

MEDIA SCIENCES INTERNATIONAL INC
Form 10-Q
February 11, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2009

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

For the transition period from _____ to _____.

Commission file number: 1-16053

MEDIA SCIENCES INTERNATIONAL, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

87-0475073
(IRS Employer Identification No.)

8 Allerman Road, Oakland, NJ 07436
(Address of principal executive offices) (Zip Code)

(201) 677-9311
(Registrant's telephone number, including area code)

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 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 such shorter period that the registrant was required to submit and post such files). Yes No

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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 (Check one):

Large accelerated filer	<input type="radio"/>	Accelerated filer	<input type="radio"/>
Non-accelerated filer (Do not check if a smaller reporting company)	<input type="radio"/>	Smaller reporting company	<input checked="" type="radio"/>

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

As of January 27, 2010, we had 11,989,914 shares of common stock outstanding.

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MEDIA SCIENCES INTERNATIONAL, INC.
AND SUBSIDIARIES

FORM 10-Q
FOR THE QUARTER ENDED DECEMBER 31, 2009

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS	December 31, 2009 (Unaudited)	June 30, 2009
CURRENT ASSETS:		
Cash and cash equivalents	\$ 438,163	\$ 550,602
Accounts receivable, net	2,931,038	3,427,550
Inventories, net	6,895,198	6,392,441
Taxes receivable	48,728	20,257
Deferred tax assets	830,447	830,447
Prepaid expenses and other current assets	420,593	541,153
Total Current Assets	11,564,167	11,762,450
PROPERTY AND EQUIPMENT, NET	1,785,973	2,096,986
OTHER ASSETS:		
Goodwill and other intangible assets, net	3,584,231	3,584,231
Deferred tax assets	378,074	279,486
Other assets	66,578	75,159
Total Other Assets	4,028,883	3,938,876
TOTAL ASSETS	\$ 17,379,023	\$ 17,798,312
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	1,063,168	1,128,187
Accrued compensation and benefits	428,900	690,948
Other accrued expenses and current liabilities	884,787	1,151,325
Short-term capital lease obligation	–	69,815
Accrued product warranty costs	447,967	436,578
Deferred rent liability	35,649	63,863
Deferred revenue	81,274	209,079
Total Current Liabilities	2,941,745	3,749,795
OTHER LIABILITIES:		
Long-term debt	3,115,866	2,749,132
Deferred rent liability	42,726	58,010
Convertible debt, net of discount of \$333,978 in December and \$401,830 in June	916,022	848,170
Warrant liabilities	11,742	–
Deferred revenue, less current portion	4,398	38,708
Total Other Liabilities	4,090,754	3,694,020

TOTAL LIABILITIES	7,032,499	7,443,815
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY:		
Preferred Stock, \$.001 par value		
Authorized 5,000,000 shares; none issued	–	–
Common Stock, \$.001 par value 25,000,000 shares authorized;		
issued and outstanding, respectively, 12,971,434 and 11,989,914		
shares in December and 12,397,757 and 11,771,966 shares in June	11,990	11,772
Additional paid-in capital	13,023,671	13,000,680
Accumulated other comprehensive income (loss)	(41,625)	216
Accumulated deficit	(2,647,512)	(2,658,171)
Total Shareholders' Equity	10,346,524	10,354,497
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 17,379,023	\$ 17,798,312

See accompanying notes to condensed consolidated financial statements.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
NET REVENUES	\$5,586,319	\$5,156,705	\$11,093,069	\$10,909,110
COST OF GOODS SOLD:				
Cost of goods sold, excluding depreciation and amortization, product warranty, shipping and freight	2,366,827	2,551,580	4,980,605	5,203,804
Depreciation and amortization	79,084	139,627	215,685	257,116
Product warranty	519,491	227,330	987,863	441,499
Shipping and freight	108,698	116,141	267,252	263,766
Total cost of goods sold	3,074,100	3,034,678	6,451,405	6,166,185
GROSS PROFIT	2,512,219	2,122,027	4,641,664	4,742,925
OTHER COSTS AND EXPENSES:				
Research and development	372,004	348,194	712,884	721,246
Selling, general and administrative, excluding depreciation and amortization	2,033,453	2,495,540	3,950,143	5,248,447
Depreciation and amortization	62,956	92,467	137,798	186,400
Litigation settlement	-	-	-	(1,500,000)
Total other costs and expenses	2,468,413	2,936,201	4,800,825	4,656,093
INCOME (LOSS) FROM OPERATIONS	43,806	(814,174)	(159,161)	86,832
Interest expense	(89,914)	(74,231)	(176,769)	(129,155)
Interest income	51	2,307	71	2,966
Gain (loss) on change in fair value of warrant liabilities	14,205	-	(4,962)	-
Amortization of debt discount on convertible debt	(35,173)	(26,211)	(67,852)	(26,211)
LOSS BEFORE INCOME TAXES	(67,025)	(912,309)	(408,673)	(65,568)
Benefit for income taxes	16,169	395,572	98,588	26,227
NET LOSS	\$(50,856)	\$(516,737)	\$(310,085)	\$(39,341)
LOSS PER SHARE				
Basic and diluted	\$(0.00)	\$(0.04)	\$(0.03)	\$(0.00)
WEIGHTED AVERAGE SHARES USED TO COMPUTE LOSS PER SHARE				
Basic and diluted	11,945,712	11,721,467	11,891,969	11,719,283

See accompanying notes to condensed consolidated financial statements

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY AND
COMPREHENSIVE LOSS
SIX MONTHS ENDED DECEMBER 31, 2009
(UNAUDITED)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (loss)	Accumulated Deficit	Total Shareholders' Equity
BALANCES, JUNE 30, 2009	11,771,966	\$ 11,772	\$ 13,000,680	\$ 216	\$ (2,658,171)	\$ 10,354,497
Cumulative effect of change in accounting principle – ASC Topic 815-10 adoption	–	–	(327,524)	–	320,744	(6,780)
Components of comprehensive loss:						
Net loss	–	–	–	–	(310,085)	(310,085)
Cumulative translation adjustment	–	–	–	(41,841)	–	(41,841)
Total comprehensive loss	–	–	–	–	–	(351,926)
Vested restricted stock units	217,948	218	(218)	–	–	–
Stock-based compensation expense	–	–	350,733	–	–	350,733
BALANCES, DECEMBER 31, 2009	11,989,914	\$ 11,990	\$ 13,023,671	\$ (41,625)	\$ (2,647,512)	\$ 10,346,524

See accompanying notes to condensed consolidated financial statements.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Six Months Ended December 31,	
	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (310,085)	\$ (39,341)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	394,220	471,108
Stock-based compensation expense	345,602	363,416
Deferred income taxes	(98,588)	(26,227)
Provision for (reduction of) inventory obsolescence reserves	(58,319)	67,610
Provision for (recovery of) returns and doubtful accounts allowance	90,063	(52,568)
Amortization of debt discount on convertible debt	67,852	26,211
Loss on change in fair value of warrant liabilities	4,962	-
Changes in operating assets and liabilities:		
Accounts receivable	370,662	146,854
Inventories	(439,308)	1,957,369
Income taxes	(29,074)	(4,160)
Prepaid expenses and other current assets	110,598	(25,863)
Accounts payable	(66,043)	(1,625,183)
Accrued compensation and benefits	(266,793)	(302,124)
Other accrued expenses and current liabilities	(244,740)	(910,236)
Accrued product warranty costs	11,389	(11,432)
Deferred rent liability	(43,498)	(23,268)
Deferred revenue	(162,115)	(204,920)
Net cash used by operating activities	(323,215)	(192,754)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(83,207)	(597,482)
Net cash used in investing activities	(83,207)	(597,482)
CASH FLOWS FROM FINANCING ACTIVITIES		
Decrease in restricted cash	18,450	-
Bank credit line proceeds	366,734	284,474
Capital lease obligation repayments	(69,815)	(200,000)
Proceeds from issuance of subordinated convertible debt	-	1,250,000
Net cash provided by financing activities	315,369	1,334,474
Effect of exchange rate changes on cash and cash equivalents	(21,386)	(61,334)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(112,439)	482,904
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	550,602	236,571
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 438,163	\$ 719,475

SUPPLEMENTAL CASH FLOW INFORMATION

Interest paid	\$ 158,426	\$ 111,447
Income taxes paid	\$ 49,160	\$ 6,240

SUPPLEMENTAL DISCLOSURE OF NON-CASH
TRANSACTIONS

Capital lease additions	\$ -	\$ 528,488
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See accompanying notes to condensed consolidated financial statements.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – NATURE OF BUSINESS AND BASIS OF PRESENTATION

Nature of Business. Media Sciences International, Inc. is a holding company which conducts its business through its operating subsidiaries. The Company is a manufacturer of business color printer supplies, which the Company distributes through an international network of dealers and distributors.

Basis of Presentation. The condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to Article 8 of Rule S-X. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair presentation of the financial position, results of operations and cash flows for the periods indicated. You should read these condensed consolidated financial statements in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended June 30, 2009, filed with the SEC on September 24, 2009. The June 30, 2009 consolidated balance sheet data was derived from audited consolidated financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America.

