 | 2015 |
| Net Income (Loss) | $224,783 | $(19,895,288) |
| Other Comprehensive Income (Loss) | | |
| Foreign currency translation adjustment | 545,784 | (258,463) |
| Unrealized gain on equity securities, net of taxes of $2,727,050 and $2,786, respectively | 4,551,878 | 4,458 |
| Less: reclassification of realized gain on equity securities included in net income (loss), net of taxes of $1,782,823 and $0, respectively | (2,975,813) | - |
| Total other comprehensive income (loss) | 2,121,849 | (254,005) |
| Comprehensive Income (Loss) | $2,346,632 | $(20,149,293) |

See accompanying notes to consolidated financial statements.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows (Unaudited)**

| | Six Months Ended June 30, 2016 | Six Months Ended June 30, 2015 |
|---|---|---|
| Operating Activities | | |
| Net income (loss) | $224,783 | $(19,895,288) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | |
| Depreciation and amortization of equipment and improvements | 527,243 | 527,987 |
| Amortization of identifiable intangible assets | 1,448,379 | 1,492,129 |
| Provision for bad debts | (109,982) | 18,235 |
| Allowance for sales adjustments | 14,041 | 168,184 |
| Provision for inventory obsolescence | 401,121 | (47,474) |
| Deferred rent | (39,623) | (43,506) |
| Stock-based compensation | 1,373,381 | 2,868,808 |
| Deferred income taxes | 78,853 | 270,255 |
| Gain on sale of investment | (4,740,136) | - |
| Loss on disposal of equipment | 18,615 | - |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (1,175,699) | (560,785) |
| Inventories | 2,474,347 | (4,555,063) |
| Prepaid expenses and other assets | 507,121 | 1,685,116 |
| Accounts payable | (912,947) | 1,333,982 |
| Accrued expenses and other liabilities | (4,478,244) | (1,782,281) |
| Net cash used in operating activities | (4,388,747) | (18,519,701) |
| Investing Activities | | |
| Purchase of investments | (35,008,483) | (35,000,230) |
| Proceeds from sale of investments | 42,606,631 | 45,996,000 |
| Purchase of equipment and improvements | (165,093) | (964,061) |
| Net cash provided by investing activities | 7,433,055 | 10,031,709 |
| Financing Activities | | |
| Proceeds from exercise of stock options and warrants, net of costs | 5,700 | 1,991,130 |
| Payment of withholding taxes related to employee stock-based compensation | (18,010) | (67,409) |
| Net cash (used in) provided by financing activities | (12,310) | 1,923,721 |
| Effect of exchange rate changes on cash and cash equivalents | 152,413 | 173,121 |
| Net increase (decrease) in cash and cash equivalents | 3,184,411 | (6,391,150) |
| Cash and cash equivalents | | |
| Beginning of period | 15,814,205 | 19,396,845 |
| End of period | $18,998,616 | $13,005,695 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |

| | | |
|---|---|---|
| Taxes | $430,922 | $- |

See accompanying notes to consolidated financial statements.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

## 1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiaries (the “Company”) is a medical device company focused on two segments of the wound care marketplace: advanced wound care and traditional wound care products. The Company markets its products principally through direct sales representatives in the United States (“U.S.”), Canada and the United Kingdom (“U.K.”), and through independent distributors within other select international markets. The Company’s U.S. distribution facilities are located in St. Louis, Missouri and Houston, Texas. The Company utilizes third party distributors for distribution in Canada, Europe, Latin America, Asia and the Pacific. The Company has manufacturing facilities in Toronto, Canada and Nantong, China. See Note 12 for information on an announced sale and acquisition subsequent to June 30, 2016, which will impact the Company.

**Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. Information included in the consolidated balance sheet as of December 31, 2015 has been derived from the consolidated financial statements and footnotes thereto for the year ended December 31, 2015, included in the Annual Report on Form 10-K previously filed with the Securities and Exchange Commission. For further information refer to the Annual Report on Form 10-K for the year ended December 31, 2015.

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

**Use of Estimates** – The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Although these estimates are based on knowledge of current events and actions which may be undertaken in the future, actual results may ultimately differ from these estimates. 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.

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

**Net Income (Loss) per Share** – Net income (loss) per common share – basic is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Net income (loss) per common share – diluted reflects the potential dilution of earnings by including the effects of the assumed exercise, conversion or issuance of potentially issuable shares of common stock ("potentially dilutive securities"), including those attributable to stock options, warrants, convertible preferred stock and restricted stock units, in the weighted average number of common shares outstanding for a period, if dilutive. The effects of convertible preferred stock are determined using the if converted method. The effects of the assumed exercise of warrants and stock options, and assumed lapse of restrictions on restricted stock awards, are determined using the treasury stock method.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

Total dilutive shares that have been used to compute diluted income (loss) per common share for the three and six months ended June 30, 2016 and 2015 are outlined below:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Weighted average common shares outstanding - basic | 25,915,065 | 25,759,843 | 25,897,179 | 25,656,875 |
| Dilutive shares attributable to: | | | | |
| Convertible preferred stock | 73,332 | - | 73,332 | - |
| Additional stock issuable related to conversion of preferred stock | 49,782 | - | 49,782 | - |
| Restricted share units | - | - | - | - |
| Warrants | - | - | - | - |
| Stock options | 20,714 | - | 15,754 | - |
| Sub-total dilutive shares | 143,828 | - | 138,868 | - |
| Weighted average common shares outstanding - diluted | 26,058,893 | 25,759,843 | 26,036,047 | 25,656,875 |

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Excluded dilutive shares: | | | | |
| Convertible preferred stock | - | 73,332 | - | 73,332 |
| Additional stock issuable related to conversion of preferred stock | - | 49,782 | - | 49,782 |
| Restricted share units | 196,800 | 677,500 | 196,800 | 677,500 |
| Warrants | 50,000 | 1,755,330 | 50,000 | 1,755,330 |
| Stock options | 2,617,607 | 2,540,607 | 2,622,567 | 2,540,607 |
| Total dilutive shares | 2,864,407 | 5,096,551 | 2,869,367 | 5,096,551 |

**Recently Issued Accounting Pronouncements** – In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, *Revenue from Contracts with Customers*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. In August 2015, the FASB issued ASU No. 2015-14 which defers the effective date of ASU No. 2014-09 until fiscal years beginning after December 15, 2017 with early application permitted for fiscal years beginning after December 15, 2016. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting. In March 2016, the FASB issued ASU No. 2016-08, which clarifies the implementation guidance provided in ASU 2014-09 on principal versus agent considerations. In April 2016, the FASB issued ASU 2016-10, which clarifies the implementation guidance in ASU 2014-09 on licensing and identifying performance obligations. Both ASU 2016-08 and ASU 2016-10 must be adopted concurrently with ASU 2014-09. We are currently evaluating the transition methods and the impact the adoption of these standards will have on our consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, *Accounting for Equity Investments and Financial Liabilities*, which changes the income statement impact of equity investments held by an entity, as well as the recognition of changes in fair value of financial liabilities when the fair value option is elected. The standard is effective for annual and interim periods in fiscal years beginning after December 15, 2017 for public business entities. Early adoption is not permitted for the provision related to equity investments. After the Company adopts this ASU for the year beginning January 1, 2018, any change in the fair value of the Company's equity investments will be included in other income, net in the Consolidated Statement of Operations.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*, which revises the accounting related to lessee accounting. Under the new guidance, lessees will be required to recognize a lease liability and a right-of-use asset for all leases. Consistent with current guidance, the recognition, measurement, and presentation of expenses and cash flows arising from a lease primarily will depend on its classification as a finance or operating lease. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within that reporting period. Early adoption is permitted. The new standard is to be applied using a modified retrospective approach. The Company is currently evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU No. 2016-09, *Improvements to Employee Share-Based Payment Accounting*, which simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The standard is effective for annual periods beginning after December 15, 2016 for public business entities. Early adoption is permitted. The Company is currently evaluating the effect that ASU 2016-09 will have on its consolidated financial statements and related disclosures.

