

PSYCHEMEDICS CORP  
Form 10-Q  
May 18, 2009

**Table of Contents**

**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, 2009**

**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  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 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)

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 12, 2009 was 5,843,067.

**PSYCHEMEDICS CORPORATION**  
**FORM 10-Q FOR THE QUARTER ENDED MARCH 31, 2009**  
**INDEX**

|   | <b>Page</b> |
|---|-------------|
| <b>PART I FINANCIAL INFORMATION</b>   |             |
| <b>Item 1 Financial Statements (Unaudited)</b>  |             |
| <u>Condensed Balance Sheets as of March 31, 2009 and December 31, 2008</u>                          | 3           |
| <u>Condensed Statements of Income for the Three Months Ended March 31, 2009 and 2008</u>            | 4           |
| <u>Condensed Statements of Cash Flows for the Three Months Ended March 31, 2009 and 2008</u>        | 5           |
| <u>Notes to Condensed Financial Statements</u>  | 6           |
| <b>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</b> |             |
| <u>Overview</u>   | 13          |
| <u>Results of Operations</u>  | 13          |
| <u>Liquidity and Capital Resources</u>  | 14          |
| <u>Critical Accounting Policies and Estimates</u>   | 16          |
| <b>Item 3 Quantitative and Qualitative Disclosures About Market Risk</b>                            | 18          |
| <b>Item 4 Controls and Procedures</b>   | 18          |
| <b>PART II OTHER INFORMATION</b>  |             |
| <b>Item 1A Risk Factors</b>   | 19          |
| <b>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</b>                           | 19          |
| <b>Item 6 Exhibits</b>  | 19          |
| <b>Signatures</b>   | 20          |
| <b>Exhibit Index</b>  | 21          |
| <u>Exhibit 31.1</u>   |             |
| <u>Exhibit 31.2</u>   |             |
| <u>Exhibit 32.1</u>   |             |

Exhibit 32.2

**Table of Contents****PSYCHEMEDICS CORPORATION  
CONDENSED BALANCE SHEETS**

|  | March 31, 2009<br>Unaudited | December 31, 2008    |
|--|-----------------------------|----------------------|
| <b>ASSETS</b>  |                             |                      |
| Current Assets:  |                             |                      |
| Cash and cash equivalents  | \$ 5,487,075                | \$ 6,630,119         |
| Accounts receivable, net of allowance of \$246,478 in 2009 and \$246,462 in 2008   | 2,741,716                   | 3,398,455            |
| Prepaid expenses   | 1,084,148                   | 1,023,841            |
| Other current assets   | 347,514                     | 82,045               |
| Deferred tax assets  | 490,762                     | 449,398              |
| <b>Total Current Assets</b>  | <b>10,151,215</b>           | <b>11,583,858</b>    |
| Fixed Assets   |                             |                      |
| Equipment & leasehold improvements   | 10,905,223                  | 10,877,479           |
| Less accumulated depreciation  | (10,143,689)                | (10,047,755)         |
| <b>Net Fixed Assets</b>  | <b>761,534</b>              | <b>829,724</b>       |
| Deferred tax assets, long-term   | 139,021                     | 139,021              |
| Other assets   | 74,716                      | 75,183               |
| <b>Total Assets</b>  | <b>\$ 11,126,486</b>        | <b>\$ 12,627,786</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                             |                      |
| Current Liabilities:   |                             |                      |
| Accounts payable   | 313,896                     | 644,894              |
| Accrued expenses   | 946,220                     | 1,268,924            |
| Deferred revenue   | 123,210                     | 154,080              |
| <b>Total Current Liabilities</b>   | <b>1,383,326</b>            | <b>2,067,898</b>     |
| 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. 5,843,068 shares issued in 2009 and 5,843,068 shares issued in 2008 | 29,216                      | 29,216               |
| Paid-in capital  | 27,226,179                  | 27,118,743           |
| Accumulated deficit  | (7,458,871)                 | (6,614,114)          |
| Less Treasury stock, at cost, 664,523 shares in 2009 and 647,304 shares in 2008  | (10,053,364)                | (9,973,957)          |
| <b>Total Shareholders Equity</b>   | <b>9,743,160</b>            | <b>10,559,888</b>    |

|   |               |               |
|---|---------------|---------------|
| Total Liabilities & Shareholders Equity | \$ 11,126,486 | \$ 12,627,786 |
|---|---------------|---------------|

See accompanying notes to condensed financial statements.

