

PSYCHEMEDICS CORP  
Form 10-Q  
May 06, 2011

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

FORM 10-Q

Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2011

or

Transition report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 1-13738

PSYCHEMEDICS CORPORATION  
(Exact Name of Registrant as Specified in its Charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

58-1701987  
(I.R.S. Employer Identification No.)

125 Nagog Park  
Acton, MA  
(Address of Principal Executive Offices)

01720  
(Zip Code)

Registrant's telephone number including area code: (978) 206-8220

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934).

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company   
(Do not check if smaller reporting Company)

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes  No

The number of shares of Common Stock of the Registrant, par value \$0.005 per share, outstanding at May 6, 2011 was 5,230,568.

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PSYCHEMEDICS CORPORATION  
FORM 10-Q FOR THE QUARTER ENDED MARCH 31, 2011

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PSYCHEMEDICS CORPORATION  
CONDENSED BALANCE SHEETS  
(UNAUDITED)

|  | March 31,<br>2011 | December 31,<br>2010 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Current Assets:  |                   |                      |
| Cash and cash equivalents  | \$2,719,179       | \$ 3,720,488         |
| Short-term investments   | 2,019,350         | 2,018,452            |
| Accounts receivable, net of allowance for doubtful accounts of \$134,694 in 2011 and \$119,295 in 2010 | 4,495,666         | 3,905,821            |
| Prepaid expenses and other current assets  | 922,306           | 700,822              |
| Deferred tax assets  | 277,846           | 239,831              |
| Total Current Assets   | 10,434,347        | 10,585,414           |
| Fixed Assets:  |                   |                      |
| Equipment & leasehold improvements   | 11,959,096        | 11,730,866           |
| Less accumulated depreciation  | (10,747,076)      | (10,663,996)         |
| Net Fixed Assets   | 1,212,020         | 1,066,870            |
| Other Assets   | 169,084           | 114,037              |
| Total Assets   | \$ 11,815,451     | \$ 11,766,321        |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                   |                      |
| Current Liabilities:   |                   |                      |
| Accounts payable   | \$463,992         | \$ 699,833           |
| Accrued expenses   | 1,262,488         | 1,302,370            |
| Deferred revenue   | 13,372            | 16,605               |
| Total Current Liabilities  | 1,739,852         | 2,018,808            |
| Shareholders' Equity:  |                   |                      |
| Preferred-stock, \$0.005 par value, 872,521 shares authorized, no shares issued or outstanding         | —                 | —                    |
| Common stock, \$0.005 par value; 50,000,000 shares authorized 5,877,358 shares issued in 2011 and 2010 | 29,387            | 29,387               |
| Paid-in capital  | 27,860,031        | 27,764,992           |
| Accumulated deficit  | (7,754,421 )      | (7,987,468 )         |
| Less - Treasury stock, at cost, 665,345 shares in 2011 and 2010  | (10,059,398)      | (10,059,398)         |
| Total Shareholders' Equity   | 10,075,599        | 9,747,513            |
| Total Liabilities and Shareholders' Equity   | \$ 11,815,451     | \$ 11,766,321        |

See accompanying notes to condensed financial statements

PSYCHEMEDICS CORPORATION  
CONDENSED STATEMENTS OF INCOME  
(UNAUDITED)

|   | Three Months Ended<br>March 31, |             |
|---|---------------------------------|-------------|
|   | 2011                            | 2010        |
| Revenues  | \$5,999,739                     | \$4,464,243 |
| Cost of revenues                                    | 2,383,026                       | 1,910,654   |
| Gross profit  | 3,616,713                       | 2,553,589   |
| Operating Expenses:                                 |                                 |             |
| General & administrative                            | 970,064                         | 971,614     |
| Marketing & selling                                 | 1,014,117                       | 623,631     |
| Research & development                              | 142,451                         | 122,481     |
| Total Operating Expenses                            | 2,126,632                       | 1,717,726   |
| Operating income                                    | 1,490,081                       | 835,863     |
| Interest income                                     | 2,205                           | 8,176       |
| Net income before provision for income taxes        | 1,492,286                       | 844,039     |
| Provision for income taxes                          | 633,798                         | 337,615     |
| Net income  | \$858,488                       | \$506,424   |
| Basic net income per share                          | \$0.16                          | \$0.10      |
| Diluted net income per share                        | \$0.16                          | \$0.10      |
| Dividends declared per share                        | \$0.12                          | \$0.12      |
| Weighted average common shares outstanding, basic   | 5,212,013                       | 5,197,349   |
| Weighted average common shares outstanding, diluted | 5,242,518                       | 5,206,584   |