**2. Discontinued Operations**

Effective November 12, 2015, the Company approved a plan to terminate its Phase 3 Aclerastide (DSC127) clinical program for diabetic foot ulcer healing. This action was based on futility determinations emanating out of the planned, pre-specified interim analyses of trial data conducted by the program's independent Data Monitoring Committee ("DMC"). The decision to end the studies followed the recommendation by the DMC to stop the trials. Based on this recommendation, the Company initiated an orderly termination of all its existing pharmaceutical development activities, comprised of the diabetic foot ulcer healing program and two other programs utilizing the DSC127 compound for other therapeutic indications. As a result of these actions, the Company's pharmaceutical development activities have been reported as discontinued operations in the Company's Consolidated Financial Statements. Amounts previously reported in the Pharmaceutical Wound Care segment have been reclassified to conform to this presentation to allow for meaningful comparison of continuing operations. There were no noncash charges included in the loss from discontinued operations in the consolidated statement of operations for the three and six months ended June 30, 2015.

At June 30, 2016, the Company had $1,477,511 of unpaid severance, cancellation and closure costs included in liabilities of discontinued operations on the Consolidated Balance Sheet.

**3. Restructuring and Other Charges**

During the fourth quarter of 2015, the Company implemented a plan to reduce its cost structure in consideration of prospective market expectations for the business, coupled with the decision to move the business towards positive cash flow and profitability as soon as feasibly possible. The restructuring plan included the elimination of 39 positions and certain other non-employee discretionary costs. The Company incurred severance charges from continuing operations of $952,534 associated with the elimination of the positions.

Effective December 21, 2015, the Company’s Chairman of the Board, President and Chief Executive Officer (“CEO”) departed from the Company. On February 26, 2016, the former CEO resigned from the Company’s Board of Directors. While a national recruiting search for a permanent CEO is in process, the former lead director of the Company has assumed the role of Executive Chairman and Interim CEO.

The Company incurred compensation and other benefit severance charges of $1,506,021, including $114,573 of stock-based compensation, associated with the former CEO’s departure. The payments are payable over a two year period.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

A summary of the Company's restructuring activity for the six months ended June 30, 2016 is as follows:

| | CEO | Other Employees | Total |
|---|---|---|---|
| Balance, January 1, 2016 | $1,252,105 | $826,932 | $2,079,037 |
| Charges during period | - | - | - |
| Payments during period | (369,596) | (779,059) | (1,148,655) |
| Balance, June 30, 2016 | $882,509 | $47,873 | $930,382 |
| Less current portion | (589,048) | (47,873) | (636,921) |
| Long term portion | $293,461 | $- | $293,461 |

**4. Cash and Cash Equivalents and Investments**

**Cash and Cash Equivalents**

The Company considers cash and cash equivalents as amounts on hand, on deposit in financial institutions and highly liquid investments purchased with an original maturity of three months or less. The Company maintains cash and cash equivalents and money market mutual funds with various domestic and foreign financial institutions within the ordinary course of business, which at times may exceed jurisdictional insurance limits. Money market mutual funds consist of funds deposited into mutual funds investing in U.S. government and non-government obligations.

**Investments in Debt Securities**

Investments in debt securities include certificates of deposit purchased with an original maturity greater than three months which are deposited in various U.S. financial institutions and are fully insured by the Federal Deposit Insurance Corporation. The Company intends to hold the certificates of deposit to maturity and accordingly these investments are carried at amortized cost. Investments in debt securities with maturities greater than one year from the balance sheet date are classified as a long-term asset.

**Investment in Equity Securities**

In 2013 and 2014, the Company purchased an aggregate 2,802,277 shares of Comvita Limited ("Comvita") common stock for $8,483,693. In May of 2016, the Company received net proceeds of $7,594,158 from the sale of 925,000 shares of Comvita stock resulting in a gain of $4,740,136 which is included in other income in the consolidated statement of operations. The Company utilized the specific identification method to determine the cost basis of the shares of Comvita stock that were sold. At June 30, 2016, the remaining 1,877,277 shares of Comvita common stock owned by the Company represented approximately 5.0% of Comvita's outstanding shares.

The investment in Comvita common stock is classified as an available-for-sale investment carried at fair value, with any unrealized gains and losses associated with the investment included in accumulated other comprehensive income and any dividends received recorded in other income, net in the Consolidated Statement of Operations. The investment is classified as a long term asset. As of June 30, 2016, the fair value of the Comvita common stock was $15,776,448 as determined by the quoted market price of the outstanding stock on the New Zealand stock exchange. The cumulative increase in fair value of $10,146,777 has been recorded in accumulated other comprehensive income, net of taxes.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

Cash and cash equivalents and investments at June 30, 2016 and December 31, 2015 consisted of the following:

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Cash | $ 18,998,616 | $ 10,784,522 |
| Cash equivalents | - | 5,029,683 |
| Cash and cash equivalents | 18,998,616 | 15,814,205 |
| Investments in debt securities | 25,000,000 | 25,003,990 |
| Investment in equity securities | 15,776,448 | 16,110,178 |
| Total investments | 40,776,448 | 41,114,168 |
| Total cash and cash equivalents and investments | $ 59,775,064 | $ 56,928,373 |

The following table provides fair value information as of June 30, 2016:

| | | Fair Value Measurements, Using | | |
|---|---|---|---|---|
| | Total carrying value as of June 30, 2016 | Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Cash and cash equivalents | $ 18,998,616 | $ 18,998,616 | $ - | $ - |
| Investments in debt securities | 25,000,000 | 25,000,000 | - | - |
| Investment in equity securities | 15,776,448 | 15,776,448 | - | - |
| Total investments | 40,776,448 | 40,776,448 | - | - |
| Total | $ 59,775,064 | $ 59,775,064 | $ - | $ - |

The following table provides fair value information as of December 31, 2015:

| | Total carrying value as of December 31, 2015 | Fair Value Measurements, Using Quoted prices in active markets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
|---|---|---|---|---|
| Cash and cash equivalents | $ 15,814,205 | $ 15,814,205 | $ - | $ - |
| Investments in debt securities | 25,003,990 | 25,003,990 | - | - |
| Investment in equity securities | 16,110,178 | 16,110,178 | - | - |
| Total investments | 41,114,168 | 41,114,168 | - | - |
| Total | $ 56,928,373 | $ 56,928,373 | $ - | $ - |