**Table of Contents**

**PSYCHEMEDICS CORPORATION**  
**CONDENSED STATEMENTS OF INCOME**  
**UNAUDITED**

|   | Three Months Ended<br>March 31, |              |
|---|---------------------------------|--------------|
|   | 2009                            | 2008         |
| Revenue   | \$ 4,078,837                    | \$ 5,708,863 |
| Cost of Revenue                                     | 1,986,911                       | 2,387,301    |
| Gross Profit  | 2,091,926                       | 3,321,562    |
| Operating Expenses:                                 |                                 |              |
| General & Administrative                            | 1,042,495                       | 1,022,302    |
| Marketing & Selling                                 | 871,464                         | 798,645      |
| Research & Development                              | 125,046                         | 117,780      |
| Operating Expenses                                  | 2,039,005                       | 1,938,727    |
| Operating Income                                    | 52,921                          | 1,382,835    |
| Interest Income                                     | 15,507                          | 111,771      |
| Net Income Before Provision for Income Taxes        | 68,428                          | 1,494,606    |
| Provision for Income Taxes                          | 29,903                          | 605,000      |
| Net Income  | \$ 38,525                       | \$ 889,606   |
| Basic net income per share                          | \$ 0.01                         | \$ 0.17      |
| Diluted net income per share                        | \$ 0.01                         | \$ 0.17      |
| Dividends declared per share                        | \$ 0.17                         | \$ 0.15      |
| Weighted average common shares outstanding, basic   | 5,190,747                       | 5,220,711    |
| Weighted average common shares outstanding, diluted | 5,204,876                       | 5,308,962    |

See accompanying notes to condensed financial statements.





Table of Contents

**PSYCHEMEDICS CORPORATION**  
**CONDENSED STATEMENTS OF CASH FLOWS**  
**UNAUDITED**

|   | <b>For the Three Months Ended</b> |                       |
|---|-----------------------------------|-----------------------|
|   | <b>March 31,</b>                  | <b>March 31, 2008</b> |
|   | <b>2009</b>                       |                       |
| <b>Cash Flows From Operating Activities:</b>  |                                   |                       |
| Net Income  | \$ 38,525                         | \$ 889,606            |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                                   |                       |
| Depreciation and amortization   | 96,401                            | 84,456                |
| Stock-based compensation expense  | 107,436                           | 75,876                |
| Deferred income taxes   | (41,364)                          | (27,923)              |
| Changes in operating assets and liabilities:  |                                   |                       |
| Accounts Receivable   | 656,739                           | (15,056)              |
| Prepaid expenses and other current assets   | (325,776)                         | (642,699)             |
| Accounts payable  | (330,998)                         | (151,645)             |
| Accrued expenses  | (322,704)                         | 78,532                |
| Accrued income tax  |                                   | (16,924)              |
| Deferred revenue  | (30,870)                          | (30,329)              |
| <b>Net Cash Provided By (Used In) Operating Activities:</b>                                 | <b>(152,611)</b>                  | <b>243,894</b>        |
| <b>Cash Flows Provided By (Used In) Investing Activities:</b>                               |                                   |                       |
| Redemptions of Short-Term Investments   |                                   | 1,075,000             |
| Purchases of equipment and leasehold improvements   | (27,744)                          | (28,446)              |
| Other Assets  |                                   | (3,345)               |
| <b>Net Cash Provided By (Used In) Investing Activities:</b>                                 | <b>(27,744)</b>                   | <b>1,043,209</b>      |
| <b>Cash Flows Used In Financing Activities:</b>   |                                   |                       |
| Net Proceeds from issuance of Stock   |                                   | 44,460                |
| Acquisition of Treasury Stock   | (79,407)                          | (334,504)             |
| Cash Dividends paid   | (883,282)                         | (784,340)             |
| <b>Net Cash Used In Financing Activities:</b>   | <b>(962,689)</b>                  | <b>(1,074,384)</b>    |
| <b>Net Increase (Decrease) In Cash and Cash Equivalents:</b>                                | <b>(1,143,044)</b>                | <b>212,719</b>        |
| Cash and Cash Equivalents, Beginning Of Period:   | 6,630,119                         | 6,096,664             |

