PSYCHEMEDICS CORP
Form 10-Q
July 31, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2015

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	**58-1701987**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

125 Nagog Park
Acton, MA 01720
(Address of Principal Executive Offices) (Zip Code)

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 ¨ (Do not check if smaller reporting Company) Smaller Reporting Company x

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 x

The number of shares of Common Stock of the Registrant, par value $0.005 per share, outstanding at July 25, 2015 was 5,422,541.

PSYCHEMEDICS CORPORATION

FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2015

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PSYCHEMEDICS CORPORATION

CONDENSED BALANCE SHEETS

(UNAUDITED)

	June 30, 2015	December 31, 2014
ASSETS		
Current Assets:		
Cash and cash equivalents	$2,104,060	$3,612,153
Accounts receivable, net of allowance for doubtful accounts of $44,398 in 2015 and $95,525 in 2014	4,516,155	4,078,133
Prepaid expenses and other current assets	1,364,014	689,995
Income tax receivable	268,866	1,819,743
Deferred tax assets	543,380	376,529
Total Current Assets	8,796,475	10,576,553
Fixed Assets, net of accumulated amortization and depreciation of $6,249,983 in 2015 and $5,788,551 in 2014	13,236,421	12,740,131
Other assets	743,768	761,025
Total Assets	$22,776,664	$24,077,709
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$589,552	$845,071
Accrued expenses	1,796,806	1,351,333
Current portion of long-term debt	1,399,925	1,399,925
Total Current Liabilities	3,786,283	3,596,329
Long-term debt	4,148,195	4,848,158
Deferred tax liabilities, long-term	2,796,666	2,796,666
Total Liabilities	10,731,144	11,241,153
Commitments and Contingencies (Note 7)		
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 6,090,671 shares issued in 2015 and 6,043,191 shares issued in 2014	30,453	30,216

Additional paid-in capital	29,748,157	29,454,023
Accumulated deficit	(7,651,301)	(6,565,894)
Less - Treasury stock, at cost, 668,130 shares	(10,081,789)	(10,081,789)
Total Shareholders' Equity	12,045,520	12,836,556
Total Liabilities and Shareholders' Equity	$22,776,664	$24,077,709

See accompanying notes to condensed financial statements

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PSYCHEMEDICS CORPORATION

CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

	Three Months Ended June 30, 2015	2014	Six Months Ended June 30, 2015	2014
Revenues	$7,001,409	$7,694,137	$13,757,150	$14,738,958
Cost of revenues	3,731,667	3,802,874	7,148,540	7,051,913
Gross profit	3,269,742	3,891,263	6,608,610	7,687,045
Operating Expenses:				
General & administrative	1,154,489	1,128,616	2,298,579	2,312,763
Marketing & selling	1,322,117	1,165,510	2,610,598	2,264,110
Research & development	437,090	277,429	892,872	622,412
Total Operating Expenses	2,913,696	2,571,555	5,802,049	5,199,285
Operating income	356,046	1,319,708	806,561	2,487,760
Other income (expense), net	(30,877)	3,235	(64,204)	4,784
Net income before provision for income taxes	325,169	1,322,943	742,357	2,492,544
Provision for income taxes	72,840	466,024	212,506	879,466
Net income and comprehensive income	$252,329	$856,919	$529,851	$1,613,078
Basic net income per share	$0.05	$0.16	$0.10	$0.30
Diluted net income per share	$0.05	$0.16	$0.10	$0.30
Dividends declared per share	$0.15	$0.15	$0.30	$0.30
Weighted average common shares outstanding, basic	5,399,270	5,352,664	5,387,232	5,335,347
Weighted average common shares outstanding, diluted	5,408,372	5,375,076	5,396,740	5,367,307