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets. Level 2 inputs are quoted prices for similar assets in active markets or inputs that are observable for the asset, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on management's own assumptions used to measure assets at fair value. A financial asset's classification is determined based on the lowest level input that is significant to the fair value measurement.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

## 5. Inventories

Inventories include the following:

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Finished goods | $ 12,887,368 | $ 15,347,592 |
| Work in process | 397,813 | 346,233 |
| Packaging materials | 1,250,579 | 1,152,993 |
| Raw materials | 3,751,013 | 3,843,888 |
| Total inventories | $ 18,286,773 | $ 20,690,706 |

## 6. Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities include the following:

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Accrued compensation and related taxes | $ 1,344,408 | $ 2,390,855 |
| Liabilities related to restructuring (Note 3) | 930,382 | 2,079,037 |
| Accrued sales incentives and other fees | 627,633 | 613,186 |
| Accrued royalties | 461,591 | 444,563 |
| Other | 2,271,539 | 2,178,077 |
| Total accrued expenses and other liabilities | $ 5,635,553 | $ 7,705,718 |
| Less current portion | (4,951,112) | (6,691,340) |
| Long term liabilities | $ 684,441 | $ 1,014,378 |

## 7. Stockholders' Equity

**Preferred Stock**

Subsequent to the issuances of its preferred stock, the Company has undertaken a number of common stock offerings that impact the preferred stock conversion ratios. As of June 30, 2016, current Series A and B preferred stockholders holding 73,332 preferred shares are entitled to receive an aggregate of 123,114 shares (49,782 additional shares) of common stock upon conversion of their holdings, as a result of the conversion ratio adjustments. The number of shares issuable upon conversion is subject to further adjustment should the Company in the future undertake one or more offerings of its common stock at less than the prevailing market price.

Upon conversion, the 49,782 incremental shares associated with the conversion ratio adjustments will be recorded to common stock at par with the offset to additional paid in capital as all of the convertible preferred stock was issued prior to the November 16, 2000 effective date of certain provisions of Accounting Standards Codification 470 (formerly Emerging Issues Task Force Issue No. 00-27 *Application of Issue No. 98-5 to Certain Convertible Instruments).*

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

**Common Stock**

During the six months ended June 30, 2016, the Company issued 86,931 shares of common stock consisting of: 2,057 shares upon the exercise of stock options for which the Company received $5,700 and 84,874 shares of common stock in connection with the vesting of 90,450 restricted share units.

**Stock Purchase Warrants**

At June 30, 2016, the Company had 50,000 warrants outstanding expiring on January 14, 2019 with an exercise price of $11.81 to purchase shares of the Company's common stock.

There were no warrants exercised during the six months ended June 30, 2016. There were 1,705,330 warrants forfeited during the six months ended June 30, 2016.

**Equity Based Compensation**

Under the Derma Sciences, Inc. 2012 Equity Incentive Plan (the "EIP Plan") the Company is authorized to issue 6,000,000 shares of common stock. The EIP Plan authorizes the Company to grant equity-based and cash-based incentive compensation in the form of stock options, stock appreciation rights, restricted shares, restricted share units, other share-based awards and cash-based awards, for the purpose of providing the Company's employees, non-employee directors and consultants with incentives and rewards for performance. At June 30, 2016, options to purchase 2,638,321 shares and 196,800 restricted share units were issued and outstanding under the EIP Plan and 1,945,512 shares were available for grant.

**Stock Options**

The EIP Plan permits the granting of both incentive and nonqualified stock options to employees and nonqualified stock options to non-employee directors and consultants of the Company. The option exercise price may not be less than the fair market value of the stock on the date of the grant of the option. The duration of each option may not exceed 10 years from the date of grant.

For the three and six months ended June 30, 2016 and 2015, the fair value of each option award was estimated at the date of grant using the Black-Scholes option-pricing model. The weighted-average assumptions used were as follows:

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | | 2015 | | 2016 | | 2015 | |
| Risk-free interest rate | 1.10 | % | 1.12 | % | 1.43 | % | 1.61 | % |
| Volatility factor | 40.0 | % | 36.8 | % | 43.9 | % | 45.7 | % |
| Dividend yield | 0 | % | 0 | % | 0 | % | 0 | % |
| Expected option life (years) | 3.47 | | 3.59 | | 5.54 | | 5.69 | |

The risk-free rate utilized represents the U.S. treasury yield curve rate for the expected option life at the time of grant. The volatility factor was calculated based on the Company's historical stock price volatility equal to the expected life of the option at the grant date. The dividend yield is 0% since the Company does not anticipate paying dividends in the near future. The simplified expected option life method is used to determine the expected option life for Company employees and directors while the contractual option life period is utilized for consultants.

Based on the Company's historical experience of options that were forfeited before becoming fully vested, the Company has assumed an annualized forfeiture rate of 1.0% for all options. The Company will record additional expense if the actual forfeiture rate is lower than estimated, and will record a recovery of prior expense if the actual forfeiture rate is higher than estimated.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

A summary of the Company’s stock option activity and related information for the six months ended June 30, 2016 is as follows:

| | Options | Weighted Average Exercise Price |
|---|---|---|
| Outstanding – January 1, 2016 | 2,301,760 | $ 9.04 |
| Granted | 621,390 | $ 3.35 |
| Forfeited | (52,452 ) | $ 7.41 |
| Exercised | (3,675 ) | $ 3.17 |
| Expired | (228,702 ) | $ 9.33 |
| Outstanding – June 30, 2016 | 2,638,321 | $ 7.71 |
| Expected to vest – June 30, 2016 | 2,611,938 | $ 7.71 |
| Exercisable at June 30, 2016 | 1,972,383 | $ 8.44 |

During the six months ended June 30, 2016, the Company granted 501,490 service based options and 119,900 performance based options to Company employees. The weighted average fair value per share of options granted during the six months ended June 30, 2016 was $1.40.

During the six months ended June 30, 2016, 3,675 stock options were exercised on a for-cash and cashless basis. A total of 2,057 shares of common stock were issued in connection with the stock option exercises. The intrinsic value of options exercised in 2016 was $1,560.

During the three and six months ended June 30, 2016 and 2015, stock option compensation expense was recorded as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Cost of sales | $ 26,230 | $ 36,898 | $ 69,949 | $ 109,601 |

| | | | | |
|---|---|---|---|---|
| Selling, general and administrative expenses | 280,589 | 540,568 | 699,281 | 1,324,646 |
| Discontinued operations | - | (2,605) | - | 44,184 |
| Total stock option compensation expense | $ 306,819 | $ 574,861 | $ 769,230 | $ 1,478,431 |

As of June 30, 2016, there was $1,240,494 of unrecognized compensation cost related to nonvested service based awards and $100,543 related to nonvested performance based awards. These costs are expected to be recognized over the options' remaining weighted average vesting period of 2.11 years and 0.50 years for the service and performance based awards, respectively.