Edgar Filing: PSYCHEMEDICS CORP - Form 10-Q

|   |              |              |
|---|--------------|--------------|
| Cash and Cash Equivalents, End Of Period: | \$ 5,487,075 | \$ 6,309,383 |
|---|--------------|--------------|

Supplemental Disclosures of Cash Flow Information

|                            |  |            |
|----------------------------|--|------------|
| Cash paid for income taxes |  | \$ 830,000 |
|----------------------------|--|------------|

See accompanying notes to condensed financial statements.

**Table of Contents**

**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, 2008, filed on March 23, 2009. 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 ended March 31, 2009 may not be indicative of the results that may be expected for the year ending December 31, 2009, 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 consist of cash savings and U.S. government reserve money market accounts at March 31, 2009 and 2008. While the money market account contains U.S. federal government backed issues, the account itself is not federally insured. As of March 31, 2009, \$4.0 million were in U.S. federal government-backed money market accounts.

**3. Stock-Based Compensation**

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, 2009, 158,100 shares remained available for future grant under the 2006 Equity Incentive Plan.

**Table of Contents**

**PSYCHEMEDICS CORPORATION**  
**NOTES TO CONDENSED FINANCIAL STATEMENTS**  
**UNAUDITED**

**3. Stock-Based Compensation (continued)**

A summary of activity for SUAs (Stock Unit Awards) under the Company's 2006 Equity Incentive Plan for the three months ended March 31, 2009 is as follows:

|                                     | <b>Number<br/>of<br/>Shares</b> | <b>Aggregate<br/>Intrinsic<br/>Value (1)<br/>(000s)</b> |
|-------------------------------------|---------------------------------|---|
| Outstanding, December 31, 2008      | 67,600                          |   |
| Granted                             |                                 |   |
| Terminated                          |                                 |   |
| Converted to common stock           |                                 |   |
| Outstanding, March 31, 2009         | 67,600                          | \$ 385  |
| Available for grant, March 31, 2009 | 158,100                         |   |

(1) The aggregate intrinsic value on this table was calculated based on the closing market value of the Company's stock on March 31, 2009 (\$5.70).

A summary of stock option activity for the Company's expired stock option plans for the three months ended March 31, 2009 is as follows:

|                                | <b>Number<br/>of<br/>Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price Per<br/>Share</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life</b> | <b>Aggregate<br/>Intrinsic<br/>Value (2)<br/>(000s)</b> |
|--------------------------------|---------------------------------|--|--|---|
| Outstanding, December 31, 2008 | 392,110                         | \$ 15.22   |  |   |
| Granted                        |                                 |  |  |   |
| Exercised                      |                                 |  |  |   |
| Terminated                     |                                 |  |  |   |
| Outstanding, March 31, 2009    | 392,110                         | \$ 15.22   | 4.2 years  | \$  |
| Exercisable, March 31, 2009    | 392,110                         | \$ 15.22   | 4.2 years  | \$  |

Available for grant, March 31, 2009

- (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, 2009 (\$5.70) exceeded the exercise price of the underlying options, multiplied by the number of shares subject to each option.

Table of Contents

**PSYCHEMEDICS CORPORATION**  
**NOTES TO CONDENSED FINANCIAL STATEMENTS**  
**UNAUDITED**

**3. Stock-Based Compensation (continued)**

The total intrinsic value of stock options exercised, during the three months ended March 31, 2008, calculated based on the amount by which the market value of the Company's stock at the time of exercise exceeded the exercise price, was \$5 thousand. No options were exercised during the three month period ended March 31, 2009.

