PSYCHEMEDICS CORP
Form 10-Q
May 14, 2007

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

(Mark One)

þ **QUARTERLY REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For quarterly period ended March 31, 2007

o **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 Issuer as specified in its charter)

Delaware	58-1701987
(State or other jurisdiction of incorporation of organization)	(I.R.S. Employer Identification No.)
125 Nagog Park, Acton, MA	01720
(Address of principal executive offices)	(Zip Code)

Issuer s telephone number, including area code (978) 206-8220

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15 (d) of the Exchange Act during the past 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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company.

YES o NO þ

Number of shares outstanding of only class of Issuer s Common Stock as of May 14, 2007: Common Stock $.005 par value (5,199,047 shares).

PSYCHEMEDICS CORPORATION

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PSYCHEMEDICS CORPORATION
CONDENSED BALANCE SHEETS

	MARCH 31, 2007 (Unaudited)	DECEMBER 31, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 3,787,983	$ 4,180,235
Short-term investments	3,716,505	3,683,192
Accounts receivable, net of allowance for doubtful accounts of $283,281 in 2007 and $333,281 in 2006	3,462,224	3,196,384
Prepaid expenses and other current assets	1,141,793	818,693
Deferred tax assets	423,728	412,486
Total current assets	12,532,233	12,290,990
PROPERTY AND EQUIPMENT:		
Equipment and leasehold improvements, at cost	10,547,749	10,376,718
Less-accumulated depreciation and amortization	(9,715,831)	(9,630,190)
	831,918	746,528
DEFERRED TAX ASSETS	183,555	183,555
OTHER ASSETS, NET	39,830	39,830
	$ 13,587,536	$ 13,260,903
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 228,406	$ 499,420
Accrued expenses	721,174	865,575
Deferred revenue	360,630	392,403
Total current liabilities	1,310,210	1,757,398
SHAREHOLDERS EQUITY:		
Preferred stock, $0.005 par value; 872,521 shares authorized; none issued or outstanding		
Common stock; $0.005 par value; 50,000,000 shares authorized; 5,779,844 shares and 5,756,044 shares issued in 2007 and 2006, respectively	28,899	28,780
Paid-in capital	25,996,730	25,609,800
Accumulated deficit	(4,625,612)	(5,012,384)
Less Treasury stock, at cost; 583,797 shares	(9,122,691)	(9,122,691)
Total shareholders equity	12,277,326	11,503,505
	$ 13,587,536	$ 13,260,903

See accompanying notes to financial statements and management s discussion and analysis of financial condition and results of operations.

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PSYCHEMEDICS CORPORATION
CONDENSED STATEMENTS OF INCOME
(unaudited)

	THREE MONTHS ENDED MARCH 31, 2007	2006
REVENUE	$ 5,716,606	$ 5,066,730
COST OF REVENUE	2,454,481	2,116,149
Gross profit	3,262,125	2,950,581
EXPENSES:		
General and administrative	832,453	763,981
Marketing and selling	704,644	665,567
Research and development	94,923	112,578
	1,632,020	1,542,126
OPERATING INCOME	1,630,105	1,408,455
INTEREST INCOME	96,404	58,710
INCOME BEFORE INCOME TAXES	1,726,509	1,467,165
PROVISION FOR INCOME TAXES	691,600	545,000
NET INCOME	$ 1,034,909	$ 922,165
BASIC NET INCOME PER SHARE	$ 0.20	$ 0.18
DILUTED NET INCOME PER SHARE	$ 0.20	$ 0.18
DIVIDENDS DECLARED PER SHARE	$ 0.125	$ 0.10
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING, BASIC	5,179,250	5,167,097
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING, DILUTED	5,264,708	5,209,456

See accompanying notes to financial statements and management s discussion and analysis of financial condition and results of operations.

