PSYCHEMEDICS CORP
Form 10-Q
July 30, 2014

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, 2014

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	**(I.R.S. Employer Identification No.)**

Incorporation or Organization)

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 ¨	Smaller Reporting Company x
		(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 x

The number of shares of Common Stock of the Registrant, par value $0.005 per share, outstanding at July 30, 2014 was 5,375,061.

PSYCHEMEDICS CORPORATION

FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2014

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PSYCHEMEDICS CORPORATION

CONDENSED BALANCE SHEETS

(UNAUDITED)

	June 30, 2014	December 31, 2013
ASSETS		
Current Assets:		
Cash and cash equivalents	$2,348,526	$3,970,512
Accounts receivable, net of allowance for doubtful accounts of $126,375 in 2014 and $144,921 in 2013	5,623,208	4,368,864
Prepaid expenses and other current assets	1,260,234	769,269
Income tax receivable	152,915	554,828
Deferred tax assets	405,993	292,795
Total Current Assets	9,790,876	9,956,268
Fixed Assets, net of accumulated amortization and depreciation of $5,527,891 in 2014 and $5,175,722 in 2013	12,232,718	6,050,203
Other assets	677,245	543,345
Total Assets	$22,700,839	$16,549,816
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$1,179,074	$510,550
Accrued expenses	1,670,953	2,447,920
Current portion of long-term debt	1,232,254	—
Total Current Liabilities	4,082,281	2,958,470
Long-term debt	4,715,099	—
Deferred tax liabilities, long-term	1,314,221	1,314,221
Total Liabilities	10,111,601	4,272,691
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 6,043,191 shares issued in 2014 and 5,981,896 shares issued in 2013	29,956	29,910
Additional paid-in capital	29,187,450	28,888,712

Accumulated deficit	(6,546,379)	(6,559,708)
Less - Treasury stock, at cost, 668,130 shares	(10,081,789)	(10,081,789)
Total Shareholders' Equity	12,589,238	12,277,125
Total Liabilities and Shareholders' Equity	$22,700,839	$16,549,816

See accompanying notes to condensed financial statements

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PSYCHEMEDICS CORPORATION

CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Revenues	$7,694,137	$6,898,737	$14,738,958	$13,331,179
Cost of revenues	3,802,874	2,819,788	7,051,913	5,764,959
Gross profit	3,891,263	4,078,949	7,687,045	7,566,220
Operating Expenses:				
General & administrative	1,128,616	1,006,950	2,312,763	2,000,661
Marketing & selling	1,165,510	1,150,244	2,264,110	2,276,902
Research & development	277,429	190,036	622,412	354,746
Total Operating Expenses	2,571,555	2,347,230	5,199,285	4,632,309
Operating income	1,319,708	1,731,719	2,487,760	2,933,911
Other income	3,235	300	4,784	91,713
Net income before provision for income taxes	1,322,943	1,732,019	2,492,544	3,025,624
Provision for income taxes	466,024	669,093	879,466	1,140,353
Net income and comprehensive income	$856,919	$1,062,926	$1,613,078	$1,885,271
Basic net income per share	$0.16	$0.20	$0.30	$0.36
Diluted net income per share	$0.16	$0.20	$0.30	$0.36
Dividends declared per share	$0.15	$0.15	$0.30	$0.30
Weighted average common shares outstanding, basic	5,352,664	5,305,296	5,335,347	5,289,066
Weighted average common shares outstanding, diluted	5,375,076	5,316,657	5,367,307	5,304,129