**Restricted Share Units**

The Company has issued service, performance and market-based restricted share units to employees, consultants and directors of the Company. Expense for restricted share awards is amortized on a straight-line basis over the awards' vesting period. The fair value of service and performance awards are determined using the quoted market price of the Company's common stock on the date of grant, while market based performance awards are valued using a binomial/lattice pricing mode.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

The following table summarizes the restricted share unit activity for the period:

| | Number of Units | Weighted Average Fair Value |
|---|---|---|
| Unvested – January 1, 2016 | 152,750 | $ 8.59 |
| Granted | 136,800 | $ 3.91 |
| Vested | (90,450 ) | $ 7.50 |
| Cancelled | (2,300 ) | $ 8.83 |
| Unvested – June 30, 2016 | 196,800 | $ 5.83 |

In connection with the vesting of restricted share unit awards during the six months ended June 30, 2016, 5,576 common stock shares with a fair value of $18,010 were withheld in satisfaction of employee tax withholding obligations.

During the three months ended June 30, 2016 and 2015, restricted share unit compensation expense was $271,949 and $666,966, respectively, and for the six months ended June 30, 2016 and 2015 restricted share unit compensation expense was $555,418 and $1,319,707, respectively, and included in selling, general and administrative expense.

As of June 30, 2016, the intrinsic value of the non-vested awards was $775,392 and there was $797,333 of unrecognized compensation cost related to unvested restricted share unit awards. These costs are expected to be recognized over the restricted shares units' remaining weighted average vesting period of 0.78 years.

In May of 2016, in consideration of prior service to the Company, the Company granted two retiring directors 30,000 stock options, and accelerated the vesting of any of their unvested stock options and restricted share units, and extended the expiration date of their vested stock options from 90 days from the date of their separation from the Company to the earlier of (i) 36 months from the separation date or (ii) the awards' original expiration date. An additional $48,733 of stock based compensation expense was recognized during the three months ended June 30, 2016 and included in selling, general and administrative expense in connection with the retirements.

In May of 2015, in consideration of prior service to the Company, the Company granted a retiring director 15,000 stock options, accelerated the vesting of his unvested stock options and restricted share units, and extended the expiration date of his vested stock options from 90 days from his retirement date to the earlier of (i) 36 months from his retirement date or (ii) the awards' original expiration date. An additional $70,670 of stock based compensation expense was recognized during the three months ended June 30, 2015 and included in selling, general and administrative expense in connection with the retirement.

**Shares Reserved for Future Issuance**

At June 30, 2016, the Company had reserved the following shares of common stock for future issuance:

| | |
|---|---|
| Convertible preferred stock (series A – B) | 73,332 |
| Additional stock issuable related to conversion of preferred stock (series A – B) | 49,782 |
| Common stock options outstanding | 2,638,321 |
| Common stock warrants outstanding | 50,000 |
| Restricted share units outstanding | 196,800 |
| Common stock equivalents available for grant | 1,945,512 |
| Total common stock shares reserved | 4,953,747 |

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

**8. Accumulated Other Comprehensive Income**

The Company's accumulated other comprehensive income as of June 30, 2016 was as follows:

| | Foreign Currency Translation Adjustments | Unrealized Gain on Equity Securities, Net of Taxes | Total |
|---|---|---|---|
| Balance at January 1, 2016 | $ 555,938 | $ 4,716,970 | $ 5,272,908 |
| Other comprehensive income before reclassification | 545,784 | 4,551,878 | 5,097,662 |
| Amounts reclassified from accumulated other comprehensive income | - | (2,975,813) | (2,975,813) |
| Balance at June 30, 2016 | $ 1,101,722 | $ 6,293,035 | $ 7,394,757 |

| | Amount reclassified from accumulated other comprehensive income for the three and six months ended June 30, 2016 | Affected line item in the consolidated statements of operations |
|---|---|---|
| Unrealized gain on equity securities, net of taxes | | |
| Realized gain on equity securities | $ (4,758,636) | Other income, net |
| Income tax provision | 1,782,823 | Income tax provision |
| Total reclassification | $ (2,975,813) | |

**9. Operating Segments**

The Company operates in two segments: advanced wound care and traditional wound care products. They are managed separately as each segment requires different technology, marketing and sales strategies. Advanced wound care products principally consist of both novel and otherwise differentiated dressings, devices and skin substitutes designed to promote wound healing and/or prevent infection. Traditional wound care products principally consist of commodity related dressings, ointments, gauze bandages, adhesive bandages, wound closure strips, catheter fasteners and skin care products.

Advanced and traditional wound care products are marketed globally to acute care, extended care, home health care, wound and burn care clinics and physician offices. The Company utilizes a broad network of well-established distributors to deploy the majority of its products to end users. A smaller portion of the Company’s sales are sold directly to care providers and through retail. The advanced and traditional wound care products are both manufactured internally and sourced from third party suppliers. The majority of marketing expenses are deployed in support of advanced wound care products with traditional wound care products requiring limited support. The Company utilizes direct sales representatives, distributor relationships and contractual relationships with buying groups and wound care service providers to sell its products. Direct sales representatives are used solely in support of advanced wound care sales in the U.S. and the U.K. and for both advanced and traditional wound care products in Canada.

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

Each operating segment is managed at the segment contribution level consisting of gross profit minus direct expense consisting of distribution, marketing, sales, research and development and intangible amortization expenses. Expenses are allocated directly by segment to the extent possible. Expenses common to both operating segments are allocated consistently using activity based assumptions. The aggregation or allocation of indirect expenses by segment is not practical.

Operating segment sales, gross profit, segment contribution and other related information for 2016 and 2015 from continuing operations were as follows:

| Three Months Ended June 30, 2016 | Advanced Wound Care | Traditional Wound Care | Other | Total Company |
|---|---|---|---|---|
| Net sales | $10,974,270 | $11,233,791 | $- | $22,208,061 |
| Gross profit | 5,852,464 | 2,407,382 | - | 8,259,846 |
| Direct expense | (6,227,238) | (1,101,690) | - | (7,328,928) |
| Segment contribution | $(374,774) | $1,305,692 | - | 930,918 |
| Indirect income, net | | | $1,051,618 | 1,051,618 |
| Net income from continuing operations | | | | $1,982,536 |

| Three Months Ended June 30, 2015 | | | | |
|---|---|---|---|---|
| Net sales | $10,292,016 | $12,264,348 | $- | $22,556,364 |
| Gross profit | 4,862,036 | 3,509,212 | - | 8,371,248 |
| Direct expense | (8,694,042) | (1,433,222) | - | (10,127,264) |
| Segment contribution | $(3,832,006) | $2,075,990 | - | (1,756,016) |
| Indirect expenses, net | | | $(3,269,749) | (3,269,749) |
| Net loss from continuing operations | | | | $(5,025,765) |

| Six Months Ended June 30, 2016 | Advanced Wound Care | Traditional Wound Care | Other | Total Company |
|---|---|---|---|---|
| Net sales | $21,574,441 | $20,876,177 | $- | $42,450,618 |
| Gross profit | 11,237,610 | 4,729,759 | - | 15,967,369 |
| Direct expense | (12,212,481) | (2,118,554) | - | (14,331,035) |
| Segment contribution | $(974,871) | $2,611,205 | - | 1,636,334 |
| Indirect expenses, net | | | $(1,411,551) | (1,411,551) |
| Net income from continuing operations | | | | $224,783 |

| | | | | |
|---|---|---|---|---|
| Six Months Ended June 30, 2015 | | | | |
| Net sales | $20,063,040 | $21,991,976 | $- | $42,055,016 |
| Gross profit | 9,763,160 | 6,143,214 | - | 15,906,374 |
| Direct expense | (17,129,122) | (2,746,673 ) | - | (19,875,795) |
| Segment contribution | $(7,365,962 ) | $3,396,541 | - | (3,969,421 ) |
| Indirect expenses, net | | | $(7,507,644) | (7,507,644 ) |
| Net loss from continuing operations | | | | $(11,477,065) |