See accompanying notes to condensed financial statements

PSYCHEMEDICS CORPORATION  
CONDENSED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

Three Months Ended  
March 31,  
2011                  2010

**CASH FLOWS FROM OPERATING ACTIVITIES:**

|   |            |            |
|---|------------|------------|
| Net income  | \$ 858,488 | \$ 506,424 |
| Adjustments to reconcile net income to net cash provided by operating activities: |            |            |
| Depreciation and amortization   | 84,522     | 64,082     |
| Stock-based compensation  | 95,039     | 93,628     |
| Deferred income taxes   | (38,015 )  | (37,826 )  |
| Changes in assets and liabilities   |            |            |
| Accounts receivable   | (589,845 ) | (199,793 ) |
| Prepaid expenses and other current assets   | (221,484 ) | (219,282 ) |
| Accounts payable  | (235,841 ) | 102,549    |
| Accrued expenses  | (39,882 )  | (137,753 ) |
| Deferred revenue  | (3,233 )   | (4,815 )   |
| Net cash provided by (used in) operating activities                               | (90,251 )  | 167,215    |

**CASH FLOWS USED IN INVESTING ACTIVITIES:**

|   |              |              |
|---|--------------|--------------|
| Purchases of short-term investments               | (9,125,863 ) | (1,007,768 ) |
| Sales of short-term investments                   | 9,124,965    | -            |
| Purchases of equipment and leasehold improvements | (228,230 )   | (189,674 )   |
| Other assets                                      | (56,489 )    | -            |
| Net cash used in investing activities             | (285,617 )   | (1,197,442 ) |

**CASH FLOWS USED IN FINANCING ACTIVITIES:**

|  |              |              |
|--|--------------|--------------|
| Cash dividends paid                            | (625,441 )   | (623,682 )   |
| Net cash used in financing activities          | (625,441 )   | (623,682 )   |
| Net decrease in cash                           | (1,001,309 ) | (1,653,909 ) |
| Cash and Cash Equivalents, beginning of period | 3,720,488    | 4,840,367    |
| Cash and Cash Equivalents, end of period       | \$ 2,719,179 | \$ 3,186,458 |

**Supplemental Disclosures of Cash Flow Information:**

|                            |            |            |
|----------------------------|------------|------------|
| Cash paid for income taxes | \$ 450,000 | \$ 500,000 |
|----------------------------|------------|------------|

See accompanying notes to condensed financial statements



PSYCHEMEDICS CORPORATION  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
(UNAUDITED)

1. Interim Financial Statements

The accompanying unaudited interim financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission for reporting on Form 10-Q. Accordingly, certain information and footnote disclosure required for complete financial statements are not included herein. It is recommended that these financial statements be read in conjunction with the financial statements and related notes of Psychemedics Corporation (“the Company,” “our Company,” “our” or “we”) as reported in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010, filed on March 25, 2011. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of financial position, results of operations, and cash flows at the dates and for the periods presented have been included. The results of operations for the three months ended March 31, 2011 may not be indicative of the results that may be expected for the year ending December 31, 2011, or any other period.

2. Cash, Cash Equivalents & Short-Term Investments

The Company considers all highly liquid investments with original maturities of 90 days or less to be cash equivalents. Cash equivalents consist of cash savings and U.S. government insured certificates of deposit (CDs). As of March 31, 2011 and December 31, 2010, all cash equivalents were in U.S. government insured certificates of deposit.