The consolidated financial statements include the accounts of Media Sciences International, Inc., a Delaware corporation, and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. As of December 31, 2009, other than those resulting from adoption of recent accounting pronouncements discussed in Note 2, there have been no significant changes to any of the Company’s accounting policies as set forth in the Annual Report on Form 10-K for the year ended June 30, 2009. The Company has evaluated material subsequent events through February 11, 2010, the date these financial statements were issued. No material subsequent events came to our attention except as disclosed in Note 12.

The results of operations for the three and six months ended December 31, 2009 are not necessarily indicative of the results that may be expected for any other interim period or for the full year ending June 30, 2010.

Liquidity. Over the next twelve months, the Company’s operations may require additional funds and it may seek to raise such additional funds through public or private sales of debt or equity securities, or securities convertible or exchangeable into such securities, strategic relationships, bank debt, lease financing arrangements, or other available means. No assurance can be provided that additional funding, if sought, will be available or, if available, will be on acceptable terms to meet the Company’s business needs. If additional funds are raised through the issuance of equity securities, stockholders may experience dilution, or such equity securities may have rights, preferences, or privileges senior to those of the holders of the Company’s common stock. If additional funds are raised through debt financing, the debt financing may involve significant cash payment obligations and financial or operational covenants that may restrict the Company’s ability to operate its business. An inability to fund its operations or fulfill outstanding obligations could have a material adverse effect on the Company’s business, financial condition and results of operations.

Accumulated Other Comprehensive Income (loss). Accumulated other comprehensive income (loss) represents currency translation adjustments. Assets and liabilities of the Company's United Kingdom and China subsidiaries have been translated at current exchange rates, and related revenues and expenses have been translated at average rates of exchange in effect during the period. The functional currency of the Company's foreign subsidiaries is as follows: Media Sciences UK, Ltd., the British pound; Media Sciences Hong Kong Co. Limited, the Hong Kong dollar; and Media Sciences (Dongguan) Company Limited, the Chinese yuan. Realized foreign currency transaction gains and losses are recorded as a component of selling, general and administrative expense.

Reclassifications. Certain prior period balances have been reclassified to conform to the current financial statement presentation. These reclassifications had no impact on previously reported results of operations or shareholders' equity.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – NATURE OF BUSINESS AND BASIS OF PRESENTATION (CONTINUED)

Estimates and Uncertainties. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company's most significant estimates and assumptions made in the preparation of the financial statements relate to revenue recognition, accounts receivable reserves, inventory reserves, income taxes, warranty reserves, and certain accrued expenses. Actual results could differ from those estimates.

Fair Value Measurements. The Company measures fair value in accordance with authoritative guidance for fair value measurements, which defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. The authoritative guidance defines fair value as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, there exists a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

- Level 1 – unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access as of the measurement date.
- Level 2 – inputs other than quoted prices included within Level 1 that are directly observable for the asset or liability or indirectly observable through corroboration with observable market data.
- Level 3 – unobservable inputs for the asset or liability only used when there is little, if any, market activity for the asset or liability at the measurement date.

This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

Recurring Fair Value Estimates. The Company's recurring fair value measurements at December 31, 2009 were as follows:

	Fair Value as of December 31,2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Increases (decreases) during the six months ended December 31, 2009
Liabilities:					
Warrant obligations	\$ 11,742	–	–	\$ 11,742	\$ 4,962

Recurring Level 3 Activity, Reconciliation and Basis for Valuation. The table below provides a reconciliation of the beginning and ending balances for the major classes of assets and liabilities measured at fair value using significant unobservable inputs (Level 3). The table reflects gains and losses for the quarter for all financial liabilities categorized as Level 3 as of December 31, 2009. See Note 2, Implementation of EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) is Indexed to an Entity's Own Stock" (ASC Topic 815-10), for discussion regarding the Company's warrant obligations.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – NATURE OF BUSINESS AND BASIS OF PRESENTATION (CONTINUED)

Changes in our Fair Value Measurements Using Significant Unobservable Inputs (Level 3):

	Increases (decreases)
Liabilities:	
Balance as of July 1, 2009	\$ 6,780
Increase in fair value of warrants	19,167
Balance as of September 30, 2009	\$ 25,947
Decrease in fair value of warrants	(14,205)
Balance as of December 31, 2009	\$ 11,742

The fair value of each warrant group is estimated using the Black-Scholes option pricing model with the following weighted average assumptions as of (number of warrants in thousands):

	Original Value	July 1, 2009	December 31, 2009
Number of warrants	1,515	1,515	1,515
Exercise price	\$1.65	\$1.65	\$1.65
Risk free interest rate	2.13%	1.53%	1.08%
Expected warrant lives in years	3.0	2.9	2.0
Expected volatility	61.3%	74%	74%
Expected dividend yields	None	None	None
Fair value per share	\$0.216	\$0.005	\$0.008
Common stock price	\$1.43	\$0.17(a)	\$0.225(a)
Fair value of warrants	\$327,524	\$6,780	\$11,742

(a) Due to the low average daily trading volume of our common stock, we have discounted the common stock price in the Black-Scholes valuation model to reflect the adverse impact on our share price which would result from a dramatic increase in the number of shares of our common stock outstanding upon the exercise of these warrants.

There are no assets or liabilities measured at fair value on a nonrecurring basis.

Fair Value of Financial Instruments. The carrying value of cash and cash equivalents, accounts receivable, accounts payable and short-term debt reasonably approximate their fair value due to the relatively short maturities of these instruments. Long-term debt carrying values approximate their fair values at the balance sheet dates. The fair value estimates presented herein were based on market or other information available to management. The use of different assumptions and/or estimation methodologies could have a significant effect on the estimated fair value amounts.

Restricted Cash. At December 31, 2009 and June 30, 2009, \$122,451 and \$140,901, respectively, of bank deposits located in China were classified as restricted due to regulatory restrictions impacting the availability of the funds during dissolution of the legal entity. This restricted cash is reflected in other current assets in the condensed consolidated balance sheets.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – NATURE OF BUSINESS AND BASIS OF PRESENTATION (CONTINUED)

Loss on change in fair value of warrant liabilities. In accordance with authoritative guidance, the Company is required to account for investor warrants as if they were derivative liabilities (See Note 2, Implementation of EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) is Indexed to an Entity's Own Stock" (ASC Topic 815-10)). The Company is required to mark to market each reporting quarter the value of the investor warrants. The periodic change in value of the deemed obligations associated with these warrants is recorded as either non-cash gain (if the value of the warrants decrease) or as non-cash loss (if the value of the warrants increase). Although the value of the warrants is affected by interest rates, the remaining contractual conversion period, and the Company's stock volatility, the primary cause of the change in the value of the embedded derivative and investor warrants will be the value of the Company's common stock at each measurement date. If the stock price goes up, the value of this deemed liability will generally increase and if the stock price goes down the value of this deemed liability will generally decrease.

Income Taxes. The Company recognizes deferred tax assets, net of applicable valuation allowances, related to net operating loss carry-forwards and certain temporary differences and deferred tax liabilities related to certain temporary differences. The Company recognizes a future tax benefit to the extent that realization of such benefit is considered to be more likely than not. This determination is based on projected taxable income and tax planning strategies. Otherwise, a valuation allowance is applied. To the extent that the Company's deferred tax assets require valuation allowances in the future, the recording of such valuation allowances would result in an increase to its tax provision in the period in which the Company determines that such a valuation allowance is required.

The Company evaluates the need for a deferred tax valuation allowance quarterly. A valuation allowance was required as of March 31, 2009 as it was deemed more likely than not that certain State net operating loss carry forwards and other future deductible temporary differences included in the Company's deferred tax assets will not be realized. At December 31, 2009 and June 30, 2009, the valuation allowance associated with these state tax attributes was \$532,000. This valuation allowance adjustment had no impact on the Company's cash flows or future prospects, nor does it alter the Company's ability to utilize these tax attributes, the utilization of which is primarily dependent upon future taxable income. Under United States generally accepted accounting principles ("GAAP"), if and when the Company's results demonstrate a pattern of future profitability and reverse the current cumulative loss trend, this valuation allowance may be adjusted and may result in the reinstatement of all or a part of the net deferred tax assets.

Although the Company incurred substantial losses before income taxes for the quarter ended December 31, 2009 and the years ended June 30, 2009 and 2008, management believes that it is more likely than not that the Company will have sufficient taxable income in future years to realize its remaining net federal deferred income tax assets. However, if future events change management's assumptions and estimates regarding the Company's future earnings, a significant deferred tax asset valuation allowance may have to be established.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS

FASB Establishes Accounting Standards Codification™

In June 2009, the FASB issued Accounting Standards Update No. 2009-01, “Generally Accepted Accounting Principles” (Accounting Standards Codification™ (“ASC”) Topic 105) which establishes the FASB Accounting Standards Codification (“the Codification”, “ASC”, or “authoritative guidance”) as the official single source of authoritative U.S. GAAP. All existing accounting standards are superseded. All other accounting guidance not included in the Codification will be considered non-authoritative. The Codification also includes all relevant Securities and Exchange Commission (“SEC”) guidance organized using the same topical structure in separate sections within the Codification.

Following the Codification, the Board will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates (“ASU”) which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification.