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**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

The following table presents net sales by location of entity:

| Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|
| | 2016 | 2015 | | 2016 | 2015 |
| United States | 83 % | 83 % | United States | 83 % | 83 % |
| Canada | 11 % | 12 % | Canada | 11 % | 11 % |
| Rest of World | 6 % | 5 % | Rest of World | 6 % | 6 % |

For the three months ended June 30, 2016 and 2015, the Company had a major Canadian customer comprising 11% and 12%, respectively, of consolidated net sales. For the six months ended June 30, 2016 and 2015, this same customer comprised 11% and 11%, respectively, of consolidated net sales. At June 30, 2016 and December 31, 2015 the Company was in a net liability position to this customer due to the timing of receivables and related rebate obligations.

**10. Income Taxes**

The following table summarizes the income provision and effective tax rate for continuing operations for the three and six months ended June 30, 2016 and 2015:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Current tax expense | $ 274,020 | $ 77,908 | $ 228,874 | $ 82,653 |
| Deferred tax expense | 253,505 | 266,949 | 78,853 | 270,255 |
| Income tax expense | $ 527,525 | $ 344,857 | $ 307,727 | $ 352,908 |
| Effective tax rate | 21.0 % | (3.9 )% | 57.8 % | (1.8 )% |

For the three and six months ended June 30, 2016, the Company recognized income tax expense consisting of a U.S. and foreign income tax expense. The U.S. income tax expense relates to the tax impact of the unrealized gain on equity securities from accumulated other comprehensive income and tax treatment of goodwill net of amortization for financial reporting but not tax purposes of acquired identified intangible assets. The foreign income tax expense relates to income taxes recognized as a result of income recognized by the Canadian operations and taxes paid on a dividend from the Comvita investment.

For the three and six months ended June 30, 2015 the Company recognized income tax expense consisting of foreign and U.S. income tax expenses. The foreign income tax expense relates to income taxes recognized as a result of the net income incurred by the Canadian operations and taxes paid on a dividend from the Comvita investment. The U.S. income tax expense consists of a deferred tax expense due to differences in financial reporting and tax treatment of goodwill net of amortization for financial reporting but not tax purposes of acquired identified intangible assets.

**11. Commitments and Contingencies**

**Comvita Licensing Agreement**

In February 2010, the Company entered into a new agreement with Comvita (the “Comvita Agreement”) under which the Company received perpetual and exclusive worldwide licensing rights for Manuka Honey based MEDIHONEY wound and skin care products for all markets outside of the consumer market. The Comvita Agreement also provides that Comvita will serve as the Company’s supplier for Manuka Honey and will not provide Manuka Honey to any other entities for use in the professional medical-surgical marketplace. The Comvita Agreement calls for graduated royalty payments based on sales and milestone payments. The license rights may be terminated or rendered non-exclusive by Comvita if the Company fails to meet certain minimum royalty requirements.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

Comvita is a stockholder of the Company. The Company purchased $1,334,892 and $1,436,100 of medical grade honey from Comvita in the six months ended June 30, 2016 and 2015, respectively. In addition, the Company incurred MEDIHONEY royalties of $685,695 and $635,898 in the six months ended June 30, 2016 and 2015, respectively. Amounts due to Comvita for raw material purchases and royalties totaled $615,365 and $506,795 at June 30, 2016 and December 31, 2015, respectively.

**BioDLogics, LLC License Agreement**

On January 14, 2014, the Company entered into a license, market development and commercialization agreement (the "Agreement") with BioDLogics, LLC ("BioD") relating to BioD's human placental based products (the "Licensed Products") and intellectual property related thereto.

Under the Agreement, BioD granted to the Company an exclusive, perpetual, royalty-bearing license to use, offer for sale and sell, the Licensed Products in North America (the "Territory"), including the rights to sublicense solely as provided in the Agreement, for a broad range of dermal applications (the "Field"). During the term of the Agreement, the Company will be responsible for the sale and marketing of the Licensed Products in the Field throughout the Territory. As part of its commercialization efforts, the Company is required to fund clinical studies up to $2,000,000 in support of the Field pursuant to the Agreement.

Royalties are payable to BioD under the agreement based upon a sliding scale of the Company's net sales of Licensed Products within the Territory and declining as net sales increase. Royalty rates range from the low double digits and decline to the mid-single digits. The Company incurred BioD royalties of $166,074 and $127,040 in the six months ended June 30, 2016 and 2015, respectively. The Agreement also requires the Company to make milestone payments to BioD of up to $19,750,000 based upon the achievement of certain development events and annual net sales levels.

The Agreement may be terminated as follows: (i) upon mutual agreement of the parties; (ii) by BioD if the Company challenges certain BioD patents or trade secrets; (iii) by BioD if the Company fails to meet the annual minimum net sales requirement under the Agreement, unless the Company pays the difference between the amount of royalties that would have been due had the minimum annual net sales for such year been achieved and royalty payments made by the Company with respect to net sales during such year plus any milestone payments payable; or (iv) by either party in the event of a material breach or certain events of bankruptcy. The annual minimum net sales requirement commenced in 2015. The Company achieved the minimum net sales requirement for the April 1, 2015 through March 31, 2016 contract year. On July 27, 2016 the Company agreed to acquire BioD, LLC, the parent company of BioDLogics, LLC (Note 12).

**Canadian Distribution Agreement**

In May 2005, the Company entered into a distribution agreement with a Canadian company to serve as the exclusive distributor of its products in Canada. The agreement also appoints the distributor as the Company's Canadian servicing agent to fulfill supply contracts held directly by the Company. The agreement was most recently amended in May 2016, extending it through August 31, 2016, while negotiations for a new agreement proceed.

The Company recognizes revenue under the agreement when title and risk of loss pass to the distributor and collectability is reasonably assured, which is at the time product is shipped to the distributor. Payment terms from the distributor are 30 days. Either party has the right to terminate the agreement when an event of default (as defined) has occurred with respect to the other party. The distributor is entitled to continue to sell or otherwise dispose of all inventory owned by it from and after the date of contract expiration or termination. If termination of the agreement is not occasioned by breach by the distributor, the distributor will be entitled on notice to the Company to return saleable inventory (as defined) to the Company. At June 30, 2016, the distributor's inventory of Company products was approximately $2,284,000. Estimated returns are reserved at the time of sale. Since the inception of the agreement, sales returns have been minimal.

**Contingencies**

On occasion, the Company is involved in claims and other legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations, or liquidity.