As of March 31, 2011, the Company had \$2.0 million of CDs with maturities of greater than 13 weeks classified as short-term investments. The Company accounts for investment securities in accordance with the FASB codification topic ASC 320, “Fair Value Debt and Equity Securities,” (ASC 320). Under ASC 320, investments that the Company has positive intent and ability to hold to maturity are classified as held-to-maturity and are reported at amortized cost, which approximates fair market value. The Company intends and has the ability to hold all the CDs to maturity.

3. Stock-Based Compensation

2006 Equity Incentive Plan

The Company’s 2006 Equity Incentive Plan provides for the grant or issuance to officers, directors, employees and consultants of options with terms of up to ten years, restricted stock, issuances of stock bonuses or other stock-based awards, covering up to 250,000 shares of common stock. As of March 31, 2011, 84,450 shares remained available for future grant under the 2006 Equity Incentive Plan.

PSYCHEMEDICS CORPORATION  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
(UNAUDITED)

3. Stock-Based Compensation (continued)

The Company did not grant any stock or stock unit awards (SUAs) in the first three months of 2011 or 2010. There were no previously granted awards that terminated during the first three months of 2011 or 2010. Historically, the SUAs vest over a period of two years for non-employee board members and four years for employees and are convertible into an equivalent number of shares of the Company's common stock provided that the director or employee receiving the award remains continuously employed throughout the vesting period. The Company records compensation expense related to the SUAs on a straight-line basis over the vesting term of the SUAs. Employees are issued shares upon vesting, net of tax withholdings, unless the employee chooses to receive all shares and pay for the associated employment taxes. No other types of equity-based awards have been granted or issued under the 2006 Equity Incentive Plan.

A summary of activity for SUAs under the Company's 2006 Equity Incentive Plan for the three months ended March 31, 2011 is as follows:

|                                     | Number<br>of<br>Shares | Aggregate<br>Intrinsic<br>Value (1)<br>(000s ) |
|-------------------------------------|------------------------|--|
| Unvested, December 31, 2010         | 94,700                 |  |
| Granted                             | -                      |  |
| Forfeited/expired                   | -                      |  |
| Converted to common stock           | -                      |  |
| Unvested, March 31, 2011            | 94,700                 | \$ 1,046                                       |
| Available for grant, March 31, 2011 | 84,450                 |  |

(1) The aggregate intrinsic value on this table was calculated based on the closing market value of the Company's stock on March 31, 2011 (\$11.05).

On March 24, 2011, the Company's Board of Directors approved an amendment and restatement of the 2006 Equity Incentive Plan (now called the 2006 Incentive Plan), which included an increase in the number of shares available for issuance thereunder by 250,000 shares, subject to shareholder approval at the 2011 Annual Stockholders' meeting to be held on May 24, 2011. All references in this footnote 3 to the Plan and the number of shares reserved for issuance and available for future issuance thereunder exclude the effect of the amendment and restatement.

PSYCHEMEDICS CORPORATION  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
(UNAUDITED)

3. Stock-Based Compensation (continued)

Expired Plans

As of March 31, 2011, the Company also had outstanding an aggregate of 279,071 options to acquire common stock under plans that had previously expired. A summary of stock option activity for the Company's expired stock option plans for the three months ended March 31, 2011 is as follows:

|                                     | Number<br>of<br>Shares | Weighted<br>Average<br>Exercise<br>Price Per<br>Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value (2)<br>(000s) |
|-------------------------------------|------------------------|---|---|---|
| Outstanding, December 31, 2010      | 289,371                | \$ 13.96  |   |   |
| Granted                             | -                      | -   |   |   |
| Exercised                           | -                      | -   |   |   |
| Terminated/Expired                  | (10,300 )              | \$ 19.48  |   |   |
| Outstanding, March 31, 2011         | 279,071                | \$ 13.76  | 3.5 years   | \$ 37   |
| Exercisable, March 31, 2011         | 279,071                | \$ 13.96  | 3.5 years   | \$ 37   |
| Available for grant, March 31, 2011 | -                      |   |   |   |

(2)The aggregate intrinsic value on this table was calculated based on the amount, if any, by which the closing market value of the Company's stock on the March 31, 2011 (\$11.05) exceeded the exercise price of the underlying options, multiplied by the number of shares subject to each option.