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PSYCHEMEDICS CORPORATION
CONDENSED STATEMENTS OF CASH FLOWS
(unaudited)

	THREE MONTHS ENDED MARCH 31, 2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,034,909	$ 922,165
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	85,641	78,523
Stock-based compensation expense	31,394	7,644
Deferred income taxes	(11,242)	
Changes in current assets and liabilities:		
Accounts receivable	(265,840)	(108,177)
Prepaid expenses and other current assets	(323,100)	(319,078)
Accounts payable	(271,014)	(105,422)
Accrued expenses	(144,401)	(552,590)
Deferred revenue	(31,773)	12,176
Net cash provided by (used in) operating activities	104,574	(64,759)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of short-term investments	(33,313)	(500,000)
Purchases of property and equipment	(171,031)	(16,160)
Net cash used in investing activities	(204,344)	(516,160)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Tax benefit associated with exercise of options	22,385	
Cash dividends paid	(648,137)	(516,710)
Net proceeds from the exercise of options	333,270	
Net cash used in financing activities	(292,482)	(516,710)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(392,252)	(1,097,629)
CASH AND CASH EQUIVALENTS, beginning of period	4,180,235	3,352,519
CASH AND CASH EQUIVALENTS, end of period	$ 3,787,983	$ 2,254,890

See accompanying notes to financial statements and management s discussion and analysis of financial condition and results of operations.

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PSYCHEMEDICS CORPORATION
NOTES TO CONDENSED FINANCIAL STATEMENTS
March 31, 2007

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) as reported in the Company s Annual Report on Form 10-K for the year ended December 31, 2006. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of financial position, results of operations, and cash flows at the dates and for the periods presented have been included. The results of operations for the three months ended March 31, 2007 may not be indicative of the results that may be expected for the year ending December 31, 2007, or any other period.

2. Stock-Based Compensation

The Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123R) effective January 1, 2006. SFAS 123R requires the recognition of the fair value of stock-based compensation as a charge against earnings. The Company recognizes stock-based compensation expense over the requisite service period of the individual grantees, which generally equals the vesting period. Based on the provisions of SFAS 123R, the Company s stock-based compensation is accounted for as equity instruments. Prior to January 1, 2006, the Company followed Accounting Principles Board (APB) Opinion 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for stock-based compensation. The Company elected the modified prospective transition method for adopting SFAS 123R. Under this method, the provisions of SFAS 123R apply to all awards granted or modified after the date of adoption, as well as to the future vesting of awards granted and not vested as of the date of adoption.

On March 22, 2006 the Company adopted a new stock-based plan (the 2006 Equity Incentive Plan) for officers, directors, employees and consultants, which was approved by the Company s shareholders at the 2006 Annual Shareholders meeting. Under the 2006 Equity Incentive Plan, the Company is authorized to grant options with terms of up to ten years, grant restricted stock, issue stock bonuses or grant other stock-based awards. As of March 31, 2007, a total of 250,000 shares of common stock were reserved for issuance under the 2006 Equity Incentive Plan.

The Company also has stock option plans that have expired, but shares can be issued upon exercise of outstanding options that were granted prior to such expiration. Activity for these plans is included in this footnote. Options granted under the plans consisted of both non-qualified and incentive stock options and were granted in each case at a price that was not less than the fair

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market value of the common stock at the date of grant. These options generally have lives of ten years and vest either immediately or over periods up to four years.

Under the provisions of SFAS 123R, the Company recorded $31,394 and $7,644 of stock-based compensation in the accompanying statements of income for the three months March 31, 2007 and 2006, respectively. The Company granted 26,700 stock unit awards (SUAs) to certain members of management and its directors on May 11, 2006. The fair value of the SUAs was $16.70 per share, which was the closing price of the Company s stock on May 11, 2006. The SUAs vest over a period of two to four years and are convertible into an equivalent number of shares of the Company s common stock provided that the awardee remains continuously employed, or continues to serve as a director, as the case may be, throughout the vesting periods. No stock-based awards were granted or modified during the three months ended March 31, 2007.

SFAS 123R requires the measurement of the fair value of stock options or warrants to be included in the statement of income or disclosed in the notes to financial statements. The Company has computed the value of options using the Black-Scholes option pricing model.

A summary of stock option activity for the Company s expired stock option plans for the three months ended March 31, 2007 is as follows:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (1)
Outstanding, December 31, 2006	527,858	$ 15.79		
Granted				
Exercised	(23,800)	14.00		$ 65,234
Terminated	(26,095)	22.23		
Outstanding, March 31, 2007	477,963	$ 15.53	5.8 years	$ 1,025,712
Exercisable, March 31, 2007	477,113	$ 15.54	5.8 years	$ 1,018,691
Available for grant, March 31, 2007				

(1) 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 March 31, 2007 ($16.91) exceeded the exercise price of the underlying

options, multiplied by the number of shares subject to each option. The aggregate intrinsic value for the options exercised was calculated based on the amount by which the average closing market value of the Company s stock on the dates of exercise ($16.77) exceeded the exercise price of the underlying options, multiplied by the number of shares subject to each option.