See accompanying notes to condensed financial statements

PSYCHEMEDICS CORPORATION

CONDENSED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Six Months Ended June 30, 2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$1,613,078	$1,885,271
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	469,307	418,064
Stock-based compensation	288,188	234,289
Changes in assets and liabilities:		
Accounts receivable	(1,254,344)	(569,531)
Prepaid expenses, other current assets, and income tax receivable	(89,052)	698,862
Accounts payable	668,524	(92,597)
Accrued expenses	(1,383,094)	(331,777)
Deferred income taxes	(113,198)	(94,247)
Net cash provided by operating activities	199,409	2,148,334
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of equipment and leasehold improvements	(5,787,821)	(317,638)
Cost of internally developed software	(246,570)	(378,791)
Other assets	(145,204)	(100,971)
Net cash used in investing activities	(6,179,595)	(797,400)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from exercise of stock options	47,564	8,844
Proceeds from issuance of stock, net of tax withholding	(36,968)	(111,249)
Proceeds from equipment financing	6,000,000	—
Payments of equipment financing	(52,647)	—
Cash dividends paid	(1,599,749)	(1,585,139)
Net cash provided by (used in) financing activities	4,358,200	(1,687,544)
Net decrease in cash and cash equivalents	(1,621,986)	(336,610)
Cash and cash equivalents, beginning of period	3,970,512	3,065,785
Cash and cash equivalents, end of period	$2,348,526	$2,729,175
Supplemental Disclosures of Cash Flow Information:		
Cash paid for income taxes	$411,860	$190,000
Cash paid for interest	$5,572	$-

Purchases of equipment through accrued liabilities	$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, 2013, filed on February 28, 2014. 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 six months ended June 30, 2014 may not be indicative of the results that may be expected for the year ending December 31, 2014, 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. There were no cash equivalents as of June 30, 2014.

3. Stock-Based Compensation

<u>2006 Equity Incentive Plan</u>

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, 2014, 146,885 shares remained available for future grant under the 2006 Incentive Plan.

The Company granted SUAs covering 44,575 shares of common stock on May 8, 2014. 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, 2014 is as follows:

	Number of Shares	Aggregate Intrinsic Value (1) (000s)
Unvested, December 31, 2013	138,975	
Granted	44,575	
Forfeited/expired	(9,879)	
Converted to common stock	(52,046)	
Unvested, June 30, 2014	121,625	$1,722,210
Available for grant, June 30, 2014	146,885	

(1) The aggregate intrinsic value on this table was calculated based on the closing market value of the Company's stock on June 30, 2014 ($14.16).

<u>Expired Plans</u>

As of June 30, 2014, the Company also had outstanding an aggregate of 136,050 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 six months ended June 30, 2014 is as follows:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (2) (000s)
Outstanding, December 31, 2013	176,950	$ 14.04		

Granted	-	-		
Exercised	(40,900)	$ 12.84		
Terminated/Expired	-			
Outstanding, June 30, 2014	136,050	$ 14.40	0.9 years	$ 0
Exercisable, June 30, 2014	136,050	$ 14.40	0.9 years	$ 0
Available for grant, June 30, 2014	-			

(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 June 30, 2014 ($14.16) exceeded the exercise price of the underlying options, multiplied by the number of shares subject to each option.

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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, 2014, a total of 404,560 shares of common stock were reserved for issuance under the various stock option and stock-based plans. As of June 30, 2014, the unamortized fair value of awards relating to outstanding SUAs and options was $1,436 thousand, which is expected to be amortized over a weighted average period of 3.1 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 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		Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
	(in thousands)			
Weighted average common shares outstanding, basic	5,353	5,305	5,335	5,289
Dilutive common equivalent shares	22	12	32	15
Weighted average common shares outstanding, diluted	5,375	5,317	5,367	5,304

For the three month and six month periods ended June 30, 2013, options to purchase 177 thousand common shares were outstanding but not included in the diluted weighted average common share calculation as the effect would have been antidilutive.

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, 2014, the Company declared a quarterly dividend of $0.15 per share for a total of $806 thousand, which will be paid on August 18, 2014 to shareholders of record on August 7, 2014.

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"), 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 $6 million of new and used equipment purchases to be made over the following 12 months or purchases recently made. Each such purchase financed under the Equipment Loan Arrangement is 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 covenants as of June 30, 2014.