The Codification is not intended to change GAAP, but it did change the way GAAP is organized and presented. The Codification was effective for our first quarter 2010 financial statements and the principal impact on our financial statements is limited to disclosures as all future references to authoritative accounting literature will be referenced in accordance with the Codification. In order to ease the transition to the Codification, we are providing the Codification cross-reference alongside the references to the standards issued and adopted prior to the adoption of the Codification. ASC Topic 105 was effective for the Company’s interim reporting period ending on September 30, 2009. This authoritative guidance did not have a material impact on the Company’s consolidated financial position, results of operations or cash flows.

Implementation of EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) is Indexed to an Entity’s Own Stock" (ASC Topic 815-10)

In June 2008, the FASB ratified EITF Issue No. 07-5 which provides that an entity should use a two-step approach to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock, including evaluating the instrument's contingent exercise and settlement provisions. Equity-linked instruments (or embedded features) that otherwise meet the definition of a derivative as outlined in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" (ASC Topic 815), are not accounted for as derivatives if certain criteria are met, one of which is that the instrument (or embedded feature) must be indexed to the entity's stock. ASC Topic 815-10 provides guidance on determining if equity-linked instruments (or embedded features) such as warrants to purchase our stock are considered indexed to our stock.

ASC Topic 815-10 became effective for the Company in its fiscal year beginning July 1, 2009 and was applied to outstanding instruments as of that date. The adoption of the pronouncement’s requirements can affect the accounting for warrants and many convertible instruments with provisions that protect holders from a decline in the stock price (or “down-round” provisions). Down-round provisions reduce the exercise price of a warrant or convertible instrument if a company either issues equity shares for a price that is lower than the exercise price of those instruments or issues new warrants or convertible instruments that have a lower exercise price. All of the Company’s outstanding warrants and its convertible debt contain such provisions.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS (CONTINUED)

Outstanding instruments evaluated included (a) the Company's outstanding convertible debt and (b) warrants issued concurrent with the convertible debt issuance. With respect to the convertible debt element, based on guidance found in ASC Topic 815-10, we determined the economic characteristics and risks of the conversion element are clearly and closely related to and inseparable from the debt instrument. Thus adoption of the pronouncement did not affect the accounting treatment of the Company's convertible debt. A contingent beneficial conversion amount is required to be calculated and recognized when and if the adjusted conversion price of the convertible debt, currently \$1.65, is adjusted to reflect a down round stock issuance that reduces the conversion price below the \$1.22 fair value of the common stock on the issuance date of the convertible debt.

However, because the Company's warrants have "down-round" provisions, they can no longer be recorded in equity. Beginning July 1, 2009, the Company recognized the fair value of these warrants as a liability on its consolidated balance sheet, despite the fact that this deemed liability will never be settled in cash. Further, ASC Topic 815-10 requires warrants with "down-round" features to be recognized as a derivative liability. Accordingly, changes in the fair value of the warrants at each reporting period are required to be recognized as non-cash expense or income in the consolidated statement of operations. Future movements in the Company's stock price alone can materially affect both its results of operations and financial position in the future. Substantial movements in the Company's stock price could result in material volatility in our results of operations and financial position.

Upon adoption, a cumulative effect adjustment was recorded, based on amounts that would have been recognized if this guidance had been applied from the issuance date of the affected instruments. The following table illustrates the changes to the Company's consolidated balance sheet resulting from the implementation of ASC Topic 815-10:

	Balance at June 30, 2009	Cumulative Effect Adjustment	Balance at July 1, 2009
Warrant liabilities	–	\$ 6,780	\$ 6,780
Additional paid-in capital	\$ 13,000,680	\$ (327,524)	\$ 12,673,156
Accumulated deficit	\$ (2,658,171)	\$ 320,744	\$ (2,337,427)

The fair value of the warrants of \$327,524 was included in additional paid-in capital on the issuance date of the warrants (September 24, 2008). As a result of reclassifying these warrants from equity to liabilities, the cumulative effect of these adjustments on July 1, 2009 was a reduction of additional paid-in capital of \$327,524 and a corresponding reduction of the Company's accumulated deficit, less the \$6,780 fair value of the warrant obligation recognized at July 1, 2009.

As of December 31, 2009, the Company determined that, using the Black Scholes model, the fair value of the warrant obligations had increased by \$4,962. Accordingly, for the six months ended December 31, 2009, the Company recorded a "Loss on change in fair value of warrant liabilities" to its statement of operations. See Note 1, Fair Value Measurements, for more detail regarding the Black-Scholes assumptions used to estimate the fair value of the Company's warrant obligation.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS (CONTINUED)

Fair Value Accounting

In 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (ASC Topic 820) which defines fair value, establishes a market-based framework or hierarchy for measuring fair value and expands disclosures about fair value measurements. This guidance is applicable whenever another accounting pronouncement requires or permits assets and liabilities to be measured at fair value. It does not expand or require any new fair value measures; however the application of this statement may change current practice. We adopted this guidance for financial assets and liabilities effective July 1, 2008 and for non financial assets and liabilities effective July 1, 2009. The adoption did not have a material effect on our financial condition or results of operations.

In April 2009, the FASB issued the following updates that provide additional application guidance and enhance disclosures regarding fair value measurements and impairments of securities:

- FSP FAS 157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly” (ASC Topic 820-10-65). This update relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms the need to exercise judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. The FSP was effective for the Company’s annual reporting for the fiscal year ended on June 30, 2009. The implementation of FSP SFAS No. 157-4 did not materially impact the Company’s financial position, results of operations or cash flows.
- FSP FAS 107-1 and APB 28-1, “Interim Disclosures about Fair Value of Financial Instruments” (ASC Topic 320-10-65). This update requires fair value disclosures for financial instruments that are not currently reflected on the balance sheet at fair value on a quarterly basis. The disclosure requirement under this FSP was effective for the Company’s interim reporting period ending on September 30, 2009 and all appropriate disclosures have been reflected herein.

In August 2009, the FASB issued authoritative guidance for measuring liabilities at fair value that reaffirms the existing definition of fair value and reintroduces the concept of entry value into the determination of fair value of liabilities. Entry value is the amount an entity would receive to enter into an identical liability. The guidance was effective for our interim reporting period ending on December 31, 2009. The implementation did not have a material impact on our financial position, results of operations or cash flows.

Other Accounting Changes

In October 2009, the FASB amended its Emerging Issues Task Force (“EITF”) authoritative guidance addressing revenue arrangements with multiple deliverables. The guidance requires revenue to be allocated to multiple elements using relative fair value based on vendor-specific-objective-evidence, third party evidence or estimated selling price. The residual method also becomes obsolete under this guidance. This guidance is effective for our interim reporting period ending on September 30, 2010. We are currently evaluating the impact of the implementation of this guidance on our financial position, results of operations and cash flows.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 – CONDENSED CONSOLIDATED BALANCE SHEET COMPONENTS

		December 31, 2009 (Unaudited)	June 30, 2009
Accounts receivable, net			
Accounts receivable, gross		\$ 3,107,307	\$ 3,513,756
Allowance for doubtful accounts		(40,000)	(50,000)
Allowance for returns		(136,269)	(36,206)
		\$ 2,931,038	\$ 3,427,550
Inventories, net of reserves			
Raw materials		\$ 2,160,293	\$ 2,184,245
Finished goods		5,017,821	4,549,431
Less: reserves for obsolescence		(282,916)	(341,235)
		\$ 6,895,198	\$ 6,392,441
Property and Equipment, net			
	Useful Lives		
Equipment	3 – 7 years	\$ 2,894,265	\$ 2,801,027
Furniture and fixtures	7 years	578,672	578,672
Automobiles	5 years	30,434	30,434
Leasehold improvements	5 – 10 years	909,772	895,909
Tooling and molds	3 years	2,877,405	2,908,778
Construction-in-progress		304,710	297,230
		7,595,258	7,512,050
Less: Accumulated depreciation and amortization		5,809,285	5,415,064
		\$ 1,785,973	\$ 2,096,986
Goodwill and other intangible assets, net			
Goodwill		\$ 3,965,977	\$ 3,965,977
Other	1-5 years	46,000	46,000
		4,011,977	4,011,977
Less: Accumulated amortization		427,746	427,746
		\$ 3,584,231	\$ 3,584,231

NOTE 4 – DEBT

Bank Debt

The Company's indebtedness under secured commercial loan agreements consisted of the following:

December 31, 2009 (Unaudited)	June 30, 2009
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Short-term capital lease obligation	\$	–	\$	69,815
Bank term notes	\$	1,500,000	\$	1,500,000
Bank line of credit		1,615,866		1,249,132
Less: current maturities		–		–
Long-term debt	\$	3,115,866	\$	2,749,132
Total bank debt	\$	3,115,866	\$	2,818,947

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – DEBT (CONTINUED)

On February 12, 2008, the Company entered into an agreement with Sovereign Bank for a three year revolving line of credit. As amended, the advance limit under the line of credit is the lesser of: (a) \$4,900,000; or (b) up to 80% of eligible domestic accounts receivable and up to the lesser of \$750,000 or 75% of eligible foreign receivables plus up to the lesser of: (i) \$2,500,000; or (ii) 50% of eligible inventory; or (iii) 60% of the maximum amount available to be advanced under the line. The line of credit is collateralized by a first priority security interest in substantially all of the Company's U.S. based assets and its foreign receivables and requires payments of interest only through the facilities three year term. As amended on October 27, 2009, the interest rate on the term note and the line of credit varies based on the bank's prime rate and is equal to the greater of the bank's prime rate plus 3.25% or 7%. At December 31, 2009 the applicable interest rate on amounts drawn under the term note and the line of credit was 7%.