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A summary of activity for SUAs for the three months ended March 31, 2007 is as follows:

	Number of Shares	Aggregate Intrinsic Value (2)
Outstanding, December 31, 2006	26,700	
Granted		
Vested		
Terminated	(2,000)	
Outstanding, March 31, 2007	24,700	$ 417,677
Available for grant, March 31, 2007	225,300	

(2) The aggregate intrinsic value on this table was calculated based on the closing market value of the Company s stock on March 31, 2007 ($16.91).

As of March 31, 2007, a total of 727,963 shares of common stock were reserved for issuance under the various stock option and stock-based plans. As of March 2007, the fair value of awards relating to stock options had been fully amortized. As of March 31, 2007, the unamortized fair value of awards relating to SUAs was $306,443.

3. 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.

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

	Three Months Ended	
	March 31, 2007	March 31, 2006
Weighted average common shares outstanding	5,179,250	5,167,097
Dilutive common equivalent shares	85,458	42,359
Weighted average common shares outstanding, assuming dilution	5,264,708	5,209,456

For the three months ended March 31, 2007 and 2006, options to purchase 137,136 and 200,919 common shares, respectively, were outstanding but not included in the diluted weighted average common share calculation as the effect would have been antidilutive.

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4. Revenue Recognition

The Company performs drug testing as well as provides 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 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.

In 2003, the Company adopted Emerging Issue Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, which was effective for all transactions entered into subsequent to June 15, 2003. The Company applied the consensus reached under EITF 00-21 and concluded that the testing, training and storage elements are considered one unit of accounting for revenue recognition purposes as the training and storage costs do not have stand-alone value to the customer. The Company has concluded that the predominant deliverable in the arrangement is the testing of the units and has recognized revenue as that service is performed and reported to the customer.

Deferred revenue represents payments received in advance of the performance of drug testing procedures. 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 $49,327 of revenue in the results of operations in the first quarter of 2007 related to test kits that were sold for which the Company s obligations to provide service were deemed remote.

At March 31, 2007 and December 31, 2006, the Company had deferred revenue of approximately $361,000 and $392,000, 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.

5. Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), an interpretation of Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition and will become effective for the Company for fiscal years beginning after December 15, 2006. The Company has adopted FIN48 without material effect in the financial statements. The Company s evaluation was performed for the tax years ended December 31, 2003, 2004, 2005 and 2006, the tax years which remain subject to examination by major tax jurisdictions as of March 31, 2007.

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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 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and is required to be adopted by the Company in fiscal 2008. The Company is currently evaluating the effect that the adoption of SFAS 157 will have on its results of operations and financial condition but does not expect it to have a material impact.

In September 2006, the SEC issued SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of each of the company s balance sheet and statement of operations and the related financial statement disclosures. Early application of the guidance in SAB 108 is encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006. The adoption of SAB 108 did not have an impact on the Company s results of operations and financial condition.

In fiscal 2006, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154), which replaces APB Opinion No. 20, *Accounting Changes* and SFAS No.3, *Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28.* SFAS 154, which was adopted by the Company in fiscal 2006, provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159) including an amendment of FASB Statement No. 115. SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for the Company beginning in the first quarter of year 2008, although earlier adoption without effect is permitted. The Company is currently assessing the impact of SFAS 159 but does not presently anticipate it will have a material impact on the Company s results of operations and financial condition.

6. 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.

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7. Subsequent Event Dividends

On May 3, 2007, the Company declared a quarterly dividend of $0.15 per share, which will be paid on June 22, 2007 to shareholders of record on June 8, 2007.

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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 revenues, 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, cash dividends, cost savings, capital expenditures 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, 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, financial and operational risks associated with possible expansion of testing facilities used by the Company, government regulation (including, but not limited to, Food and Drug Administration regulations), competition and general economic conditions. With respect to the continued payment of cash dividends, factors include, but are not limited to, available surplus, cash flow, capital expenditure reserves required, and other factors that the Board of Directors of the Company may take into account.

OVERVIEW

Psychemedics Corporation was incorporated in 1986. The Company utilizes a patented hair analysis method involving radioimmunoassay technology and mass spectrometry confirmation to analyze human hair to detect abused substances.