As of March 31, 2009, a total of 617,810 shares of common stock were reserved for issuance under the various stock option and stock-based plans. As of March 31, 2009, the unamortized fair value of awards relating to SUAs was \$775 thousand.

**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 assume the full vesting of all outstanding, unvested SUAs. The Company's unvested SUAs do not have stock dividend rights and, consequently, are not included in share totals.

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

|   | <b>Three Months Ended</b> |                  |
|---|---------------------------|------------------|
|   | <b>(000s)</b>             |                  |
|   | <b>March 31,</b>          | <b>March 31,</b> |
|   | <b>2009</b>               | <b>2008</b>      |
| Weighted average common shares                                | 5,191                     | 5,221            |
| Common equivalent shares                                      | 14                        | 88               |
| Weighted average common shares outstanding, assuming dilution | 5,205                     | 5,309            |

For the three months ended March 31, 2009 and 2008, options to purchase 392 thousand and 155 thousand common shares, respectively, were outstanding but not included in the diluted weighted average common share calculation as the effect would have been antidilutive.

**Table of Contents**

**PSYCHEMEDICS CORPORATION  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
UNAUDITED**

**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 Emerging Issue Task Force ( EITF ) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. In accordance with EITF 00-21, 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 \$35 thousand and \$29 thousand of revenue in the results of operations for the three months ended March 31, 2009 and 2008, respectively, related to test kits that were sold for which the Company's obligations to provide service were deemed remote.

At March 31, 2009 and December 31, 2008, the Company had deferred revenue of approximately \$123 thousand and \$154 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.

**Table of Contents**

**PSYCHEMEDICS CORPORATION  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
UNAUDITED**

**6. Fair Value Measurements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 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. SFAS 157 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. SFAS 157 became effective for financial statements issued for fiscal years beginning after November 15, 2007 and was adopted by the Company in 2008 without material effect on the Company's financial position or results of operations.

SFAS 157 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 and investments. The Company's cash and cash equivalents and 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.



Table of Contents

**PSYCHEMEDICS CORPORATION**  
**NOTES TO CONDENSED FINANCIAL STATEMENTS**  
**UNAUDITED**

**6. Fair Value Measurements (continued)**

In February 2008, the FASB issued Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157* ( FSP 157-2 ) that defers the effective date of applying the provisions of SFAS 157 to the fair value measurement of nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (or at least annually), until fiscal years beginning after November 15, 2008. The Company believes that FSP 157-2 does not have a material impact on its results of operations and financial condition.

**7. Recent Accounting Pronouncements**

In April 2008, the FASB issued FSP No. FAS 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP No. 142-3 ). FSP No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets* ( SFAS 142 ). The objective of FSP No. 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(revised 2007), *Business Combinations*, ( SFAS 141(R) ), and other accounting principles generally accepted in the United States. FSP No. 142-3 applies to all intangible assets, whether acquired in a business combination or otherwise, and shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years and should be applied prospectively to intangible assets acquired after the effective date. Early adoption is prohibited. The Company is in the process of evaluating FSP No. 142-3 and does not expect it to have a significant impact on its financial statements.

In December 2007, the FASB issued SFAS No. 141 (R), *Business Combinations* ( SFAS 141R ). SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. SFAS 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141R will become effective as of the beginning of the Company's fiscal year beginning after December 15, 2008. SFAS 141R will be adopted on a prospective basis for new acquisitions subsequent to the effective date. With respect to potential transactions that may be executed subsequent to adoption, the accounting consequences could be materially different than under the current accounting rules.

**Table of Contents**

In April 2009, the FASB issued FSP FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* ( FSP FAS 141(R)- 1 ). This FSP requires that assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value if fair value can be reasonably estimated. If fair value cannot be reasonably estimated, the asset or liability would generally be recognized in accordance with SFAS No. 5, *Accounting for Contingencies* and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* . Further, the FASB removed the subsequent accounting guidance for assets and liabilities arising from contingencies from SFAS No. 141(R). The requirements of FSP FAS 141(R)-1 carry forward without significant revision of the guidance on contingencies of SFAS No. 141, *Business Combinations* , which was superseded by SFAS No. 141(R) (see previous paragraph). FSP FAS 141(R)-1 also eliminates the requirement to disclose an estimate of the range of possible outcomes of recognized contingencies at the acquisition date. For unrecognized contingencies, the FASB requires that entities include only the disclosures required by SFAS No. 5. FSP FAS 141(R)-1 will become effective as of the beginning of the Company s fiscal year beginning after December 15, 2008. With respect to potential transactions that may be executed subsequent to adoption, the accounting consequences could be materially different than under the current accounting rules.