See accompanying notes to condensed financial statements

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PSYCHEMEDICS CORPORATION

CONDENSED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Six Months Ended June 30, 2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$529,851	$1,613,078
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	707,303	469,307
Stock-based compensation	342,992	288,188
Changes in assets and liabilities:		
Accounts receivable	(438,022)	(1,254,344)
Prepaid expenses, other current assets, and income tax receivable	876,858	(89,052)
Accounts payable	(255,519)	668,524
Accrued expenses	178,497	(1,383,094)
Deferred income taxes	(166,851)	(113,198)
Net cash provided by operating activities	1,775,109	199,409
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of equipment and leasehold improvements	(699,192)	(5,787,821)
Cost of internally developed software	(220,019)	(246,570)
Other assets	(149)	(145,204)
Net cash used in investing activities	(919,360)	(6,179,595)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from exercise of stock options	91,556	47,564
Proceeds from issuance of stock, net of tax withholding	(140,177)	(36,968)
Proceeds from equipment financing	-	6,000,000
Payments of equipment financing	(699,963)	(52,647)
Cash dividends paid	(1,615,258)	(1,599,749)
Net cash provided by (used in) financing activities	(2,363,842)	4,358,200
Net decrease in cash and cash equivalents	(1,508,093)	(1,621,986)
Cash and cash equivalents, beginning of period	3,612,153	3,970,512
Cash and cash equivalents, end of period	$2,104,060	$2,348,526

Supplemental Disclosures of Cash Flow Information:		
Cash paid for income taxes	$2,870	$411,860
Cash paid for interest	$64,679	$5,572
Purchases of equipment through accrued liabilities	$266,976	$606,127

See accompanying notes to condensed financial statements

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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, 2014, filed on February 27, 2015. 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 and six months ended June 30, 2015 may not be indicative of the results that may be expected for the year ending December 31, 2015, or any other period.

2. Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of 90 days or less to be cash equivalents. Cash equivalents consisted exclusively of cash in the bank as of December 31, 2014 and June 30, 2015.

3. Stock-Based Compensation

2006 Equity Incentive Plan

The Company's 2006 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, stock unit awards (SUA's), issuances of stock bonuses or other stock-based awards, covering up to 500,000 shares of common stock. As of June 30, 2015, 118,232 shares remained available for future grant under the 2006 Incentive Plan.

On April 29, 2015 the Company granted SUAs covering 43,950 shares of common stock. 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 Incentive Plan.

PSYCHEMEDICS CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

3. Stock-Based Compensation (continued)

A summary of activity for SUAs under the Company's 2006 Incentive Plan for the six months ended June 30, 2015 is as follows:

	Number of Shares	Aggregate Intrinsic Value (1) (000s)
Unvested, December 31, 2014	121,625	
Granted	43,950	
Forfeited/expired	(15,297)	
Converted to common stock	(39,814)	
Unvested, June 30, 2015	110,464	$ 1,638
Available for grant, June 30, 2015	118,232	

(1) The aggregate intrinsic value on this table was calculated based on the closing market value of the Company's stock on June 30, 2015 ($14.83).

Expired Plans

As of June 30, 2015, all options to acquire common stock that had been outstanding on December 31, 2014, were either exercised or expired without having been exercised. A summary of stock option activity for the Company's expired stock option plans for the six months ended June 30, 2015 is as follows:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (000s)
Outstanding, December 31, 2014	136,050	$ 14.40		
Granted	-	-		

Exercised	(134,350)	$ 14.40			
Terminated/Expired	(1,700)	$ 14.40			
Outstanding, June 30, 2015	-	-	-	$	-
Exercisable, June 30, 2015	-	-	-	$	-
Available for grant, June 30, 2015	-				

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PSYCHEMEDICS CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

3. Stock-Based Compensation (continued)

All Stock-Based Compensation Plans

As of June 30, 2015, a total of 228,696 shares of common stock were reserved for issuance under the 2006 Incentive Plan. As of June 30, 2015, the unamortized fair value of awards relating to outstanding SUAs and options was $1.5 million, which is expected to be amortized over a weighted average period of 3.0 years.