All Stock-Based Compensation Plans

Exclusive of the amendment and restatement of the 2006 Equity Incentive Plan discussed above, as of March 31, 2011, a total of 458,221 shares of common stock were reserved for issuance under the various stock option and stock-based plans including the previously expired plans. As of March 31, 2011, the unamortized fair value of awards relating to outstanding SUAs and options was \$543 thousand, which is expected to be amortized over a weighted average amortized period of 2.6 years.

PSYCHEMEDICS CORPORATION  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
(UNAUDITED)

4. Basic and Diluted Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive common equivalent shares outstanding during the period. The number of dilutive common equivalent shares outstanding during the period has been determined in accordance with the treasury-stock method. Common equivalent shares consist of common stock issuable upon the exercise of outstanding options and common stock issuable upon the vesting of outstanding, unvested SUAs.

Basic and diluted weighted average common shares outstanding are as follows:

|  | Three Months Ended |                   |
|--|--------------------|-------------------|
|  | March 31,<br>2011  | March 31,<br>2010 |
|  | (in thousands)     |                   |
| Weighted average common shares                                   | 5,212              | 5,197             |
| Common equivalent shares   | 31                 | 10                |
| Weighted average common shares outstanding,<br>assuming dilution | 5,243              | 5,207             |

For the three months ended March 31, 2011 and 2010, options to purchase 278 thousand and 327 thousand common shares, respectively, were outstanding but not included in the diluted weighted average common share calculation as the effect would have been antidilutive.

5. Revenue Recognition

The Company is in the business of performing drug testing services and reporting the results thereof. The Company's drug testing services include training for collection of samples and storage of positive samples for its customers for an agreed-upon fee per unit tested of samples. The revenues are recognized when the predominant deliverable, drug testing, is provided and reported to the customer.

The Company recognizes revenue under the FASB codification topic ASC 605, "Revenue Recognition," (ASC 605). In accordance with ASC 605, the Company considers testing, training and storage elements as one unit of accounting for revenue recognition purposes, as the training and storage costs are de minimis and do not have stand-alone value to the customer. The Company recognizes revenue as the service is performed and reported to the customer, since the predominant deliverable in each arrangement is the testing element of the units.

The Company also provides expert testimony, when and if necessary, to support the results of the tests, which is generally billed separately and recognized as the services are provided.

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Deferred revenue represents payments received in advance of the performance of drug testing procedures, generally in relation to the personal drug testing kits PDT-90. Deferred revenue is recognized as revenue when the underlying test results are delivered. With respect to a portion of these transactions, there may be instances where the customer ultimately does not require performance. Revenue is then recognized when the Company can reasonably, reliably and objectively determine that it is remote that performance will be required for an estimable portion of transactions. The Company recorded \$3 thousand and \$6 thousand of revenue in the results of operations for the three months ended March 31, 2011 and 2010, respectively, related to test kits that were sold for which the Company's obligations to provide service were deemed remote.

At March 31, 2011 and December 31, 2010, the Company had deferred revenue of approximately \$13 thousand and \$17 thousand, respectively, reflecting sales of its personal drug testing service for which the performance of the related test had not yet occurred and future obligations were not deemed remote.

#### 6. Fair Value Measurements

ASC 820, Fair Value Measurements and Disclosures, provides guidance for using fair value to measure assets and liabilities. It also responds to investors' requests for expanded information about the extent to which companies' measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. ASC 820 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, and does not expand the use of fair value in any new circumstances.

It establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy prioritizes the inputs in three broad levels as follows:

- Level 1 inputs are unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets and liabilities.
- Level 2 inputs are quoted prices for similar assets and liabilities in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
- Level 3 inputs are prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

A financial asset's or liability's classification within the hierarchy is determined based on the lowest level of any input that is significant to the fair value measurement.

PSYCHEMEDICS CORPORATION  
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The financial assets of the Company measured at fair value on a recurring basis are cash and cash equivalents and short-term investments. The Company's cash and cash equivalents and short-term investments are classified within level 1 of the fair value hierarchy because they are valued using quoted market prices that are accessible at the measurement date for identical assets and liabilities.

7. Subsequent Events

The Company evaluated all events or transactions that occurred after March 31, 2011 up through the time of filing with the SEC our Quarterly Report on Form 10-Q for the period ended March 31, 2011. During this period, the Company did not have any material recognizable subsequent events, except as disclosed herein.

On May 5, 2011, the Company declared a quarterly dividend of \$0.12 per share for a total of \$628 thousand, which will be paid on May 27, 2011 to shareholders of record on May 16, 2011.

8. Recent Accounting Pronouncements

In January 2010, the FASB issued Accounting Standards Update, "Fair Value Measurements and disclosures (ASU 820) – Improving Disclosures about Fair Value Measurements," which provides additional guidance relating to fair value measurement disclosures. Specifically, companies will be required to separately disclose significant transfers into and out of Level 1 and Level 2 measurements in the fair value hierarchy and the reasons for those transfers. For Level 3 fair value measurements, the new guidance requires a gross presentation of activities within the Level 3 roll forward. Additionally, the FASB also clarified existing fair value measurement disclosure requirements relating to the level of disaggregation, inputs, and valuation techniques. This ASU became effective for interim or annual reporting periods beginning after December 15, 2009, except for the detailed Level 3 disclosures, which became effective for interim or annual reporting periods beginning after December 15, 2010. The adoption of this pronouncement did not have an effect on the Company's financial statements.

In October 2009, the FASB issued ASU No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements — a consensus of the FASB EITF, or ASU 2009-13. ASU 2009-13 will separate multiple-deliverable revenue arrangements. This update establishes a selling price hierarchy for determining the selling price of a deliverable. The amendments of this update will replace the term "fair value" in the revenue allocation guidance with "selling price" to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. The amendments of this update will eliminate the residual method of allocation and require that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. The amendments in this update will require that a vendor determine its best estimated selling price in a manner consistent with that used to determine the price to sell the deliverable on a standalone basis. This standard is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company adopted this standard in the first quarter of 2011. The adoption of this standard did not have a material impact on the Company's financial position, results of operations or cash flows.

9. Commitments and Contingencies

The Company is subject to legal proceedings and claims, which arise in the ordinary course of its business. The Company believes that based upon information available to the Company at this time, the expected outcome of these matters would not have a material impact on the Company's results of operations or financial condition.

Item 2.

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

FACTORS THAT MAY AFFECT FUTURE RESULTS

From time to time, information provided by the Company or statements made by its employees may contain "forward-looking" information which involves risks and uncertainties. In particular, statements contained in this report which are not historical facts (including, but not limited to, the Company's expectations regarding earnings, earnings per share, revenues, operating cash flows, dividends, future business, growth opportunities, new accounts, customer base, test volume, sales and marketing strategy, business strategy, general and administrative expenses, marketing and selling expenses, research and development expenses, anticipated operating results, strategies with respect to governmental agencies and regulations, cost savings, capital expenditures, liquidity of investments and anticipated cash requirements) may be "forward-looking" statements. The Company's actual results may differ from those stated in any "forward-looking" statements. Factors that may cause such differences include, but are not limited to, risks associated with the expansion of the Company's sales and marketing team, employee hiring practices of the Company's principal customers, development of markets for new products and services offered by the Company, the economic health of principal customers of the Company, global credit market volatility, financial and operational risks associated with possible expansion of testing facilities used by the Company, government regulation (including, but not limited to, Food and Drug Administration regulations), competition and general economic conditions. With respect to the continued payment of cash dividends, factors include, but are not limited to, available surplus, cash flow, capital expenditure reserves required, and other factors that the Board of Directors of the Company may take into account.