**8. 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.

**9. Subsequent Event Dividends**

On May 6, 2009, the Company declared a quarterly dividend of \$0.17 per share for a total of \$882 thousand, which will be paid on June 19, 2009 to shareholders of record on June 5, 2009.

**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.

**Table of Contents**

**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.

Revenue for the first quarter of 2009 was \$4.1 million, a decrease of 29% from first quarter 2008 revenue of \$5.7 million. The Company reported net income of \$0.01 and \$0.17 per diluted share for the three months ended March 31, 2009 and 2008, respectively. At March 31, 2009, the Company had \$5.5 million of cash and cash equivalents. The Company distributed \$833 thousand or \$0.17 per share of cash dividends to its shareholders in the three months ended March 31, 2009. The Company has paid fifty-one consecutive quarterly cash dividends.

**RESULTS OF OPERATIONS**

*Revenue* was \$4.1 million for three months ended March 31, 2009 compared to revenue of \$5.7 million for the three months ended March 31, 2008, representing a decrease of 29%. The decrease in revenue for the three months ended March 31, 2009 was a result of a decrease in testing volume from new and existing clients of 30%, while the average revenue per sample increased 2% during the same period.

*Gross profit* decreased \$1.2 million to \$2.1 million for the three months ended March 31, 2009, compared to \$3.3 million for the three months ended March 31, 2008. Direct costs fell by \$400 thousand or 17% for the three months ended March 31, 2009 compared to the same period in 2008, mainly due to decreased labor and associated costs. The gross profit margin decreased to 51% for the three months ended March 31, 2009 compared to 58% for the comparable period of 2008.

*General and administrative ( G&A ) expenses* were \$1.0 million for the three months ended March 31, 2009 and 2008. As a percentage of revenue, G&A expenses were 26% and 18% for the three months ended March 31, 2009 and 2008, respectively.

**Table of Contents**

*Marketing and selling expenses* were \$871 thousand for the three months ended March 31, 2009 as compared to \$799 thousand for the three months ended March 31, 2008, an increase of 9%. Total marketing and selling expenses represented 22% and 14% of revenue for the three months ended March 31, 2009 and 2008, respectively. The increase in marketing and selling expenses was due to higher staffing levels and related expenses.

*Research and development ( R&D ) expenses* for the three months ended March 31, 2009 were \$125 thousand, compared to \$118 thousand for the comparable period of 2008, an increase of 6%. R&D expenses represented 3% and 2% of revenue in the first quarter 2009 and 2008 respectively.

*Interest income* for the three months ended March 31, 2009 decreased by \$96 thousand to \$15 thousand when compared to the same period of 2008 in which interest income was \$112 thousand. Interest income represented interest and dividends earned on cash and cash equivalents and investments. Decreasing interest rates on our mix of cash, cash equivalents and investments caused the decrease in interest income for the three month period ended March 31, 2009.

*Provision for income taxes* During the three months ended March 31, 2009, the Company recorded a tax provision of \$30 thousand. During the three months ended March 31, 2008, the Company recorded a tax provision of \$605 thousand. These provisions represented effective tax rates of 44% and 40% for the periods ended March 31, 2009 and 2008, respectively.

**LIQUIDITY AND CAPITAL RESOURCES**

At March 31, 2009, the Company had approximately \$5.5 million of cash and cash equivalents. The Company's operating activities used net cash of \$153 thousand for the three months ended March 31, 2009. Investing activities used \$28 thousand in the three month period while financing activities used a net amount of \$963 thousand during the period.