The revolving loan may be converted into one or more term notes upon mutual agreement of the parties. On February 12, 2008, the Company entered into a non-amortizing term note with the bank in the amount of \$1,500,000, due February 12, 2011. At December 31, 2009, this note had a principal balance of \$1,500,000. As of December 31, 2009, the Company had an outstanding balance of \$1,615,866 under the revolving line and approximately \$627,000 of undrawn availability under the credit line. At June 30, 2009, the Company had outstanding with the bank the \$1,500,000 term note and had an outstanding balance of \$1,249,132 drawn under its revolving credit line, with about \$1,005,000 of undrawn availability.

The Company's current credit facilities are subject to financial covenants. Current financial covenants include monitoring a ratio of debt to tangible net worth and a fixed charge coverage ratio, as defined in the loan agreements. At December 31, 2009 and June 30, 2009, the Company was in compliance with all of its financial covenants.

Convertible Debt

On September 24, 2008, the Company completed a \$1,250,000 convertible debt financing with MicroCapital Fund, LP and MicroCapital Fund, Ltd. ("MicroCapital"). The Company issued three year notes, bearing interest at 10% payable quarterly and convertible into shares of the Company's common stock at \$1.65 per share. The Company also issued (a) five year warrants to purchase 378,787 shares of the Company's common stock at \$1.65 per share, and (b) three year warrants allowing MicroCapital to repeat its investment up to \$1,250,000 on substantially the same terms and conditions.

The Company may call the three year warrants, subject to MicroCapital's preemptive right to exercise, at a redemption price of \$0.001 per share. The three year warrants may only be called after the earlier of 90 days after the registration statement is effective or June 24, 2009 if the closing sale price of the Company's common stock equals or exceeds \$1.83 per share for at least 24 trading days within a 30 trading day period; this threshold price increases by \$0.02 per share starting with the end of the following calendar month. MicroCapital has agreed to limit the number of shares that may be acquired upon the exercise of warrants by them to 4.999% of the Company's outstanding shares of common stock, which may be waived by MicroCapital upon 60 days notice. MicroCapital has also agreed to limit the number of shares that may be acquired upon the exercise the warrants to 9.999% of the Company's outstanding shares of common stock; this limit may not be waived. The Company has registered the shares potentially issuable as a

result of the transaction.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – DEBT (CONTINUED)

The transaction was recorded in accordance with EITF 00-27 “Application of Issue #98-5 to Certain Convertible Instruments” and EITF 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjusted Conversion Ratios" (ASC Topic 470-20), on a relative fair value basis. The \$486,615 fair value of the warrants and the debt’s beneficial conversion feature was recorded to equity and as a debt discount to the value of the convertible note. This discount is being amortized using the effective interest method over the three year term of the convertible note. Amortization of debt discount on this convertible note payable amounted to \$35,173 and \$67,852, respectively, for the three and six months ended December 31, 2009. The remaining unamortized discount was \$333,978 at December 31, 2009. In connection with this transaction, the Company also recognized a \$63,955 increase in its deferred tax liabilities reflecting the non-deductible nature of future debt discount amortization that will result from the value of the beneficial conversion feature.

NOTE 5 – LOSS PER SHARE

Basic loss per share is computed using the weighted average number of common shares outstanding. Diluted loss per share is computed using the weighted average number of common shares outstanding as adjusted for the incremental shares attributable to outstanding options, restricted stock units and warrants to purchase common stock.

The following table sets forth the computation of the basic and diluted loss per share:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Numerator for basic and diluted:				
Net loss	\$(50,856)	\$(516,737)	\$(310,085)	\$(39,341)
Denominator :				
For basic loss per common share – weighted average shares outstanding	11,945,712	11,721,467	11,891,969	11,719,283
Effect of dilutive securities - stock options, restricted stock units and warrants	–	–	–	–
For diluted loss per common share – weighted average shares outstanding adjusted for assumed exercises	11,945,712	11,721,467	11,891,969	11,719,283
Basic loss per share	\$(0.00)	\$(0.04)	\$(0.03)	\$(0.00)
Diluted loss per share	\$(0.00)	\$(0.04)	\$(0.03)	\$(0.00)

The following options and warrants to purchase common stock were excluded from the computation of diluted loss per share for the three and six months ended December 31, 2009 and 2008 because their exercise price was greater than the average market price of the common stock or as a result of the Company’s net loss for those periods:

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	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2009	2008	2009	2008
Anti-dilutive options and warrants	1,108,436	791,605	1,108,436	786,105

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 – STOCK-BASED COMPENSATION

The effect of recording stock-based compensation for the three and six months ended December 31, 2009 and 2008 was as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Stock-based compensation expense by type of award:				
Employee stock options	\$69,411	\$83,634	\$140,556	\$162,346
Non-employee director stock options	–	16,738	–	71,299
Non-employee restricted stock units	–	7,350	–	14,700
Employee restricted stock units	72,972	61,425	142,024	140,756
Non-employee director restricted stock units	19,653	35,848	68,153	35,848
Forfeiture rate adjustment	–	–	–	(56,751)
Amounts capitalized as inventory	(3,237)	3,010	(5,130)	(4,782)
Total stock-based compensation expense	\$158,799	\$208,005	\$345,603	\$363,416
Tax effect of stock-based compensation recognized	(53,591)	(78,721)	(116,247)	(163,154)
Net effect on net loss	\$105,208	\$129,284	\$229,356	\$200,262
Excess tax benefit effect on:				
Cash flows from operations	\$–	\$–	\$–	\$–
Cash flows from financing activities	\$–	\$–	\$–	\$–
Effect on loss per share:				
Basic	\$0.01	\$0.01	\$0.02	\$0.02
Diluted	\$0.01	\$0.01	\$0.02	\$0.02

As of December 31, 2009, the unrecorded deferred stock-based compensation balance was \$580,136 after estimated forfeitures and will be recognized over an estimated weighted average amortization period of about 1.7 years. During the three and six months ended December 31, 2009, the Company did not grant any stock options. During the three and six months ended December 31, 2009, the Company granted 577,000 shares of restricted stock with a grant date fair value of \$243,050 after estimated forfeitures.

During the quarter ended September 30, 2008, the Company reviewed its forfeiture rate experience associated with historic stock-based compensation grants. In doing so, it was determined that an increase in its forfeiture rate estimates were appropriate. In connection with this revision in estimate, the Company recognized a non-recurring cumulative effect pretax benefit in the amount of \$56,751 during the quarter ended September 30, 2008.

Valuation Assumptions

The Company estimates the fair value of stock options using a Black-Scholes option-pricing model. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model and the straight-line attribution approach with the following weighted-average assumptions:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009 (b)	2008 (a)	2009 (b)	2008
Risk-free interest rate	–	–	–	2.8%
Dividend yield	–	–	–	0.0%
Expected stock price volatility	–	–	–	58%
Average expected life of options	–	–	–	3.2 years

(a) No stock options were granted during the three months ended December 31, 2008.

(b) No stock options were granted during the three or six months ended December 31, 2009.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 – STOCK-BASED COMPENSATION (CONTINUED)

Authoritative guidance issued by the FASB requires the use of option pricing models that were not developed for use in valuing employee stock options. The Black-Scholes option-pricing model was developed for use in estimating the fair value of short-lived exchange traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock. For the current fiscal year, the expected stock price volatility assumption was determined using the Company's historic volatility.

The Company uses the simplified method suggested by the SEC in authoritative guidance for determining the expected life of the options. Under this method, the Company calculates the expected term of an option grant by averaging its vesting and contractual term. Based on studies of the Company's historic actual option terms, compared with expected terms predicted by the simplified method, the Company has concluded that the simplified method yields materially accurate expected term estimates. The Company estimates its applicable risk-free rate based upon the yield of U.S. Treasury securities having maturities similar to the estimated term of an option grant, adjusted to reflect its continuously compounded "zero-coupon" equivalent.

Equity Incentive Program

The Company's equity incentive program is a broad-based, long-term retention program that is intended to attract and retain qualified management and technical employees, and align stockholder and employee interests. The equity incentive program presently consists of three plans (the "Plans"): the Company's 1998 Incentive Plan, as Amended and Restated (the "1998 Plan"); the Company's 2006 Stock Incentive Plan, as Amended and Restated (the "2006 Plan"); and the Company's 2009 Stock Incentive Plan (the "2009 Plan"). Under these Plans, non-employee directors, officers, key employees, consultants and all other employees may be granted options to purchase shares of the Company's stock, restricted stock units and other types of equity awards. Under the equity incentive program, stock options generally have a vesting period of three to five years, are exercisable for a period not to exceed ten years from the date of issuance and are not granted at prices less than the fair market value of the Company's common stock at the grant date. Restricted stock units may be granted with varying service-based vesting requirements.

As of December 31, 2009, there are no common shares remaining available for future issuance under the 1998 Plan, which expired on June 17, 2008. Under the Company's 2006 Plan, 1,000,000 common shares are authorized for issuance through awards of options or other equity instruments. As of December 31, 2009, 6,875 common shares were available for future issuance under the 2006 Plan. Under the Company's 2009 Plan, 1,250,000 common shares are authorized for issuance through awards of options or other equity instruments. As of December 31, 2009, 498,000 common shares were available for future issuance under the 2009 Plan.