The Company has executed three notes on March 24, 2014, May 22, 2014, and June 13, 2014 in the amounts of $1,052,943, $1,935,241 and $3,011,816, respectively, for a total amount of $6 million. The interest rate for these notes for the quarter ended June 30, 2014 was 2.15%, and represented $12,765 of interest expense. There was no long term debt for the same period in 2013.

The annual principal repayment requirements for debt obligations as of June 30, 2014 are as follows (in 000's):

2014	$632
2015	1,200
2016	1,200
2017	1,200
2018	1,200
2019	515
Total long-term debt	5,947
Less current portion of long-term debt	1,232
Total long-term debt, net of current portion	$4,715

9. Recent Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP.

The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). We are currently evaluating the impact of our pending adoption of ASU 2014-09 on our consolidated financial statements and have not yet determined the method by which we will adopt the standard in 2017.

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 2014 were $7.7 million, an increase of 12% from second quarter 2013 revenue of $6.9 million. The Company reported net income of $0.16 per diluted share for the three months ended June 30, 2014 and $0.20 for the same period in 2013. The positive impact of revenue growth on earnings was offset by expenditures related to an increase in capacity related to the previously announced opportunity in Brazil and research and development of additional tests for drugs of abuse.

At June 30, 2014, the Company had $2.3 million of cash. The Company has borrowed $6.0 million through an equipment financing arrangement for the purchase of additional equipment related to expanding capacity. The Company distributed $802 thousand or $0.15 per share of cash dividends to its shareholders in the three months ended June 30, 2014. The Company has paid 71 consecutive quarterly cash dividends.

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RESULTS OF OPERATIONS

Revenues were $7.7 million for three months ended June 30, 2014 compared to revenues of $6.9 million for the three months ended June 30, 2013, representing an increase of 12%. The increase in revenues for the three months ended June 30, 2014 was a result of an increase in testing volume of 13%. The average revenue per sample decreased 1% from the comparative period in 2013, which was primarily driven by the mix of customers. Revenues for the six months ended June 30, 2014 were $14.7 million, representing an increase of 11% in revenues from the comparable period of 2013 of $13.3 million. The increase was primarily due to an increase in volume, as test samples increased 12% from the first half of 2013.

Gross profit was $3.9 million for the three months ended June 30, 2014, compared to $4.1 million for the three months ended June 30, 2013, representing a decrease of 5%. Direct costs increased by $1.0 million or 35% for the three months ended June 30, 2014 compared to the same period in 2013, mainly due to increased costs related to capacity expansion and a greater volume of samples. The gross profit margin was 51% for the three months ended June 30, 2014 and 59% for the comparable period of 2013. Gross profit for the six months ended June 30, 2014 increased $121 thousand to $7.7 million compared to $7.6 million for the comparable period in 2013. Direct costs increased by $1.3 million or 22% for the six months ended June 30, 2014 when compared to the same period in 2013, mostly due to increased costs related to capacity expansion and a greater volume of samples. The gross profit margin for the six month period ended June 30, 2014 was 52% compared to 57% for the comparable period in 2013.

General and administrative ("G&A") expenses were $1.1 million for the three months ended June 30, 2014, compared to $1.0 million for the three months ended June 30, 2013. As a percentage of revenue, G&A expenses were 15% for the three months ended June 30, 2014 and 2013. General and administrative expenses were $2.3 million and $2.0 million for the six months ended June 30, 2014 and 2013, respectively. As a percentage of revenue, G&A expenses were 16% and 15% for the six months ended June 30, 2014 and 2013, respectively.

Marketing and selling expenses were $1.2 million for the three months ended June 30, 2014 and 2013. Total marketing and selling expenses represented 15% of revenue for the three months ended June 30, 2014, compared to 17% for the comparable period of 2013. Marketing and selling expenses were $2.3 million for the six months ended June 30, 2014 and 2013. Total marketing and selling expenses represented 15% of revenue for the six months ended June 30, 2014, compared to 17% for the comparable period of 2013.