Cash used by operating activities of \$153 thousand reflected net income of \$39 thousand adjusted for depreciation and amortization of \$96 thousand, stock based compensation of \$107 thousand and a decrease in receivables of \$657 thousand offset by an increase in prepaid expenses and other current assets (primarily insurance) of \$326 thousand and a decrease in accounts payable of \$331 thousand and a decrease in accrued expenses of \$323 thousand.

During the three months ended March 31, 2009, the Company distributed \$883 thousand in cash dividends to its shareholders. The Company repurchased 17,219 shares for treasury during the three months ended March 31, 2009 for \$79 thousand. In March 2008, the Board of Directors of the Company also authorized, under a new repurchase program, 250,000 shares for repurchase of which 17,219 shares have been repurchased since January 1, 2009 and 47,077 shares have been repurchased since March 2008. In total, 664,523 shares have been repurchased for all programs.

**Table of Contents**

Contractual obligations as of March 31, 2009 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    | \$ 522                | \$ 976       | \$                             | \$               | \$ 1,498 |
| Purchase commitment | 434                   |              |                                |                  | 434      |
|                     | \$ 956                | \$ 976       | \$                             | \$               | \$ 1,932 |

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 \$145 thousand for the three months ended March 31, 2009 as compared to \$152 thousand for the comparable period of 2008. The Company expects to purchase approximately \$434 thousand for the remainder of 2009. 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, 2009, the Company's principal sources of liquidity included an aggregate of approximately \$5.5 million of cash and cash equivalents. Management currently believes that such funds, together with cash generated from operations, should be adequate to fund anticipated working capital requirements and capital expenditures in the near term. 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, 2009, the Company had no long-term debt.

**Table of Contents**

**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 Emerging Issue Task Force ( EITF ) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. In accordance with EITF 00-21, 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 \$35 thousand and \$29 thousand of revenue in the results of operations for the three months ended March 31, 2009 and 2008, 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.

**Table of Contents**

**Allowance for Doubtful Accounts**

The allowance for doubtful accounts is based on management's assessment of the collectibility 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 FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*. FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions (tax contingencies) accounted for in accordance with SFAS No. 109. 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 FIN 48, 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, 2009 or December 31, 2008. The Company does not expect the unrecognized tax benefits to change significantly over the next twelve months.

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.

**Table of Contents**

**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 and cash equivalents, interest rate risk is mitigated.

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 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 are effective in ensuring the reporting of material information required to be included in the Company's periodic filings with the Securities and Exchange Commission. 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.



**Table of Contents****PART II OTHER INFORMATION****Item 1A. Risk Factors**

There have been no material changes in our risk factors from those disclosed in our 2008 Annual Report on Form 10-K.

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

The following table presents the aggregate quarterly purchases during the first quarter of 2009:

| <b>Month</b> | <b>Total number of shares purchased</b> | <b>Average price paid per share</b> | <b>Total number of shares purchased as part of publicly announced repurchase programs</b> | <b>Maximum number of shares that may yet be purchased under the programs (1)</b> |
|--------------|---|-------------------------------------|---|--|
| January      |   |                                     |   | 220,142  |
| February     | 3,511                                   | \$ 6.09                             | 3,511   | 216,631  |
| March        | 13,708                                  | \$ 4.23                             | 13,708  | 202,923  |

(1) On March 18, 2008, the Board of Directors authorized a new repurchase program. Under the 2008 program, the Company is authorized to repurchase up to 250,000 shares of the Company's common stock, subject to certain market conditions. As of March 31, 2009, there have been 47,077 shares repurchased under this program, leaving 202,923 available for future repurchases.

**Item 6. Exhibits**

See Exhibit Index included in this Report

**Table of Contents**

**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 15, 2009

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

Date: May 15, 2009

By: /s/ Raymond J. Ruddy  
Raymond J. Ruddy  
Vice President and Controller  
(principal accounting officer)

**Table of Contents**

**PSYCHEMEDICS CORPORATION  
FORM 10-Q  
March 31, 2009  
EXHIBIT INDEX**

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Principal Accounting Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Principal Accounting Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002