The following table summarizes the combined stock option plan and non-plan activity for the indicated periods:

	Number of Shares	Weighted Average Exercise Price
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Balance outstanding at June 30, 2009	1,085,216	\$	3.41
Six months ended December 31, 2009:			
Options granted	–		–
Options exercised	–		–
Options cancelled/expired/forfeited	(12,300)		2.07
Balance outstanding at December 31, 2009	1,072,916	\$	3.42

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 – STOCK-BASED COMPENSATION (CONTINUED)

The options outstanding and exercisable at December 31, 2009 were in the following exercise price ranges:

Range of Exercise Prices	Number Outstanding	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Contractual Life-Years	Weighted Average Exercise Price	Number Vested and Exercisable	Weighted Average Exercise Price
0.43 to \$0.85	26,600	3.3	\$0.59	26,600	\$0.59
1.00 to \$2.00	418,915	3.6	1.95	272,700	1.93
2.01 to \$6.33	627,401	5.0	4.52	440,349	4.53
	1,072,916	4.7	\$3.42	739,649	\$3.43

At December 31, 2009, 10,000 of the Company's exercisable options were in-the-money. At December 31, 2009, the aggregate intrinsic value of options outstanding and exercisable was \$4,500. No options were exercised during the three or six months ended December 31, 2009.

No stock options were granted during the three or six months ended December 31, 2009. No stock options were granted during the three months ended December 31, 2008. The weighted average grant date fair value of options granted during the six months ended December 31, 2008 was \$0.84.

The Company settles employee stock option exercises with newly issued common shares.

Restricted Stock Units

During the three months ended December 31, 2009, the Company's Board of Directors approved the grant of 252,000 shares of restricted stock units to non-employee directors and 325,000 shares of restricted stock units to employees. These restricted stock units vest over two years from the grant date for non-employee directors and over three years from the grant date for employees. The value of the restricted stock units is based on the closing market price of the Company's common stock on the date of award. Stock-based compensation expense, net of estimate forfeitures, for restricted stock units for the three and six months ended December 31, 2009 was \$92,625 and \$210,177, respectively.

As of December 31, 2009, there was \$322,733 of total unrecognized deferred stock-based compensation, after estimated forfeitures, related to non-vested restricted stock units granted under the Plans. That cost is expected to be recognized over an estimated weighted average period of 2.0 years.

The following table summarizes the Company's restricted stock unit activity for the indicated periods:

	Number of Shares	Grant Date Fair Value	Weighted Average Grant Date Fair Value Per Share
Balance unvested at June 30, 2009	625,791	\$ 773,510	\$ 1.24
Six months ended December 31, 2009:			
Restricted stock units granted	577,000	403,900	0.70
Restricted stock units vested	(217,948)	(354,325)	1.63
Restricted stock units cancelled/forfeited	(3,323)	(6,646)	2.00
Balance unvested at December 31, 2009	981,520	\$ 816,439	\$ 0.83

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7 – ACCRUED PRODUCT WARRANTY COSTS

The Company provides a warranty for all of its consumable supply products and for its INKlusive printer program, which was discontinued on April 1, 2009. Although no new INKlusive contracts were originated after April 1, 2009, remaining service and supply commitments under the program continue to be honored. The Company's warranty stipulates that it will pay reasonable and customary charges for the repair of a printer needing service as a result of using the Company's products. The Company estimates the costs that may be incurred and records a liability in the amount of such costs at the time product revenue is recognized. Factors that may affect the warranty liability and expense include the number of units shipped to customers, historical and anticipated rates of warranty claims and cost per claim. The Company periodically assesses the adequacy of the recorded warranty liability and adjusts the amount as necessary. These expenses are classified as a separately captioned item in cost of goods sold.

Changes in accrued product warranty costs for the three and six months ended December 31, 2009 and 2008 were as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Accrued product warranty costs at the beginning of the period	\$436,578	\$205,563	\$436,578	\$198,666
Warranties accrued during the period	519,491	227,330	987,863	441,499
Warranties settled during the period	(508,102)	(245,659)	(976,474)	(452,931)
Net change in accrued warranty costs	11,389	(18,329)	11,389	(11,432)
Accrued product warranty costs at the end of the period	\$447,967	\$187,234	\$447,967	\$187,234

NOTE 8 – RESEARCH AND DEVELOPMENT

Research and product development costs, which consist of salary and related benefits costs of the Company's technical staff, as well as product development costs including research of existing patents, conceptual formulation, design and testing of product alternatives, and construction of prototypes, are expensed as incurred. It also includes indirect costs, including facility costs based on the department's proportionate share of facility use. For the three months ended December 31, 2009 and 2008, the Company's research and product development costs were \$372,004 and \$348,194, respectively. For the six months ended December 31, 2009 and 2008, the Company's research and product development costs were \$712,884 and \$721,246, respectively.

NOTE 9 – ADVERTISING EXPENSES

Advertising expenses are deferred until the first use of the advertising. Deferred advertising costs at December 31, 2009 and 2008 totaled \$44,555 and \$15,276, respectively. Advertising expense for the three months ended December 31, 2009 and 2008 amounted to \$172,168 and \$180,559, respectively. Advertising expense for the six months ended

December 31, 2009 and 2008 amounted to \$307,504 and \$392,206, respectively.

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MEDIA SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10 – LITIGATION AND CONTINGENCIES

On June 23, 2006, Xerox Corporation filed a patent infringement lawsuit in the United States District Court, for the Southern District of New York, Case No. 06CV4872, against Media Sciences International, Inc. and Media Sciences, Inc., alleging that the Company's solid inks designed for use in the Xerox Phaser 8500 and 8550 printers infringe four Xerox-held patents related to the shape of the ink sticks in combination with the Xerox ink stick feed assembly. The suit seeks unspecified damages and fees. In the Company's answer and counterclaims in this action, it denied infringement and it seeks a finding of invalidity of the Xerox patents in question. The Company also submitted counterclaims against Xerox for breach of contract and violation of U.S. antitrust laws, seeking treble damages and recovery of legal fees. On September 14, 2007, the court denied Xerox's motion to dismiss the antitrust counterclaims brought by the Company. Pre-trial discovery on the infringement action was completed in September 2007. Pre-trial discovery on the Company's antitrust action was completed in July 2008. In March 2009 the court dismissed, without prejudice, the Company's antitrust claims relating to Xerox's loyalty rebate programs. In the ruling, the court relied on a 2001 Settlement Agreement between the parties resulting from a different matter, and found that before such claims are pursued, the Company must submit to arbitration. In September 2009 the court dismissed the Company's remaining antitrust claims not relating to Xerox's loyalty rebate programs. The patent infringement claims remaining before the court may be heard in the spring or summer of 2010. The loss of all or a part of the patent infringement claims could have a material adverse affect on our results of operations and financial position. The Company believes that its inks do not infringe any valid U.S. patents and that it therefore has meritorious grounds for success in this case. The Company intends to vigorously defend these allegations of infringement. There can be no assurance, however, that the Company will be successful in its defense of this action. Proceeds of this suit, if any, will be recorded in the period when received.

In May 2005, the Company filed suit in New Jersey state court against its former insurance broker for insurance malpractice. This litigation was settled in August 2008. Under the settlement, Media Sciences received proceeds of \$1,500,000. Proceeds of this settlement are recognized in the Company's results of operations. The settlement is recorded as a reduction to operating expense during the quarter ended September 30, 2008. The settlement received represents a recovery of legal fees incurred to pursue the action and a partial recovery of product warranty expense the Company incurred during its fiscal 2002 year.

Other than the above, as at December 31, 2009, the Company was not a party to any material pending legal proceeding, other than ordinary routine litigation incidental to its business.

NOTE 11 – IMPAIRMENT CHARGE

In conjunction with a plan approved by the Company's Board of Directors, the Company closed its not yet operational manufacturing facility in China. The impairment costs were recognized in accordance with the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (ASC Topic 360). During the three and six months ended December 31, 2009, cash charges totaling \$6,917 and \$26,976, respectively, were incurred against impairment reserves established in the prior fiscal year. At December 31, 2009, the remaining reserve for these impairment costs was \$13,475.

NOTE 12 – SUBSEQUENT EVENT

On February 9, 2010, the Company became aware that a printer original equipment manufacturer (OEM) had sent notices to several of the Company's European distribution customers alleging that a product line sold by them, that the Company manufactures and distributes, infringes on the OEM's European patent rights and demanding that each customer cease sale of the product. The Company has decided to cease offering these products for sale in Europe and the U.S. while the Company evaluates these claims. At this time the Company is unable to determine the potential impact this event may have on its financial position, results of operations, or cash flows. For the three months ended December 31, 2009, sale of these affected products in the U.S. and Europe represented about 4% of the Company's consolidated net revenues and less than 2% of its gross profits. At December 31, 2009, these products represented less than 6% of the Company's consolidated inventories.