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 is 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		**Six Months Ended**	
	June 30, 2015	**June 30, 2014**	**June 30, 2015**	**June 30, 2014**
	(in thousands)			
Weighted average common shares outstanding, basic	5,399	5,353	5,387	5,335
Dilutive common equivalent shares	9	22	10	32
Weighted average common shares outstanding, diluted	5,408	5,375	5,397	5,367

5. Fair Value Measurements

ASC 820, *Fair Value Measurements and Disclosures* (“ASC 820”), 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.

PSYCHEMEDICS CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

5. Fair Value Measurements (continued)

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.

The financial assets of the Company measured at fair value on a recurring basis are cash and cash equivalents. The Company's cash and cash equivalents 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.

6. Subsequent Events

On July 28, 2015, the Company declared a quarterly dividend of $0.15 per share for a total of $813 thousand, which will be paid on August 18, 2015 to shareholders of record on August 7, 2015.

7. 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.

8. Debt and Other Financing Arrangements

On March 20, 2014, the Company entered into an equipment financing arrangement with Banc of America Leasing & Capital, LLC (the "Lender"), which it amended on August 8, 2014, including a Master Loan and Security Agreement and related documentation (collectively the "Equipment Loan Arrangement") which provided the Company with the ability to finance, at its option, up to $7.5 million of new and used equipment purchases. Each such purchase financed under the Equipment Loan Arrangement was documented by the execution of an equipment note. Each note has a maturity date of 60 months from the applicable loan date, and bears interest at the then current 30-day LIBOR rate + 2.00%. Principal and interest are payable over the 60-month repayment period and principal is repayable without premium or penalty. Borrowings under the Equipment Loan Arrangement are secured by a first priority security interest in the equipment acquired with the proceeds of the equipment notes. Under the Equipment Loan Arrangement, the Company is subject to a maximum quarterly funded debt to EBITDA ratio and a minimum fixed charge coverage ratio. The Company was in compliance with all loan covenants as of June 30, 2015.

Under the Equipment Loan Arrangement, the Company executed notes on March 24, 2014, May 22, 2014, June 13, 2014 and August 8, 2014 in the amounts of $1.1 million, $1.9 million, $3.0 million and $1.0 million, respectively, for total borrowings of $7.0 million. The interest rate for these notes for the quarter ended June 30, 2015 was 2.18%, and represented $31,478 of interest expense. As of June 30, 2015, the interest rate was 2.18% and there was $5.5 million of outstanding debt related to these notes.

The annual repayment requirements for debt obligations as of June 30, 2015 were as follows (in 000's):

2015	$700
2016	1,400
2017	1,400
2018	1,400
2019	648
Total long-term debt	5,548
Less current portion of long-term debt	(1,400)
Total long-term debt, net of current portion	$4,148

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, foreign drug testing laws and regulations, required investments in plant, property and equipment, 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 employee hiring practices of the Company's principal customers, development of markets for new products and services offered by the Company, costs associated with capacity expansion, government regulation (including, but not limited to, Food and Drug Administration regulations and foreign government regulation including Brazilian commercial drivers license drug test 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, debt service obligations, and other factors that the Board of Directors of the Company may take into account.

OVERVIEW

Revenues for the second quarter of 2015 were $7.0 million, a decrease of 9% from second quarter 2014 revenue of $7.7 million. The Company reported net income of $0.05 per diluted share for the three months ended June 30, 2015 and $0.16 for the same period in 2014. The decrease in earnings was primarily the result of lower revenue compared to last year's record second quarter, as well as an increase in expenses in certain key areas, including information technology and expenses incurred to increase capacity in anticipation of an increase in expected volume from an opportunity in Brazil. The testing from the opportunity in Brazil was expected to begin in June 2015. Due to administrative issues in implementation, there was a delay in the start of the testing. However, the Brazil testing related to a law that was passed, so we expect testing to begin in the near-term. At June 30, 2015, the Company had $2.1 million of cash. The Company distributed $809 thousand or $0.15 per share of cash dividends to its shareholders in the three months ended June 30, 2015. The Company has paid 75 consecutive quarterly cash dividends.