The Company set new first quarter records for both revenue and net income during the three months ended March 31, 2007. Revenue was $5.7 million for the first quarter of 2007, 13% above revenue of $5.1 million for the first quarter of 2006. The Company reported net income of $0.20 per share in the quarter ended March 31, 2007 and net income of $0.18 per share in the quarter ended March 31, 2006. At March 31, 2007, the Company had $7.5 million of cash, cash equivalents, and short-term investments. During the first quarter of 2007, the Company distributed $0.6 million, or $0.125 per share, of cash dividends to its shareholders. The Company has paid forty-two consecutive quarterly cash dividends.

RESULTS OF OPERATIONS

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Revenue was $5,716,606 for the three months ended March 31, 2007 as compared to $5,066,730 for the comparable period of 2006, representing an increase of 13%. The increase in revenue for the first quarter of 2007 was due to an increase of 14% in testing volume from both new and existing clients, while the average revenue per sample decreased by 2% as compared to the comparable period of 2006. The Company s revenue also included the recognition of $49,327 of deferred revenue pertaining to prior sales of the Company s PDT 90 product, which the Company continues to sell to parents who are concerned about drug abuse by their children. The Company continued to add approximately the same number of new clients in the first quarter of 2007 as it did in the first quarter of 2006.

Gross margin was 57% of revenue for the three months ended March 31, 2007, as compared to 58% for the comparable period of 2006. Even though testing volume increased by 14% and fixed and semi-variable direct costs were spread over a greater number of tests performed, gross margin decreased primarily due to the decrease in average revenue per sample of 2% along with a slight increase in labor costs for the three months ended March 31, 2007, as compared to the same period of 2006.

General and administrative (G&A) expenses were $832,453 for the three months ended March 31, 2007 as compared to $763,981 for the comparable period of 2006, representing an increase of 9%. The increase in general and administrative expenses was due primarily to an increase in personnel expenses and legal fees, partially offset by a decrease in bad debt expense. All other general and administrative expenses remained relatively constant. As a percentage of revenue, G&A expenses represented 15% of revenues in both the first quarter of 2007 and 2006. The Company expects general and administrative expenses to remain relatively flat in absolute dollars and decrease as a percentage of revenue during the remainder of 2007 unless the Company is required to fully comply with the internal control testing and attestation provisions of Sarbanes-Oxley by December 31, 2007 based on its June 30, 2007 market capitalization, in which case it will incur increased professional fees and costs related to Sarbanes-Oxley testing and compliance.

Marketing and selling expenses were $704,644 for the three months ended March 31, 2007 as compared to $665,567 for the comparable period of 2006, an increase of 6%. This increase was due primarily to various operational expenses pertaining to the Company s sales support staff for the three months ended March 31, 2007 as compared to the comparable period of 2006. Total marketing and selling expenses represented 12% of revenues in the first quarter of 2007 and 13% of revenues in the first quarter of 2006. The Company expects marketing and selling expenses to increase in absolute dollars and decrease as a percentage of revenue during the remainder of 2007 as resources are committed to direct selling efforts to aggressively promote its drug testing services in order to expand its client base.

Research and development (R&D) expenses were $94,923 for the three months ended March 31, 2007 as compared to $112,578 for the comparable period of 2006, a decrease of 16%. This decrease was primarily due to a reduction in personnel expenses. R&D expenses represented 2% of revenues for the three months ended March 31, 2007 and March 31, 2006. The Company expects research and development expenses to remain relatively flat during the remainder of 2007.

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Interest income for the three months ended March 31, 2007 increased by $37,694 as compared to the comparable period of 2006 and represented interest and dividends earned on cash equivalents and short-term investments. Higher average investment balances along with an increase in the yield on investment balances in 2007 as compared to 2006 caused the increase in interest income.

During the three months ended March 31, 2007, the Company recorded a tax provision of $691,600 reflecting an effective tax rate of 40.0% as compared to a tax provision of $545,000 reflecting an effective tax rate of 37.1% for the three months ended March 31, 2006. The increase in the effective tax rates for 2007 as compared to 2006 was due primarily to state income taxes.

LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2007, the Company had approximately $7.5 million of cash, cash equivalents and short-term investments. The Company s operating activities provided net cash of $104,574 in the three months ended March 31, 2007. Investing activities used $204,344 in the three month period while financing activities used a net amount of $292,482 during the period.

Cash provided by operating activities of $104,574 principally reflected net income of $1,034,909 adjusted for depreciation and amortization of $85,641, partially offset by an increase in accounts receivable and prepaid expenses along with a lesser decrease in accrued expenses and accounts payable. The increase in accounts receivable was due to the increase in revenue during the first quarter of 2007 in comparison to the fourth quarter of 2006. The decrease in accrued expenses was due to the payment during the first quarter of increased income tax amounts and of bonus expense that was accrued as of December 31, 2006. The increase in prepaid expenses was due primarily to the payment of annual insurance premiums during the first quarter of 2007.