**DERMA SCIENCES, INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements (Unaudited)

**12. Subsequent Events**

**Sale of First Aid Division**

On July 26, 2016, the Company agreed to sell its First Aid Division ("FAD") to Dukal Corporation ("Dukal") for approximately $12,200,000. The Company will receive $9,500,000 in cash and a $2,700,000 note payable from Dukal, subject to adjustment based on final inventory figures, with principal and interest payable over 36 months. FAD net sales for the fiscal year ended December 31, 2015 were approximately $16,700,000 and contribution to the traditional wound care segment contribution was approximately $1,700,000. Dukal will assume the FAD inventory, all third party supply agreements, the lease obligation at Derma Sciences' Houston warehouse and related personnel expense. The sale is subject to certain closing conditions and is expected to close in mid-August 2016.

**Acquisition of BioD, LLC**

On August 5, 2016, the Company acquired BioD, LLC for $21,300,309 ($13,845,258 in cash and $7,455,051 in stock) subject to certain adjustments, as well as potential product regulatory milestone payments in the aggregate estimated to be up to $30,000,000 and earn outs in the first and second years based on incremental net sales growth of up to $26,500,000 payable in cash and Company stock. Any future payments in Company stock are at the Company's discretion. BioD, LLC is a privately held company engaged in the development and commercialization of novel proprietary regenerative medical products derived from placental birth tissues for use in a broad range of clinical applications, including orthopedic, spine and ophthalmic channels. For its fiscal year ended December 31, 2015, BioD, LLC had sales of approximately $18,600,000, gross profit of approximately $16,300,000, and pre-tax income of approximately $2,900,000. The Company has distributed BioDLogics products since 2014 into the wound care channel under an exclusive agreement (Note 11). BioD, LLC will operate as a wholly owned subsidiary and retain its manufacturing, distribution and sales and marketing infrastructure located in Memphis, TN. The Company is presently conducting a valuation analysis to determine the allocation of the final purchase price to the underlying assets acquired and liabilities assumed in this transaction. Through June 30, 2016, the Company has incurred $162,160 of costs related to the purchase and has charged them to selling, general and administrative expense.

In addition, certain former BioD, LLC equity holders purchased approximately $2,300,000 in shares of Company common stock at a price of $4.1692 per share.

**Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.**

*This Quarterly Report on Form 10-Q (this “Report”) includes certain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, statements about the confidence, strategies, plans, expectations, intentions, objectives, technologies, opportunities, market demand or acceptance of new or existing products of Derma Sciences, Inc., a Delaware corporation, and its subsidiaries (“we” or “us” or the “Company”), and other statements contained in this Report that are not historical facts. Forward-looking statements in this Report or hereafter included in other publicly available documents filed with the Securities and Exchange Commission (the “Commission”) reports to our stockholders and other publicly available statements issued or released by us involve known and unknown risks, uncertainties and other factors that could cause our actual results, performance (financial or operating) or achievements to differ from the future results, performance (financial or operating) or achievements expressed or implied by such forward-looking statements. Such future results are based upon management’s best estimates, current conditions and the most recent results of operations. When used in this Report, the words “expect,” “anticipate,” “intend,” “plan,” “believe,” “seek,” “estimate” and similar expressions are generally intended to identify forward-looking statements, because these forward-looking statements involve risks and uncertainties. There are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements, including our plans, objectives, expectations and intentions, changes in political, economic, business, competitive, market and regulatory factors and other factors that are discussed under the section in this Report entitled “Risk Factors,” as well as our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 filed on March 15, 2016 (the “2015 Form 10-K”) and other filings with the Commission. Neither we nor any other person assume responsibility for the accuracy or completeness of these forward-looking statements. We are under no duty to update any of the forward-looking statements after the date of this Report to conform these statements to actual results.*

**Three Months Ended June 30, 2016 Compared to Three Months Ended June 30, 2015**

Overview

*Operating Results of Three Months Ended June 30, 2016 and 2015*

The following table highlights the operating results for the three months ended June 30, 2016 and 2015:

| | Three Months Ended June 30, 2016 | 2015 | Variance | |
|---|---|---|---|---|
| Gross sales | $ 25,183,238 | $ 25,636,623 | $ (453,385 ) | (1.8 )% |
| Sales adjustments | (2,975,177 ) | (3,080,259 ) | 105,082 | (3.4 )% |
| Net sales | 22,208,061 | 22,556,364 | (348,303 ) | (1.5 )% |
| Cost of sales | 13,948,215 | 14,185,116 | (236,901 ) | (1.7 )% |
| Gross profit | 8,259,846 | 8,371,248 | (111,402 ) | (1.3 )% |
| | | | | |
| Selling, general and administrative expense | 10,284,886 | 13,701,728 | (3,416,842 ) | (24.9 )% |
| Research and development expense | - | 230,942 | (230,942 ) | * |
| Other income, net | (4,535,101 ) | (880,514 ) | (3,654,587 ) | * |
| Total | 5,749,785 | 13,052,156 | (7,302,371 ) | (55.9 )% |
| | | | | |
| Income (loss) from continuing operations before income taxes | 2,510,061 | (4,680,908 ) | 7,190,969 | 153.6 % |
| | | | | |
| Income tax provision | 527,525 | 344,857 | 182,668 | * |
| Net income (loss) from continuing operations | 1,982,536 | (5,025,765 ) | 7,008,301 | 139.4 % |
| Loss from discontinued operations, net of taxes | - | (4,259,946 ) | (4,259,946 ) | * |
| Net income (loss) | $ 1,982,536 | $ (9,285,711 ) | $ 11,268,247 | 121.4 % |

** – not meaningful*

*Sales Adjustments*

Gross to net sales adjustments comprise the following:

| | Three Months Ended June 30, | |
|---|---|---|
| | 2016 | 2015 |
| Gross sales | $25,183,238 | $25,636,623 |
| Trade rebates | (2,033,830 ) | (2,171,389 ) |
| Distributor fees | (256,466 ) | (246,204 ) |
| Sales incentives | (336,723 ) | (357,463 ) |
| Returns and allowances | (159,913 ) | (107,423 ) |
| Cash discounts | (188,245 ) | (197,780 ) |
| Total adjustments | (2,975,177 ) | (3,080,259 ) |
| Net sales | $22,208,061 | $22,556,364 |

Trade rebates decreased in 2016 versus 2015 principally due to a decrease in sales subject to rebate in the U.S. and Canada. The increase in distributor fees was commensurate with the increase in the Canadian distribution fee rate due to a change in the sales mix of products for which it is based. The decrease in sales incentives reflected lower sales subject to incentives in U.S. and Canada.