RESULTS OF OPERATIONS

Revenues were $7.0 million for three months ended June 30, 2015 compared to revenues of $7.7 million for the three months ended June 30, 2014, representing a decrease of 9%. The decrease in revenues for the three months ended June 30, 2015 was a result of a decrease in testing volume of 10%. The average revenue per sample increased 1% from the comparative period in 2014. Revenues for the six months ended June 30, 2015 were $13.8 million, representing a decrease of 7% in revenues from the comparable period of 2014 of $14.7 million. The decrease was primarily due to a decrease in volume, as test samples decreased 7% from the first half of 2014.

Gross profit decreased $0.6 million to $3.3 million for the three months ended June 30, 2015, compared to $3.9 million for the same period in 2014. Direct costs decreased by $71 thousand or 2% for the three months ended June 30, 2015 compared to the same period in 2014. The gross profit margin was 47% for the three months ended June 30, 2015 and 51% for the comparable period of 2014. The decrease in margin was attributable to lower sales. Gross profit for the six months ended June 30, 2015 decreased $1.1 million to $6.6 million compared to $7.7 million for the comparable period in 2014. Direct costs increased by $97 thousand or 1% for the six months ended June 30, 2015 when compared to the same period in 2014. The gross profit margin for the six month period ended June 30, 2015 was 48% compared to 52% for the comparable period in 2014. The decrease in margin was attributable to lower sales.

General and administrative ("G&A") expenses were $1.2 million for the three months ended June 30, 2015, compared to $1.1 million for the same period in 2014. As a percentage of revenue, G&A expenses were 16% for the three months ended June 30, 2015 and 15% for the same period in 2014. General and administrative expenses were $2.3 million for the six months ended June 30, 2015 and 2014. As a percentage of revenue, G&A expenses were 17% and 16% for the six months ended June 30, 2015 and 2014, respectively.

Marketing and selling expenses were $1.3 million for the three months ended June 30, 2015, compared to $1.2 million for the same period in 2014. Total marketing and selling expenses represented 19% of revenue for the three months ended June 30, 2015, compared to 15% for the comparable period of 2014. Marketing and selling expenses were $2.6 million for the six months ended June 30, 2014, compared to $2.3 million for the same period in 2014. Total marketing and selling expenses represented 19% of revenue for the six months ended June 30, 2015, compared to 15% for the comparable period of 2014. The increase was driven by additional personnel and additional support for customer related strategic information systems.

Research and development ("R&D") expenses for the three months ended June 30, 2015 were $437 thousand compared to $277 thousand for the comparable period of 2014, an increase of 58%. R&D expenses represented 6% and 4% of revenue for the three months ended June 30, 2015 and 2014, respectively. Research and development expenses for the six months ended June 30, 2015 were $893 thousand compared to $622 thousand in the prior year. R&D expenses represented 6% and 4% of revenue for the six months ended 2015 and 2014, respectively. The increase in R&D expenses related to additional tests of drugs of abuse and new testing processes.

Provision for income taxes During the three months ended June 30, 2015 and 2014, the Company recorded tax provisions of $73 thousand and $466 thousand, respectively. These provisions represented effective tax rates of 22% for the three months ended June 30, 2015 and 35% for the comparable period of 2014. During the six months ended June 30, 2015 and June 30, 2014, the Company recorded tax provisions of $213 thousand and $879 thousand, respectively. These provisions represented effective tax rates of 29% for the six month period ended June 30, 2015 and 35% for the comparative period last year. The reduction in tax rate is driven by two factors: the Company's state tax rate was reduced in 2015 which reduced the Company's state deferred tax liability; and the Company received additional R&D tax credits which were not utilized in the comparable period in 2014. The Company expects the year-end tax rate to be approximately 34%.

LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2015, the Company had approximately $2.1 million of cash. The Company's operating activities generated net cash of $1.8 million for the six months ended June 30, 2015. Investing activities used $919 thousand of cash while financing activities used $2.4 million of cash during the first six months of 2015.

Cash provided by operating activities of $1.8 million reflected net income of $530 thousand adjusted for depreciation and amortization of $707 thousand and stock-based compensation of $343 thousand. This was affected by the following changes in assets and liabilities: an increase in accounts receivable of $438 thousand, a decrease in prepaid expenses, other current assets and income tax receivable of $877 thousand, a decrease in accounts payable of $256 thousand, an increase in accrued expenses of $178 thousand and an increase for deferred income taxes of $167 thousand.

Cash used in investing activities included equipment and leasehold improvements of $699 thousand which were purchased during the first half of 2015. We anticipate spending $300 thousand to $600 thousand in additional capital purchases for the remainder of 2015.

Cash used by financing activities of $2.4 million included cash dividends to shareholders of $1.6 million and $700 thousand from payments on long term debt. On July 28, 2015, the Company declared a quarterly dividend of $0.15 per share for an estimated total of $813 thousand, which will be paid on August 18, 2015 to shareholders of record on August 7, 2015.

Contractual obligations and other commercial commitments as of June 30, 2015 were as follows:

	Less Than One Year	1-3 Years	4-5 years	After 5 Years	Total
	(in thousands)				
Debt principal	$1,400	$2,800	$1,348	$ -	$5,548
Operating leases	771	523	-	-	1,294
Total	$2,171	$3,323	$1,348	$ -	$6,842

At June 30, 2015, the Company's principal sources of liquidity included an aggregate of approximately $2.1 million of cash. 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.

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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.

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, stock compensation expense, 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.

Capitalized Development Costs

The Company capitalizes costs related to significant software projects developed or obtained for internal use. Costs incurred during the preliminary project work stage or conceptual stage, such as determining the performance requirements, system requirements and data conversion, are expensed as incurred. Costs incurred in the application development phase, such as coding, testing for new software and upgrades that result in additional functionality, are capitalized and are amortized using the straight-line method over the useful life of the software for 5 years. Costs incurred during the post-implementation/operation stage, including training costs and maintenance costs, are expensed as incurred. The Company capitalized internally developed software costs of $220 thousand and $247 thousand for the six months ended June 30, 2015 and 2014, respectively. Determining whether particular costs incurred are more properly attributable to the preliminary or conceptual stage, and thus expensed, or to the application development phase, and thus capitalized and amortized, depends on subjective judgments about the nature of the development work, and our judgments in this regard may differ from those made by other companies. General and administrative costs related to developing or obtaining such software is expensed as incurred.

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.

The Company follows the guidance of ASC 740, *Income Taxes* (“ASC 740”). 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 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 June 30, 2015 or December 31, 2014.

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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 long-term debt agreement entered into in March 2014, is subject to the 30 day Libor rate, which changes the Company’s interest rate on a monthly basis. The Company does not expect any changes in this rate to materially affect the Company’s performance.

Based on our ability to access our cash and cash equivalents, 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 end of the period covered by this report, our Chief Executive Officer and our Vice President - Finance 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-15. Based upon that evaluation, the Chief Executive Officer and Vice President - Finance 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 2014 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 six months of 2015.

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: July 31, 2015 By: /s/ Raymond C. Kubacki
Raymond C. Kubacki
Chairman and Chief Executive Officer
(principal executive officer)

Date: July 31, 2015 By: /s/ Neil L. Lerner
Neil L. Lerner
Vice President - Finance

(principal accounting officer)

PSYCHEMEDICS CORPORATION

FORM 10-Q

June 30, 2015

EXHIBIT INDEX