Investing cash flow principally reflects the purchase of short-term investments and capital expenditures. During the three months ended March 31, 2007, the Company purchased $33,313 of Taxable Auction Rate Preferred, 7 and 28 day Dutch Auction securities and securities issued by the U.S. Government. Capital expenditures in the first three months of 2007 were $171,031. The expenditures primarily consisted of new equipment, including laboratory and computer equipment. The Company currently plans to make capital expenditures of approximately $700,000 in 2007, primarily in connection with the purchase of additional laboratory and computer equipment. The Company believes that within the next two to five years it may be required to expand its existing laboratory or develop a second laboratory, the cost of which is currently believed to range from $2 million to $5 million, which the Company expects to fund primarily through its operating cash flows.

During the three months ended March 31, 2007, the Company distributed $648,137 in cash dividends to its shareholders. During the three months ended March 31, 2007, the Company realized $22,385 in tax benefits and $333,270 in proceeds from the exercise of stock options. The Company did not repurchase any shares for treasury during the quarter ended March 31, 2007. The Company has authorized 500,000 shares for repurchase since June of 1998, of which 466,351 shares have been repurchased.

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Contractual obligations as of March 31, 2007 were as follows:

	Less Than One Year	1-3 Years	4-5 years	After 5 Years	Total
Operating leases	$ 492,000	992,000	732,000	226,000	$ 2,442,000
Purchase commitment	294,000				294,000
	$ 786,000	$ 992,000	$ 732,000	$ 226,000	$ 2,736,000

Purchase Commitment

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 $146,991 for the three months ended March 31, 2007 as compared to $135,958 for the comparable period of 2006. The Company expects to purchase approximately $441,000 for the remainder of 2007. In exchange for exclusivity, 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 both 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, 2007, the Company s principal sources of liquidity included an aggregate of approximately $7.5 million of cash, cash equivalents and short-term investments. Management currently believes that such funds, together with cash generated from operations, should be adequate to fund anticipated working capital requirements and capital expenditures in the near term. Depending upon the Company s results of operations, its future capital needs and available marketing opportunities, the Company may use various financing sources to raise additional funds. Such sources could potentially include joint ventures, issuances of common stock or debt financing, although the Company does not have any such plans at this time. At March 31, 2007, the Company had no long-term debt.

CRITICAL ACCOUNTING POLICIES

Management believes the most critical accounting policies are as follows:

Revenue Recognition

The Company is in the business of performing drug testing 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 also provides expert testimony, when and if necessary, to support the test results, which is generally billed separately and recognized as the services are provided.

In 2003, the Company adopted Emerging Issue Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, which was effective for all transactions entered into subsequent to June 15, 2003. The Company applied the consensus reached under EITF 00-21 and concluded that the testing, training and storage elements are considered 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 has concluded that the predominant deliverable in the arrangement is the testing of the units and has recognized revenue as that service is performed and reported to the customer.

Deferred revenue represents payments received in advance of the performance of drug testing procedures. 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 $49,327 of revenue in the first quarter of 2007 related to test kits that were previously sold for which revenue had not been recognized and the Company s obligations to provide service was deemed remote.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates, including bad debts and income taxes, and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on management s assessment of the 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.

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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.

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Sensitivity. The Company maintains a short-term investment portfolio consisting principally of money market securities, Taxable Auction Rate Preferred, 7 and 28 day Dutch Auction securities and securities issued by the U.S. Government that are not sensitive to sudden interest rate changes.

Item 4. Controls and Procedures

As of the date of this report, our Chief Executive Officer 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 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.

PART II OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed in our 2006 Annual Report on Form 10-K.

Item 6. Exhibits

See Exhibit Index included in this Report

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SIGNATURES

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

	Psychemedics Corporation
Date: May 14, 2007	By: /s/ Raymond C. Kubacki, Jr.
	Raymond C. Kubacki, Jr. Chairman and Chief Executive Officer (principal executive officer)
Date: May 14, 2007	By: /s/ Thomas M. Harty
	Thomas M. Harty Accounting Manager (principal accounting officer)

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PSYCHEMEDICS CORPORATION
FORM 10-Q
March 31, 2007
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