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| | 2016 | | | 2015 | | |
|---|---|---|---|---|---|---|
| | Gross Sales | Sales Adj. | Net Sales | Gross Sales | Sales Adj. | Net Sales |
| By Entity Location | | | | | | |
| US | $19,875,571 | $(1,523,699) | $18,351,872 | $20,301,208 | $(1,543,976) | $18,757,232 |
| Canada | 3,892,613 | (1,449,431) | 2,443,182 | 4,292,562 | (1,536,283) | 2,756,279 |
| International | 1,415,054 | (2,047 ) | 1,413,007 | 1,042,853 | - | 1,042,853 |
| Total | $25,183,238 | $(2,975,177) | $22,208,061 | $25,636,623 | $(3,080,259) | $22,556,364 |

U.S. sales adjustments decreased due to lower rebates, sales incentives, and cash discounts, partially offset by higher returns and allowance. Rebates in the U.S. decreased as a result of a decrease in sales subject to rebate. U.S. sales incentives decreased due to decreased sales upon which the fees are based. Sales adjustments in Canada were lower in 2016 than 2015 due to lower rebates. The decrease in Canadian sales rebates was commensurate with the decrease in Canadian sales upon which the fees are based partially offset by an increase in the rebate percentage due to increased sales of higher rebated products.

| | 2016 | | | 2015 | | |
|---|---|---|---|---|---|---|
| | Gross Sales | Sales Adj. | Net Sales | Gross Sales | Sales Adj. | Net Sales |
| By Segment | | | | | | |
| Advanced wound care | $11,788,430 | $(814,160 ) | $10,974,270 | $11,346,818 | $(1,054,802) | $10,292,016 |
| Traditional wound care | 13,394,808 | (2,161,017) | 11,233,791 | 14,289,805 | (2,025,457) | 12,264,348 |
| Total | $25,183,238 | $(2,975,177) | $22,208,061 | $25,636,623 | $(3,080,259) | $22,556,364 |

Advanced wound care sales adjustments decreased due to lower trade rebates and sales incentives. Advanced wound care rebates and sales incentives decreased due to a decrease in sales upon which the fees are based, as well as a decrease in Medicare part B rebates. Traditional wound care sales adjustments increased in 2016 versus 2015 due to higher trade rebates and distribution fees. The increase in traditional wound care sales rebates was commensurate with the increase in sales upon which the fees are based. The traditional wound care rebate percentage also increased due to increased sales of higher rebated products. A higher distribution fee percentage also impacted the traditional wound care segment.

*Rebate Reserve Roll-Forward*

A roll-forward of the trade rebate accruals for the three months ended June 30, 2016 and 2015 were as follows:

| | Three Months Ended June 30, | |
|---|---|---|
| | 2016 | 2015 |
| Beginning balance – April 1 | $1,702,039 | $1,621,938 |
| Rebates paid | (2,045,310) | (1,902,620) |
| Rebates accrued | 2,033,830 | 2,171,389 |
| Ending balance – June 30 | $1,690,559 | $1,890,707 |

The $11,480 decrease in the trade rebate reserve balance at June 30, 2016 from April 1, 2016 principally reflected the timing of rebate payments and decrease in sales subject to rebate and the rebate percentage. There was no other significant change in the nature of our business during the three months ended June 30, 2016 as it related to the accrual and subsequent payment of rebates.

*Net Sales*

| | | | $ Variance | | | % Variance | | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | 2015 | Non FX | FX | Total | Non FX | FX | Total |
| By Entity Location | | | | | | | | |
| US | $18,351,872 | $18,757,232 | $(405,360) | $- | $(405,360) | (2.2 )% | - % | (2.2 )% |
| Canada | 2,443,182 | 2,756,279 | (197,267) | (115,830) | (313,097) | (7.2 ) | (4.2) | (11.4)% |
| International | 1,413,007 | 1,042,853 | 467,701 | (97,547 ) | 370,154 | 44.8 | (9.4) | 35.5 % |
| Total | $22,208,061 | $22,556,364 | $(134,926) | $(213,377) | $(348,303) | (0.6 )% | (0.9)% | (1.5 )% |

The decrease in net sales by the U.S. entity was driven by lower traditional wound care sales partially offset by higher advanced wound care sales. The decrease in traditional wound care sales was driven by a decrease in First Aid Division (“FAD”) sales. The 2015 FAD sales included an initial stocking order for a large U.S. retail pharmacy chain. The higher advanced wound care sales were related to higher MEDIHONEY, Total Contact Casting (“TCC”), and AMNIO sales. The decrease in net sales by the Canadian entity was driven by lower traditional wound care and advanced wound care sales. Canadian entity net sales were unfavorably impacted by our exclusive distributor’s rebalancing efforts. Canadian year over year market demand increased 3%. The increase in international sales was driven by higher advanced and traditional wound care sales.

| | | | $ Variance | | | % Variance | | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | 2015 | Non FX | FX | Total | Non FX | FX | Total |
| By Segment | | | | | | | | |
| Advanced wound care | $10,974,270 | $10,292,016 | $779,325 | $(97,071 ) | $682,254 | 7.6 % | (0.9)% | 6.6 % |
| Traditional wound care | 11,233,791 | 12,264,348 | (914,251) | (116,306) | (1,030,557) | (7.5) | (0.9) | (8.4 ) |
| Total | $22,208,061 | $22,556,364 | $(134,926) | $(213,377) | $(348,303 ) | (0.6)% | (0.9)% | (1.5 )% |

The advanced wound care sales increase was led by MEDIHONEY, TCC, and AMNIO products in the U.S and MEDIHONEY international product sales. The decrease in traditional wound care sales was driven by lower FAD sales in the U.S. and lower traditional wound care sales in Canada.

*Gross Profit*

| | 2016 | 2015 | $ Variance Non FX | $ Variance FX | $ Variance Total | % Variance Non FX | % Variance FX | % Variance Total |
|---|---|---|---|---|---|---|---|---|
| By Segment | | | | | | | | |
| Advanced wound care | $5,852,464 | $4,862,036 | $1,059,939 | $(69,511) | $990,428 | 21.8 % | (1.4)% | 20.4 % |
| Traditional wound care | 2,407,382 | 3,509,212 | (1,070,637) | (31,193) | (1,101,830) | (30.5) | (0.9) | (31.4) |
| Total | $8,259,846 | $8,371,248 | $(10,698) | $(100,704) | $(111,402) | (0.1)% | (1.2)% | (1.3)% |
| Gross Profit % | | | | | | | | |
| Advanced wound care | 53.3 % | 47.2 % | | | | | | |
| Traditional wound care | 21.4 % | 28.6 % | | | | | | |
| Total | 37.2 % | 37.1 % | | | | | | |

The increase in gross profit dollars for the advanced wound care segment was driven by higher sales and an increase in the gross profit percentage. The increase in gross profit percentage for the advanced wound care segment was driven by favorable sales mix and lower product costs. The decrease in gross profit dollars for the traditional wound care segment was driven by lower sales and gross profit percentage. The decrease in gross profit percentage for the traditional wound care segment reflected higher sales of lower margined products, higher product costs due to foreign exchange and higher manufacturing costs.

*Selling, General and Administrative Expenses*

The following table highlights selling, general and administrative expenses by function for the three months ended June 30, 2016 versus 2015:

| | | | $ Variance | | | % Variance | | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | 2015 | Non FX | FX | Total | Non FX | FX | Total |
| Distribution | $640,914 | $680,575 | $(35,249) | $(4,412) | $(39,661) | (5.2)% | (0.6)% | (5.8)% |
| Marketing | 1,680,672 | 2,543,431 | (856,537) | (6,222) | (862,759) | (33.7) | (0.2) | (33.9) |
| Sales | 4,857,343 | 6,478,566 | (1,582,638) | (38,585) | (1,621,223) | (24.4) | (0.6) | (25.0) |
| G&A | 3,105,957 | 3,999,156 | (864.391) | (28,808) | (893,199) | (21.6) | (0.7) | (22.3) |
| Total | $10,284,886 | $13,701,728 | $(3,338,815) | $(78,027) | $(3,416,842) | (24.3)% | (0.6)% | (24.9)% |

The decrease in distribution expense was related to lower operating costs due to the Company's restructuring and overall expense reduction initiatives.