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

FORWARD LOOKING STATEMENTS

Our disclosure and analysis in this report contain forward-looking information, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, about our financial results and estimates, business prospects and products in development that involve substantial risks and uncertainties. You can identify these statements by the fact that they do not relate strictly to historic or current facts. These forward-looking statements use terms such as "believes," "expects," "may", "will," "should," "anticipates," "estimate," "project," "plan," or "forecast" or other words of similar meaning relating to future operating or financial performance or by discussions of strategy that involve risks and uncertainties. From time to time, we also may make oral or written forward-looking statements in other materials we release to the public. These forward-looking statements are based on many assumptions and factors, and are subject to many conditions, including, but not limited to, our continuing ability to obtain additional financing, dependence on contracts with suppliers and major customers, competitive pricing for our products, demand for our products, changing technology, our introduction of new products, industry conditions, anticipated future revenues and results of operations, retention of key officers, management or employees, prospective business ventures or combinations and their potential effects on our business. Our actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. Forward-looking statements are made based upon management's current expectations and beliefs concerning future developments and their potential effects upon our business.

We cannot guarantee that any forward-looking statement will be realized, although we believe we have been prudent in our plans and assumptions. We cannot predict whether future developments affecting us will be those anticipated by management, and there are a number of factors that could adversely affect our future operating results or cause our actual results to differ materially from the estimates or expectations reflected in such forward-looking statements.

Factors that might cause or contribute to such differences include, but are not limited to, those discussed in this section and those set forth in Item 6, "Factors Affecting Results Including Risks and Uncertainties" included in our Form 10-K for the year ended June 30, 2009, filed September 24, 2009. You should carefully review these risks and also review the risks described in other documents we file from time to time with the SEC. You are cautioned not to place undue reliance on these forward-looking statements. We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise.

You should read the following discussion and analysis in conjunction with the information set forth in the unaudited financial statements and notes thereto, included elsewhere herein, and the audited financial statements and the notes thereto, included in our Form 10-K for the year ended June 30, 2009, filed September 24, 2009.

EXECUTIVE SUMMARY

Media Sciences International, Inc. is the leading independent manufacturer of color toner cartridges and solid inks for use in business color printers. Our products are distributed through an international network of dealers and distributors.

For the three and six months ended December 31, 2009 we experienced 8% and 2% top line net revenue growth over same year ago periods. Within this growth we continued to experience attrition of more price sensitive, lower margin, and less quality oriented imaging channel volume. This attrition was more than offset by continued growth of our sales volume into the office products and technology distribution channel. These channels tend to place greater value on product quality that is intellectual property safe and backed by warranty and technical support. Our top-line also

continues to benefit from the continued higher growth rate of our European business.

Our gross margins have been favorably affected by these shifts in our revenue mix. These shifts have resulted in a year-over-year reduction in the level of customer rebates and our European growth was further benefitted by the combination of a European price increase we implemented last year and improved euro exchange rates. Collectively, these items enhanced both our top line revenues and margins during the quarter. These favorable trends continue to be offset by warranty costs that remain elevated at historically high levels. Reducing warranty expense has been and remains a high priority of management.

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Following a year of cost reduction efforts that included closure of our start-up manufacturing operation in China, a reduction in our employee headcount of about 27%, and temporary company-wide compensation concessions, we are focused on efforts to grow our top line and further improve our profitability.

The following items significantly impacted our comparative reported results of operations for the three and six months ended December 31, 2009:

Product Warranty. During the three and six months ended December 31, 2009, we recognized \$519,000 and \$988,000 of warranty expense, respectively, representing a \$292,000 and \$546,000 increase, respectively over the amount of warranty expense recognized in the comparative year ago periods. These increases represent after tax increases of about \$193,000 (\$0.02 per share) and \$360,000 (\$0.03 per share), respectively, for the three and six months ended December 31, 2009.

Foreign Currency Effects. For the three months ended December 31, 2009, as compared with the year ago period, appreciation of the euro helped benefit our top line revenues and margins by about \$75,000. On top of this, we estimate that the European price increases we implemented last January added another \$50,000 in revenues and margins on a comparative basis. For the six months ended December 31, 2009, as compared with the year ago period, we estimate on a constant dollar basis, the devaluation of the British pound adversely affected our revenues and margins by about \$125,000. However, we estimate that our European price increases more than compensated this devaluation.

Stock-Based Compensation. For the three and six months ended December 31, 2009, our non-cash stock-based compensation expense recognized under authoritative guidance totaled \$159,000 (\$105,000 after tax or \$0.01 per share) and \$346,000 (\$229,000 after tax or \$0.02 per share), respectively. In the prior fiscal year, non-cash stock-based compensation expense totaled \$208,000 (\$129,000 after tax or \$0.01 per share) and \$363,000 (\$200,000 after tax or \$0.02 per share), respectively, for the three and six months ended December 31, 2008.

Temporary Company-wide Compensation Concessions. In January 2009, we implemented a company-wide 10% salary, wage and bonus concession. In the fall of 2008, our directors also waived their cash compensation. Effective October 1, 2009, half of these temporary concessions were reinstated and are reflected in our operating results. For the three and six months ended December 31, 2009, the savings associated with these temporary concessions were about \$65,000 (about \$43,000 after tax or about \$0.00 per share) and \$196,000 (about \$129,000 after tax or about \$0.01 per share), respectively.

Litigation. For the three and six months ended December 31, 2009, litigation costs totaled \$18,000 (about \$12,000 after tax or about \$0.00 per share) and \$23,000 (about \$15,000 after tax or about \$0.00 per share). In the comparative year ago periods, litigation costs totaled \$79,000 (about \$47,000 after tax or about \$0.00 per share) and \$263,000 (about \$158,000 after tax or about \$0.01 per share), respectively, for the three and six months ended December 31, 2008. In August 2008, the first fiscal quarter of 2009, we settled litigation with our former insurance broker in the amount of \$1,500,000 (about \$990,000 after tax or about \$0.08 per share). For more information regarding our litigation, see Note 10 to the condensed consolidated financial statements.

Business Formation and Start-up Costs. For the three and six months ended December 31, 2009, we incurred no formation and start-up costs associated with the China operations due to closure of the facility and ceasing the start-up activities late in our prior fiscal year. In the prior fiscal year, formation and start-up costs associated with these operations totaled \$344,000 (about \$206,000 after tax or about \$0.02 per share) and \$643,000 (about \$386,000 after tax or about \$0.03 per share), respectively, for the three and six months ended December 31, 2008.

Net revenues, cost of goods sold, gross profit, gross margin, income (loss) from operations, net income (loss), and diluted earnings (loss) per share are the key indicators we use to monitor our financial condition and operating performance. We also use certain non-GAAP measures such as earnings before interest, taxes, depreciation and amortization (EBITDA) to assess business trends and performance, and to forecast and plan future operations.

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The following table sets forth the key quarterly and annual GAAP financial measures we use to manage our business (in thousands, except per share data).

	Fiscal Year 2010		Fiscal Year 2009			
	1st Quarter	2st Quarter	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Net revenues	\$5,507	\$5,586	\$5,752	\$5,157	\$5,184	\$5,625
Cost of goods sold	\$3,377	\$3,074	\$3,131	\$3,035	\$3,081	\$3,576
Gross profit	\$2,129	\$2,512	\$2,621	\$2,122	\$2,103	\$2,049
Gross margin	38.7%	45.0%	45.6%	41.2%	40.6%	36.4%
Income (loss) from operations						
(a)(c)	\$(203)	\$44	\$901	\$(814)	\$(1,583)	\$0
Operating margin	(3.7)%	(0.0)%	15.7%	(15.8)%	(30.5)%	0.0%
Net income (loss)(b)(c)(d)(e)	\$(259)	\$(51)	\$477	\$(517)	\$(1,496)	\$(140)
Diluted earnings (loss) per share	\$(0.02)	\$(0.00)	\$0.04	\$(0.04)	\$(0.13)	\$(0.01)
Stock-based compensation included in above results:						
(a) Pretax	\$187	\$159	\$155	\$208	\$217	\$197
(b) After-tax	\$124	\$105	\$84	\$141	\$145	\$132

(c) 1st quarter 2009 includes the benefit of the \$1,500 litigation settlement (about \$990 after tax).

(d) 3rd quarter 2009 includes \$1,121 (about \$740 after tax) of impairment charges primarily associated with the closure of the Company's manufacturing operations in China. 4th quarter 2009 includes \$112 (about \$74 after tax) of recoveries and cash charges realized related to the impairment.

(e) 3rd & 4th quarter 2009, respectively, include a \$323 and \$209 non-cash charge related to a deferred tax asset valuation allowance.

RESULTS OF OPERATIONS

Net Revenues. For the three months ended December 31, 2009, as compared to the same period last year, net revenues increased by \$430,000 or 8% from \$5,157,000 to \$5,586,000. This increase in net revenues was primarily driven by the revenue impact of greater year-over-year sales of toner-based products and continued rapid growth of our European sales. Year-over-year for the three months, sales of color toner cartridges increased by about 18% and solid ink product sales decreased by about 10%.

For the six months ended December 31, 2009, as compared to the same period last year, net revenues increased by \$184,000 or 2% from \$10,909,000 to \$11,093,000. This increase in net revenues was primarily driven by the revenue impact of greater year-over-year sales of toner-based products and continued rapid growth of our European sales, partially offset by attrition in our sales volumes to the price sensitive and less quality oriented imaging channel. Year-over-year for the six months, sales of color toner cartridges increased by about 11% and solid ink product sales decreased by about 12%.

Price increases we implemented in January 2009 materially offset the effects of currency exchange rates for the six months ended December 31, 2009 and provided a positive benefit to our revenues, as discussed in the Executive Summary, versus the comparable year ago periods. We ended the quarter with an order backlog of \$326,000, representing a \$47,000 increase over the prior quarter ended September 30, 2009. For the comparative year ago period, we had \$343,000 of order backlog at December 31, 2008.