## OVERVIEW

Psychemedics Corporation was incorporated in 1986. The Company is the world's largest provider of hair testing for drugs of abuse, utilizing a patented hair analysis method involving radioimmunoassay technology and confirmation by mass spectrometry to analyze human hair to detect abused substances. The Company's customers include Fortune 500 companies, as well as small to mid-size corporations, schools and governmental entities located primarily in the United States.

Revenues for the first quarter of 2011 were \$6.0 million, an increase of 34% from first quarter 2010 revenue of \$4.5 million. The Company reported net income of \$0.16 per diluted share for the three months ended March 31, 2011, compared to net income of \$0.10 per share in the comparable period in 2010. At March 31, 2011, the Company had \$4.7 million of cash, cash equivalents and short-term investments. The Company distributed \$625 thousand or \$0.12 per share of cash dividends to its shareholders in the three months ended March 31, 2011. The Company has paid fifty-eight consecutive quarterly cash dividends.

## RESULTS OF OPERATIONS

Revenues were \$6.0 million for three months ended March 31, 2011 compared to revenues of \$4.5 million for the three months ended March 31, 2010, representing an increase of 34%. The increase in revenues for the three months ended March 31, 2011 was a result of an increase in testing volume from new and existing clients of 37%, while the average revenue per sample decreased 3% during the same period due to mix of clients.

Gross profit increased \$1.0 million to \$3.6 million for the three months ended March 31, 2011, compared to \$2.6 million for the three months ended March 31, 2010. Direct costs grew by \$472 thousand or 25% for the three months ended March 31, 2011 compared to the same period in 2010, mainly due to a greater volume of samples as well as a higher cost of supplies. The gross profit margin increased to 60% for the three months ended March 31, 2011 compared to 57% for the comparable period of 2010, mainly as a result of an increase in volume against direct fixed costs.

General and administrative ("G&A") expenses were \$970 thousand and \$972 thousand for the three months ended March 31, 2011 and 2010, respectively. As a percentage of revenue, G&A expenses were 16% and 22% for the three months ended March 31, 2011 and 2010, respectively. This lower percentage is a result of higher revenues, as the G&A costs were almost the same.

Marketing and selling expenses were \$1.0 million for the three months ended March 31, 2011 as compared to \$624 thousand for the three months ended March 31, 2010, an increase of 63%. Total marketing and selling expenses represented 17% of revenue for the three months ended March 31, 2011, compared to 14% for the comparable period of 2010. The increase in marketing and selling expenses was primarily from the addition of a Vice President of Sales & Marketing, which was vacant in the first quarter of 2010, as well as higher commissions and shipping costs related to higher sales.

Research and development ("R&D") expenses for the three months ended March 31, 2011 were \$142 thousand compared to \$122 thousand for the comparable period of 2010, an increase of 16%. R&D expenses represented 2% of revenue in the first quarter 2011 and 3% for the comparable period of 2010.



Interest income for the three months ended March 31, 2011 decreased by \$6 thousand to \$2 thousand when compared to the same period of 2010 in which interest income was \$8 thousand. Interest income represented interest and dividends earned on cash and cash equivalents and short-term investments. Lower interest rates on our mix of cash, cash equivalents and short-term investments caused the decrease in interest income for the three month period ended March 31, 2011.

Provision for income taxes During the three months ended March 31, 2011 and 2010, the Company recorded tax provisions of \$634 thousand and \$338 thousand, respectively. These provisions represented effective tax rates of 42% for the three months ended March 31, 2011 and 40% for the comparable period of 2010. The Company continues to monitor the effective tax rate, but does not expect a significant change for the remaining nine months of 2011.

### LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2011, the Company had approximately \$4.7 million of cash, cash equivalents and short-term investments. The Company's operating activities used net cash of \$90 thousand for the three months ended March 31, 2011. Investing activities used \$286 thousand of cash while financing activities used \$625 thousand of cash during the first three months of 2011.

Cash used by operating activities of \$90 thousand reflected net income of \$858 thousand adjusted for depreciation and amortization of \$85 thousand, and stock-based compensation of \$95 thousand. This was offset by an increase in accounts receivable of \$590 thousand, a decrease in accounts payable of \$236k, a decrease of accrued expenses of \$40 thousand, an increase in other current assets of \$221 thousand and a decrease of other current liabilities of \$3 thousand. Cash used in investing activities included equipment and leasehold improvements of \$228 thousand which were purchased during the first quarter of 2011. We anticipate spending \$300 thousand to \$600 thousand in additional capital purchases for the remainder of 2011.

During the three months ended March 31, 2011, the Company distributed \$625 thousand in cash dividends to its shareholders. In the first three months of 2011 and 2010, the Company did not repurchase any of its shares. In total, 665,345 shares have been repurchased.

Contractual obligations as of March 31, 2011 were as follows:

|                     | Less Than<br>One Year | 1-3<br>Years | 4-5<br>years<br>(in thousands) | After 5<br>Years | Total    |
|---------------------|-----------------------|--------------|--------------------------------|------------------|----------|
| Operating leases    | \$ 544                | \$ 623       | \$ 33                          | \$ -             | \$ 1,200 |
| Purchase commitment | 397                   | -            | -                              | -                | 397      |
|                     | \$ 941                | \$ 623       | \$ 33                          | \$ -             | \$ 1,597 |

The Company has a supply agreement with a vendor which requires the Company to purchase isotopes used in its drug testing procedures from this sole supplier in exchange for variable annual payments based upon prior year purchases. Purchases amounted to \$132 thousand for the three months ended March 31, 2011 as compared to \$118 thousand for the comparable period of 2010. The Company expects to purchase approximately \$397 thousand for the remainder of 2011. In exchange for exclusivity, among other things, the supplier has provided the Company with the right to purchase the isotope technology at fair market value under certain conditions, including the failure to meet the Company's purchase commitments. This agreement does not include a fixed termination date; however, it is cancelable upon mutual agreement by the parties or six months after termination notice by the Company of its intent to use a different technology in connection with its drug testing procedures.

At March 31, 2011, the Company's principal sources of liquidity included an aggregate of approximately \$4.7 million of cash, cash equivalents and short-term investments. Management currently believes that such funds, together with cash generated from operations, should be adequate to fund anticipated working capital requirements and capital expenditures for the next 12 months. Depending upon the Company's results of operations and capital needs, the Company may use various financing sources to raise additional funds, although the Company does not have any such plans at this time. At March 31, 2011, the Company had no long-term debt.

## CRITICAL ACCOUNTING POLICIES

Management believes the most critical accounting policies are as follows:

### Revenue Recognition

The Company is in the business of performing drug testing services and reporting the results thereof. The Company's drug testing services include training for collection of samples and storage of positive samples for its customers for an agreed-upon fee per unit tested of samples. The revenues are recognized when the predominant deliverable, drug testing, is provided and reported to the customer.

The Company recognizes revenue under ASC 605, Revenue Recognition. In accordance with ASC 605, the Company considers testing, training and storage elements as one unit of accounting for revenue recognition purposes, as the training and storage costs are de minimis and do not have stand-alone value to the customer. The Company recognizes revenue as the service is performed and reported to the customer, since the predominant deliverable in each arrangement is the testing of the units.

The Company also provides expert testimony, when and if necessary, to support the results of the tests, which is generally billed separately and recognized as the services are provided.

Deferred revenue represents payments received in advance of the performance of drug testing procedures, generally in relation to the personal drug testing kits PDT-90. Deferred revenue is recognized as revenue when the underlying test results are delivered. With respect to a portion of these transactions, there may be instances where the customer ultimately does not require performance. Revenue is then recognized when the Company can reasonably, reliably and objectively determine that it is remote that performance will be required for an estimable portion of transactions. The Company recorded \$3 thousand and \$6 thousand of revenue in the results of operations for the three months ended March 31, 2011 and 2010, respectively, related to test kits that were sold for which the Company's obligations to provide service were deemed remote.

### Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates, including bad debts and income taxes, 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. Actual results could differ from those estimates.

#### Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on management's assessment of the collectability of its customer accounts. Management reviews its accounts receivable aging for doubtful accounts and specifically identifies accounts that may not be collectible. The Company routinely assesses the financial strength of its customers and, as a consequence, believes that its accounts receivable credit risk exposure is limited. The Company maintains an allowance for potential credit losses but historically has not experienced any significant losses related to individual customers or groups of customers in any particular industry or geographic area. Bad debt expense has been within management's expectations.

#### Income Taxes

The Company accounts for income taxes using the liability method, which requires the Company to recognize a current tax liability or asset for current taxes payable or refundable and a deferred tax liability or asset for the estimated future tax effects of temporary differences between the financial statement and tax reporting bases of assets and liabilities to the extent that they are realizable. Deferred tax expense (benefit) results from the net change in deferred tax assets and liabilities during the year. A deferred tax valuation allowance is required if it is more likely than not that all or a portion of the recorded deferred tax assets will not be realized.

In July 2006, the Financial Accounting Standards Board ("FASB") issued ASC 740, Income Taxes. ASC 740 contains a two-step approach to recognizing and measuring uncertain tax positions (tax contingencies). The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on an audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. We consider many factors when evaluating and estimating our tax positions and tax benefits, which may require periodic adjustments and which may not accurately forecast actual outcomes. The Company adopted the provisions of ASC 740, effective January 1, 2007, without material effect in the financial statements.

The Company operates within multiple taxing jurisdictions and could be subject to audit in these jurisdictions. These audits may involve complex issues, which may require an extended period of time to resolve. The Company has provided for its estimated taxes payable in the accompanying financial statements. Interest and penalties related to income tax matters are recognized as a general and administrative expense. The Company did not have any unrecognized tax benefits and did not have any interest or penalties accrued as of March 31, 2011 or December 31, 2010.

The above listing is not intended to be a comprehensive list of all of the Company's accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the United States, with no need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Sensitivity. The Company maintains cash and cash equivalents which consist of cash, money market funds and certificates of deposit with financial institutions. Due to the conservative nature and relatively short duration of our cash, cash equivalents and short-term investments, interest rate risk is mitigated.

Based on our ability to access our cash, cash equivalents and short-term investments, our expected operating cash flows and our other sources of cash; we do not anticipate that any lack of liquidity will materially affect our ability to operate our business.

Item 4. Controls and Procedures

As of the date of this report, our Chief Executive Officer and our Controller performed an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Controller concluded that the Company's disclosure controls and procedures were effective for ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and disclosed within the time periods specified in the SEC's rules and forms, and that its disclosure controls and procedures were also effective to ensure that information required to be disclosed in the reports that it files or submits under the Exchange Act is accumulated and communicated to management, including the Company's principal executive and principal financial officers, to allow timely decisions regarding required disclosure. There were no significant changes in the Company's internal controls over financial reporting or in other factors that could significantly affect these internal controls over financial reporting subsequent to the date of the most recent evaluation.

PART II OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed in our 2010 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

There were no purchases of treasury stock in the first quarter of 2011.

Item 6. Exhibits

See Exhibit Index included in this Report

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.

Psychemedics Corporation

Date: May 6, 2011

By: /s/ Raymond C. Kubacki, Jr.  
Raymond C. Kubacki, Jr.  
Chairman and Chief Executive Officer  
(principal executive officer)

Date: May 6, 2011

By: /s/ Neil L. Lerner  
Neil L. Lerner  
Vice President and Controller  
(principal accounting officer)

PSYCHEMEDICS CORPORATION  
FORM 10-Q  
March 31, 2011  
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