Research and development ("R&D") expenses for the three months ended June 30, 2014 were $277 thousand compared to $190 thousand for the comparable period of 2013, an increase of 46%. R&D expenses represented 4% and 3% of revenue for the three months ended June 30, 2014 and 2013, respectively. Research and development expenses for the six months ended June 30, 2014 were $622 thousand compared to $355 thousand in the prior year. R&D expenses represented 4% and 3% of revenue for the six months ended 2014 and 2013, respectively. The increase in R&D expenses related to additional tests of drugs of abuse.

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Provision for income taxes During the three months ended June 30, 2014 and 2013, the Company recorded tax provisions of $466 thousand and $669 thousand, respectively. These provisions represented effective tax rates of 35% for the three months ended June 30, 2014 and 39% for the comparable period of 2013. During the six months ended June 30, 2014 and June 30, 2013, the Company recorded tax provisions of $879 thousand and $1.1 million, respectively. These provisions represented effective tax rates of 35% for the six month periods ended June 30, 2014 and 38% for the comparative period last year. The 35% represents the current estimate of the year-end tax rate. The Company continues to monitor the effective tax rate but does not expect a significant change for the remaining six months of 2014.

LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2014, the Company had approximately $2.3 million of cash. The Company's operating activities provided net cash of $199 thousand for the six months ended June 30, 2014. Investing activities used $6.2 million of cash while financing activities provided $4.4 million of cash during the first six months of 2014.

Cash provided by operating activities of $199 thousand reflected net income of $1.6 million adjusted for depreciation and amortization of $469 thousand and stock-based compensation of $288 thousand. This was affected by the following changes in assets and liabilities: an increase in accounts receivable of $1.3 million, an increase in prepaid expenses, income tax receivable and other current assets of $89 thousand, an increase in accounts payable of $669 thousand, a decrease in accrued expenses of $1.4 million, and an increase for deferred income tax assets of $113 thousand

Cash used in investing activities of $6.2 million included equipment and leasehold improvements of $5.8 million related to the Company’s capacity expansion, cost of internally developed software of $247 thousand, and other assets of $145 thousand which were purchased during the first six months of 2014. We anticipate spending $0.6 million to $0.8 million in additional capital purchases and leasehold improvements for the remainder of 2014.

Cash provided by financing activities of $4.4 million included $6.0 million of proceeds from long term debt used to purchase equipment related to capacity expansion and $48 thousand from proceeds from exercise of stock options, which was offset by $1.6 million in cash dividends to shareholders, $53 thousand from repayment of debt, and $37 thousand from proceeds from issuance of stock. On July 28, 2014, the Company declared a quarterly dividend of $0.15 per share for a total of $806 thousand, which will be paid on August 18, 2014 to shareholders of record on August 7, 2014.

Contractual obligations and other commercial commitments as of June 30, 2014 were as follows:

	Less Than One Year	1-3 Years	4-5 years	After 5 Years	Total
	(in thousands)				
Debt principal	$1,232	$2,400	$2,315	$ -	$5,947
Operating leases	$979	$1,058	$60	$ -	$2,097
Total	$2,211	$3,458	$2,375	$ -	$8,044

At June 30, 2014, the Company's principal sources of liquidity included an aggregate of approximately $2.3 million of cash and its $6.0 million equipment financing. During the third quarter, the Company expects to expand the equipment financing arrangement to fund additional equipment purchases of an estimated $900 thousand to $1.1 million. Management currently believes that such funds, together with cash generated from operations, should be adequate to fund anticipated working capital and capital equipment requirements 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.

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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 $247 thousand and $379 thousand for the six months ended June 30, 2014 and 2013, 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, 2014 or December 31, 2013.

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 date of 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 2013 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 six months of 2014.

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 30, 2014	By:	/s/ Raymond C. Kubacki
		Raymond C. Kubacki
		Chairman and Chief Executive Officer
		(principal executive officer)
Date: July 30, 2014	By:	/s/ Neil L. Lerner
		Neil L. Lerner
		Vice President - Finance

(principal accounting officer)

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PSYCHEMEDICS CORPORATION

FORM 10-Q

June 30, 2014

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