Gross Profit. Consolidated gross profit for the three months ended December 31, 2009, compared to the same period last year, increased by \$390,000 or 18% to \$2,512,000 from \$2,122,000. For the three months ended December 31, 2009, our gross margins increased by about 380 basis points to 45.0% from 41.2% in the comparative year ago period. The year-over-year improvement in our gross profit and margins for the quarter was attributed to a number of factors including: decreased level of customer rebates; lower tool and die depreciation; decreases in our inventory obsolescence reserves and sales mix. As discussed in the Executive Summary, a combination of favorable exchange rate movements, a price increase we implemented last January in our European pricing, and growth in our European revenues also had a positive impact on margins. These favorable items were partially offset by the large year-over-year increase in our warranty expense and higher inbound freight costs.

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Consolidated gross profit for the six months ended December 31, 2009, compared to the same period last year, decreased by \$101,000 or 2% to \$4,642,000 from \$4,743,000. For the six months ended December 31, 2009, our gross margins decreased by about 170 basis points to 41.8% from 43.5% in the comparative year ago period. The year-over-year decrease in our gross profit and margins for the six months was primarily attributed to an increase in our warranty expense, partially offset by lower year-over-year customer rebates and a decrease in our inventory obsolescence reserves.

Our margins reflect a portfolio of products. Generally, solid ink products generate greater margins than do toner-based products. While margins within the solid ink product line are very consistent, margins within the toner-based product line vary quite significantly. As a result, our margins can vary materially, not only as a function of the solid ink to toner sales mix, but of the sales mix within the toner-based product line itself. We expect to see changes in our margins, both favorable and unfavorable, as a result of continued changes in our sales mix.

Research and Development. Research and development spending for the three months ended December 31, 2009, compared to the same period last year, increased by \$24,000 or 7% to \$372,000 from \$348,000. For the six months ended December 31, 2009, compared to the same period last year, decreased by \$8,000 or 1% to \$713,000 from \$721,000. The nominal year-to-date decrease in our research and development costs is attributed to our cost reduction efforts over the past year. Looking forward, we expect our research and development spending to represent a similar proportion of our net revenues.

Selling, General and Administrative. Selling, general and administrative expense, exclusive of depreciation and amortization, for the three months ended December 31, 2009, compared to the same period last year, decreased by \$463,000 or 19% to \$2,033,000 from \$2,496,000. For the six months ended December 31, 2009, selling, general and administrative expense, exclusive of depreciation and amortization, as compared to the same period last year, decreased by \$1,298,000 or 25% to \$3,950,000 from \$5,248,000.

The decrease in selling, general and administrative expense was primarily driven by our cost reduction efforts and lower year-over-year costs of litigation and improvements in our currency translation loss experience. These are described in more detail in the Executive Summary.

Depreciation and Amortization. Non-manufacturing depreciation and amortization expense for the three months ended December 31, 2009 compared to the same period last year, decreased by \$29,000 or 32% to \$63,000 from \$92,000. For the six months ended December 31, 2009, compared to the same period in 2008, non-manufacturing depreciation and amortization expense decreased by \$48,000 or 26% to \$138,000 from \$186,000. The decrease in non-manufacturing depreciation and amortization expense reflects the decline in our non-manufacturing fixed asset additions over the comparative periods.

Interest Expense. For the three and six months ended December 31, 2009, we incurred interest expense of \$90,000 and \$177,000, respectively. This compares with interest expense of \$74,000 and \$129,000, respectively, for the prior year's three and six months ended December 31, 2008. These changes were the result of year-over-year increases in the Company's level of debt and higher interest rates.

Income Taxes. For the three and six months ended December 31, 2009, we recorded an income tax benefit of \$16,000 and \$99,000, respectively. This compares with income tax benefits of \$396,000 and \$26,000, respectively, for the three and six months ended December 31, 2008. For the three and six months ended December 31, 2009, our effective tax rates were 24.1%. This compares with 43.4% and 40.0%, respectively, for the three and six months ended December 31, 2008. Our effective blended state and federal tax rate varies due to the magnitude of various permanent differences between reported pretax income and what is recognized as taxable income by various taxing authorities.

Net Loss. For the three and six months ended December 31, 2009, we lost \$51,000 (\$0.00 per share basic and diluted) and \$310,000 (\$0.03 per share basic and diluted). This compares with a net loss of \$517,000 (\$0.04 per share basic and diluted) and \$39,000 (\$0.00 per share basic and diluted), respectively, for the three and six months ended December 31, 2008. Excluding the benefit of the non-recurring litigation settlement recognized in the comparative year ago period ended December 31, 2008, we would have generated a net loss of about \$1,029,000 on a pro forma basis.

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RECENT ACCOUNTING PRONOUNCEMENTS

See Note 2 to the condensed consolidated financial statements, included in Item 1 of Part I of this report, for a full description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on our consolidated financial statements, which is incorporated herein by reference.

CRITICAL ACCOUNTING POLICIES

For a description of our critical accounting policies see Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 1 to the audited financial statements included in our Form 10-K for the year ended June 30, 2009 filed September 24, 2009. With the exception of changes to our accounting policies and related disclosures resulting from the Accounting Standards Codification and adoption of authoritative guidance for fair value measurements and that associated with derivatives and hedging related to whether an instrument of an embedded feature is considered to be indexed to an entity's own stock under ASC 715-10 (pre-codification EITF Issue No. 07-5), there were no significant changes in our critical accounting policies during the six months ended December 31, 2009. See Note 2 to the condensed consolidated financial statements, included in Item 1 of Part I of this report, for a complete discussion of the impact adoption of this authoritative guidance had on our accounting policies.

LIQUIDITY AND CAPITAL RESOURCES

During the six months ended December 31, 2009, our cash and equivalents decreased by \$112,000 to \$438,000. \$323,000 of this decrease resulted from operating activities, \$83,000 was used in investing activities, and \$315,000 was provided by financing activities. Net cash used in investing activities of \$83,000 included the purchase of plant equipment, tooling and IT hardware and software, representing a decrease of \$514,000 or 86% over the \$597,000 invested during the comparative six months year ended December 31, 2008. These capital investments were primarily funded by draws on our bank credit line.

We used \$323,000 of cash in our operating activities for the six months ended December 31, 2009 as compared with \$193,000 used during the comparative six months ended December 31, 2008. The \$323,000 of cash used by operating activities during the six months ended December 31, 2009 resulted from a \$310,000 loss from operations, non-cash charges totaling \$746,000, and \$759,000 of cash used primarily to increase our non-cash working capital (current assets less cash and cash equivalents net of current liabilities). The most significant drivers behind the \$759,000 increase in our non-cash working capital include: (1) a \$578,000 reduction in our trade obligations and other accrued expenses; (2) a \$439,000 increase in our inventories; and (3) a collective \$206,000 decrease in our deferred revenue and deferred rent liabilities. These increases were partially offset by a \$371,000 decrease in our accounts receivable and a \$111,000 decrease in prepaid expenses and other current assets during the quarter.

Our INKlusive program generated operating cash flow in advance of the income statement recognition associated with printer consumables being shipped and revenues being recognized over the two year term of our typical INKlusive supply agreement. This advanced funding of the INKlusive contract consideration by a third-party leasing company resulted in up-front cash receipts and corresponding deferred revenue obligations. As of December 31, 2009, deferred revenue associated with the program totaled \$86,000, a decrease of \$162,000 from \$248,000 at June 30, 2009. The operating cash flow effect of this decrease in liability was a corresponding decrease in cash flow generated by operations. Based on declining INKlusive sales volume, we made the decision to discontinue the program effective April 1, 2009. Although no new INKlusive contracts were originated after April 1, 2009, remaining commitments under existing INKlusive supply obligations continue to be honored.

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In the comparative year ago period ended December 31, 2008 our financial position and cash flows benefited from the following:

- A \$1,500,000 litigation settlement received in August 2008. The settlement was recorded as a reduction in operating expense as it represented a recovery of legal fees previously incurred; and
- A \$1,250,000 convertible debt financing completed on September 24, 2008. In the transaction we issued three year notes, bearing interest at 10% payable quarterly and convertible into shares of our common stock at \$1.65 per share. We also issued: (a) five year warrants allowing the investor to purchase 387,787 shares of our common stock at \$1.65 per share; and (b) three year warrants allowing the investor to repeat its investment up to \$1,250,000 on substantially the same terms and conditions. The three year warrants may be called by us if certain criteria are met.

On February 12, 2008, we entered into an agreement with Sovereign Bank for a three year revolving line of credit. As amended, the advance limit under the line of credit is the lesser of: (a) \$4,900,000; or (b) up to 80% of eligible domestic accounts receivable and up to the lesser of \$750,000 or 75% of eligible foreign receivables plus up to the lesser of: (i) \$2,500,000; or (ii) 50% of eligible inventory; or (iii) 60% of the maximum amount available to be advanced under the line. The line of credit is collateralized by a first priority security interest in substantially all of our U.S. based assets and its foreign receivables and requires payments of interest only through the facilities three year term. As amended on October 27, 2009, the interest rate on the term note and the line of credit varies based on the bank's prime rate and is equal to the greater of the bank's prime rate plus 3.25% or 7%. At December 31, 2009 the applicable interest rate on amounts drawn under the term note and the line of credit was 7%.