The decrease in marketing expense reflected lower salaries, equity based compensation, and related travel expenses associated with the elimination of five positions, lower consulting costs, promotional spend, and product development expenses as a result of the Company's restructuring and expense reduction initiatives.

The decrease in sales expense reflected lower salaries, commissions, equity based compensation, operating costs and related travel expenses as a result of the Company's reduction from 50 territory managers to 38 along with the elimination of five specialty field representatives and four associated management and support staff in the U.S. and one International territory manager during the fourth quarter of 2015, as well as lower samples expense, trade show and meetings costs in connection with the restructuring and expense reduction initiatives, partially offset by higher volume driven group purchasing organization fees.

The decrease in general and administrative expense reflected lower salaries, equity based compensation and related travel expenses in connection with the vacant position created by the CEO separation from the Company in December 2015 together with three finance and one information technology positions eliminated in the fourth quarter of 2015, lower consulting, accounting, and legal costs, as well as lower public and investor relations spend in connection with the restructuring and expense reduction initiatives implemented in the fourth quarter of 2015, partially offset by due diligence fees incurred in 2016.

| | | | $ Variance | | | % Variance | | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | 2015 | Non FX | FX | Total | Non FX | FX | Total |
| By Entity Location | | | | | | | | |
| US | $8,879,794 | $12,025,346 | $(3,145,553) | $- | $(3,145,552) | (26.2)% | - % | (26.2)% |
| Canada | 889,103 | 1,148,338 | (216,528) | (42,707) | (259,235) | (18.9) | (3.7) | (22.6) |
| International | 515,989 | 528,044 | 23,267 | (35,322) | (12,055) | 4.4 | (6.7) | (2.3) |
| Total | $10,284,886 | $13,701,728 | $(3,338,814) | $(78,028) | $(3,416,842) | (24.3)% | (0.6)% | (24.9)% |

The decrease in expenses in the U.S. in 2016 reflected lower marketing, sales, and executive salaries and related equity based compensation, travel expenses, consulting costs and promotional spend in connection with the fourth quarter 2015 restructuring and expense reduction initiatives, partially offset by due diligence fees incurred in 2016. The decrease in expenses in Canada in 2016 reflected lower compensation associated with the elimination of two positions, travel, and consulting costs. The decrease in International expenses in 2016 reflected lower compensation and travel costs associated with the elimination of one position.

| | | | $ Variance | | | % Variance | | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | 2015 | Non FX | FX | Total | Non FX | FX | Total |
| By Segment | | | | | | | | |
| Advanced wound care | $6,227,238 | $8,463,100 | $(2,193,546) | $(42,316) | $(2,235,862) | (25.9)% | (0.5)% | (26.4)% |
| Traditional wound care | 1,101,690 | 1,433,222 | (324,627) | (6,905) | (331,532) | (22.6) | (0.5) | (23.1) |
| Other | 2,955,958 | 3,805,406 | (820,641) | (28,807) | (849,448) | (21.5) | (0.8) | (22.3) |
| Total | $10,284,886 | $13,701,728 | $(3,338,814) | $(78,028) | $(3,416,842) | (24.3)% | (0.6)% | (24.9)% |

*Research and Development Expense*

The decrease in research and development expense reflected the completion of AMNIO post marketing clinical studies in the advanced wound care segment in 2015. No additional research and development projects have been initiated to date in 2016.

*Other Income, net*

Other income, net increased $3,654,587 to $4,535,101 in 2016 from $880,514 in 2015 due principally to a $4,740,136 gain on the sale of the Comvita investment partially offset by the impact of foreign exchange losses. The foreign exchange losses were significantly impacted by Great Britain's referendum vote in June, 2016 to withdraw from the European Union.

*Income Tax Provision*

Income tax provision increased $182,668 to $527,525 in 2016 from $344,857 in 2015 due principally to the U.S. income tax impact of the unrealized gain on equity securities from accumulated other comprehensive income and tax treatment of goodwill net of amortization for financial reporting but not tax purposes of acquired identified intangible assets, partially offset by lower income from the Canadian operations.

*Net Loss from Continuing Operations*

For the three months ended June 30, 2016, we generated net income from continuing operations of $1,982,536, or $0.08 per share (basic and diluted), compared to a net loss from continuing operations of $5,025,765, or $0.20 per share (basic and diluted), in 2015.

*Net Loss from Discontinued Operations*

Effective November 2015, management approved a plan to terminate the Company's Phase 3 (DSC127) clinical program for diabetic foot ulcer healing. The decision to end the program followed the recommendation by the independent Data Monitoring Committee to stop the program based on its interim assessment. Based on this recommendation, we initiated an orderly termination of all our existing pharmaceutical development programs comprised of the diabetic foot healing program and two other programs utilizing the DSC127 compound for other therapeutic indications.

In connection with this decision, our entire pharmaceutical development staff, comprised of six positions, was terminated and the process of closing down the programs commenced. The close down activities were substantially completed by the end of 2015.

There was no loss from discontinued operations during the second quarter of 2016 as the Company ceased expenditures on the project. For the three months ended June 30, 2015, we incurred a net loss from discontinued operations of $4,259,946, or $0.17 per share (basic and diluted).

*Total Net Loss*

For the three months ended June 30, 2016, we generated net income of $1,982,536, or $0.08 per share (basic and diluted), compared to a net loss of $9,285,711, or $0.36 per share (basic and diluted), in 2015.

**Six Months Ended June 30, 2016 Compared to Six Months Ended June 30, 2015**

Overview

*Operating Results of Six Months Ended June 30, 2016 and 2015*

The following table highlights the operating results for the six months ended June 30, 2016 and 2015:

| | Six Months Ended June 30, | | Variance | |
|---|---|---|---|---|
| | 2016 | 2015 | | |
| Gross sales | $47,950,142 | $47,533,696 | $416,446 | 0.9 % |
| Sales adjustments | (5,499,524) | (5,478,680) | (20,844) | 0.4 % |
| Net sales | 42,450,618 | 42,055,016 | 395,602 | 0.9 % |
| Cost of sales | 26,483,249 | 26,148,642 | 334,607 | 1.3 % |
| Gross profit | 15,967,369 | 15,906,374 | 60,995 | 0.4 % |
| | | | | |
| Selling, general and administrative expense | 20,238,000 | 26,960,133 | (6,722,133) | (24.9)% |
| Research and development expense | - | 583,124 | (583,124) | * |
| Other income, net | (4,803,141) | (512,726) | (4,290,415) | * |
| Total | 15,434,859 | 27,030,531 | (11,595,672) | (42.9)% |
| | | | | |
| Income (loss) from continuing operations before income taxes | 532,510 | (11,124,157) | 11,656,667 | * |
| | | | | |
| Income tax provision | 307,727 | 352,908 | (45,181) | * |
| Net income (loss) from continuing operations | 224,783 | (11,477,065) | 11,701,848 | * |
| Loss from discontinued operations, net of taxes | - | (8,418,223) | (8,418,223) | * |
| Net income (loss) | $224,783 | $(19,895,288) | $20,120,071 | |