The revolving loan may be converted into one or more term notes upon mutual agreement of the parties. On February 12, 2008, we entered into a non-amortizing term note with the bank in the amount of \$1,500,000, due February 12, 2011. At December 31, 2009, this note had a principal balance of \$1,500,000. As of December 31, 2009, we had an outstanding balance of \$1,615,866 under the revolving line and approximately \$627,000 of undrawn availability under the credit line. At June 30, 2009, we had outstanding with the bank the \$1,500,000 term note and had an outstanding balance of \$1,249,132 drawn under its revolving credit line, with about \$1,005,000 of undrawn availability.

Our current credit facilities are subject to financial covenants. At June 30, 2009 and December 31, 2009, we were in compliance with all of our financial covenants. Current financial covenants include monitoring a ratio of debt to tangible net worth and a fixed charge coverage ratio, each are described below:

- Ratio of Debt to Tangible Net Worth -- The Borrower is not to cause or permit its ratio of total liabilities to Tangible Net Worth to be more than 2.5:1, tested quarterly. Tangible Net Worth is defined as book net worth less all intangible assets. Both total liabilities and Tangible Net Worth are to be determined according to GAAP.
- Fixed Charge Coverage Ratio -- The Borrower is not to cause or permit its Fixed Charge coverage ratio, tested quarterly, on a rolling three month basis for the quarter ended December 31, 2009, on a rolling six, nine and twelve month basis for each quarter ending thereafter until quarter ending September 30, 2010; and thereupon for the quarter ending September 30, 2010 and each quarter thereafter based upon a trailing twelve month basis, to be less than 1.05:1. Fixed Charge is defined as earnings before interest, taxes, depreciation and amortization ("EBITDA") (including an add back for non-cash stock based compensation) less the sum of: cash taxes; cash capital expenditures; any cash dividends, distributions or loans, and other cash payments not captured on the current profit and loss statement, divided by principal payments on term debt (or capital leases), and cash interest. For all of the foregoing determinations, any equity contribution made to the Borrower will be applied to offset cash capital expenditures. For those of the foregoing determinations made during fiscal periods 2009 and 2010 only which will be determined on a rolling twelve month basis, cash received by Borrower from convertible debt offerings and associated warrants will be applied to offset cash capital expenditures together with the payments made to PNC Equipment Finance LLC/PNC Leasing pursuant to paragraph 5 of the Third Amendment.

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The most restrictive of these covenants is the Fixed Charge Coverage Ratio. For the three months ended December 31, 2009, our Fixed Charge Coverage Ratio was 2.9:1. Reference should also be made to our "Risk Factors" found in of our Form 10-K for the year ended June 30, 2009, filed September 24, 2009, where we specifically discuss: "Covenants in our debt instruments could trigger a default adversely affecting our ability to execute our business plan, our ability to obtain further financing, and potentially adversely affect the ownership of our assets."

Over the next twelve months, our operations may require additional funds and may seek to raise such additional funds through public or private sales of debt or equity securities, or securities convertible or exchangeable into such securities, strategic relationships, bank debt, lease financing arrangements, or other available means. We cannot provide assurance that additional funding, if sought, will be available or, if available, will be on acceptable terms to meet our business needs. If additional funds are raised through the issuance of equity securities, stockholders may experience dilution, or such equity securities may have rights, preferences, or privileges senior to those of the holders of our common stock. If additional funds are raised through debt financing, the debt financing may involve significant cash payment obligations and financial or operational covenants that may restrict our ability to operate our business. An inability to fund our operations or fulfill outstanding obligations could have a material adverse effect on our business, financial condition and results of operations.

SEASONALITY

Historically, we have not experienced any significant seasonality in our business. As we continue to grow our international business relative to our North American business and as our distribution channel customer mix changes, we may experience a more notable level of seasonality, especially during the summer months and other periods such as calendar year end.

MARKET RISK

We are exposed to various market risks, including changes in foreign currency exchange rates and commodity price inflation. Market risk is the potential loss arising from adverse changes in market rates and prices, such as foreign currency exchange, commodity price inflation and interest rates. We do not hedge our foreign currency exposures as the net impact of these exposures has historically been insignificant. We had no forward foreign exchange contracts outstanding as of December 31, 2009. In the future we may hedge these exposures based on our assessment of their significance.

Foreign Currency Exchange Risk

A significant portion of our business is conducted in countries other than the U.S. We are primarily exposed to changes in exchange rates for the Euro, the British Pound, the Japanese yen, and the Chinese yuan. At December 31, 2009, about 58% of our receivables were invoiced and collected in U.S. dollars. Beginning in our fiscal second quarter ended December 31, 2007, we were exposed to currency exchange risk from euro and British pound-denominated sales. For these transactions we expect to be a net receiver of the foreign currency and therefore benefit from a weaker U.S. dollar and are adversely affected by a stronger U.S. dollar.

Today, a significant portion of our toner-based products are purchased in U.S. dollars from Asian vendors and contract manufacturers. Although such transactions are denominated in U.S. dollars, over time, we are adversely affected by a weaker U.S. dollar, in the form of price increases, and, conversely, benefit from a stronger U.S. dollar. In these transactions, we benefit from a stronger U.S. dollar and are adversely affected by a weaker U.S. dollar. Accordingly, changes in exchange rates, and in particular a weakening of the U.S. dollar, may adversely affect our consolidated operating expenses and operating margins which are expressed in U.S. dollars.

See the discussion above under the heading "Executive Summary" in Item 2 of this report regarding the impact during the current reporting periods of changes in foreign exchange rates.

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Commodity Price Inflation Risk

Over the last twelve months, we have experienced increases in raw material costs and the costs of shipping and freight to deliver those materials and finished products to our facility and, where paid for by us, shipments to customers. While we have historically offset a significant portion of this inflation in operating costs through increased productivity and improved yield, recent increases have impacted profit margins. We are pursuing efforts to improve our procurement of raw materials. We can provide no assurance that our efforts to mitigate increases in raw materials and shipping and freight costs will be successful.

Interest Rate Risk

At December 31, 2009, we had about \$3,116,000 of debt outstanding under its line of credit and term notes. Interest expense under this line of credit is variable, based on its lender's prime rate. Accordingly, we are subject to interest rate risk in the form of greater interest expense in the event of rising interest rates. We estimate that a 10% increase in interest rates, based on our present level of borrowings, would result in the Company incurring about \$22,000 pretax (\$15,000 after tax) of greater interest expense.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Reference is made to the information set forth under the caption “Market Risk” included in Item 2 of Part I of this report, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Also refer to the last paragraph of “Liquidity and Capital Resources” contained in Item 2 of Part I this report for additional discussion of issues regarding liquidity.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. As required by Rule 13a-15(b) under the Exchange Act, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the effectiveness of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms, and is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting. There has been no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) under the Exchange Act, that occurred during the quarter ended December 31, 2009, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth above under Note 10 contained in the “Notes to condensed consolidated financial statements” in Item 1 of Part I of this report is incorporated herein by reference.

ITEM 1A. RISK FACTORS

A description of factors that could materially affect our business, financial condition or operating results is included in Item 1A “Risk Factors” of our Form 10-K for the year ended June 30, 2009, filed September 24, 2009 and is incorporated herein by reference.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

We held an annual meeting of stockholders on December 17, 2009, at which our stockholders voted on the following items:

1. the election of directors to serve until the next annual meeting and until their successors have been duly elected and qualified; and
2. the ratification of the selection of Amper, Politziner & Mattia, P.C. as our independent registered public accounting firm for the fiscal year ending June 30, 2010.

The nominees for directors were elected based upon the following votes:

	For	Votes Withheld
1. Election of directors		
Michael W. Levin	8,714,617	969,219
Willem van Rijn	8,705,070	978,765
Paul C. Baker	8,734,124	949,711
Edwin Ruzinsky	8,704,970	978,865
Henry Royer	8,682,891	1,000,944
Dennis Ridgeway	8,741,224	942,611

The voting results on the other proposals were as follow:

	For	Against	Abstentions	Non-Votes
2. Ratification of selection of independent registered public accounting firm	9,663,273	20,330	232	–

ITEM 5. OTHER INFORMATION

Not applicable.

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ITEM 6. EXHIBITS

The following exhibits are filed with this report:

Exhibit No.	Description
10.1	Fourth Agreement of Amendment to Revolving Loan and Security Agreement and Other Documents (incorporated by reference to Exhibit 10.1 of Form 8-K, filed on October 29, 2009)
10.2	Lease Extension Rider (incorporated by reference to Exhibit 10.1 of Form 8-K, filed on November 24, 2009)
10.3+	Form of Employment Agreement with Michael Levin (incorporated by reference to Exhibit 10.2 of Form 8-K, filed on November 24, 2009)
31.1*	Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a)
31.2*	Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a)
32.1*	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2*	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

* Filed herewith

+ Represents executive compensation plan or agreement

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SIGNATURES

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

MEDIA SCIENCES INTERNATIONAL,
INC.

Dated: February 11, 2010

By: /s/ Michael W. Levin
Michael W. Levin
Chief Executive Officer

Dated: February 11, 2010

By: /s/ Kevan D. Bloomgren
Kevan D. Bloomgren
Chief Financial Officer