PSYCHEMEDICS CORP
Form 10-Q
November 08, 2006

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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 September 30, 2006

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 (State or other jurisdiction of incorporation of organization)	58-1701987 (I.R.S. Employer Identification No.)
125 Nagog Park, Acton, MA (Address of principal executive offices)	01720 (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 November 8, 2006: Common Stock $.005 par value (5,172,247 shares).

PSYCHEMEDICS CORPORATION

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PSYCHEMEDICS CORPORATION
CONDENSED BALANCE SHEETS

	SEPTEMBER 30, 2006 (Unaudited)	DECEMBER 31, 2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 3,038,509	$ 3,352,519
Short-term investments	3,600,000	2,550,000
Accounts receivable, net of allowance for doubtful accounts of $373,281 in 2006 and $461,282 in 2005	4,276,040	3,272,278
Prepaid expenses and other current assets	538,174	387,426
Deferred tax assets	538,399	520,152
Total current assets	11,991,122	10,082,375
PROPERTY AND EQUIPMENT:		
Equipment and leasehold improvements, at cost	10,245,823	10,119,679
Less-accumulated depreciation and amortization	(9,559,405)	(9,342,747)
	686,418	776,932
DEFERRED TAX ASSETS	245,889	245,889
OTHER ASSETS, NET	39,830	39,830
	$ 12,963,259	$ 11,145,026
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 224,742	$ 367,535
Accrued expenses	1,171,166	1,292,257
Deferred revenue	625,793	590,670
Total current liabilities	2,021,701	2,250,462
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; 5,756,044 shares and 5,750,894 shares issued in 2006 and 2005, respectively	28,780	28,754
Paid-in capital	25,577,283	25,446,781
Accumulated deficit	(5,541,814)	(7,458,280)
Less Treasury stock, at cost; 583,797 shares	(9,122,691)	(9,122,691)
Total shareholders equity	10,941,558	8,894,564
	$ 12,963,259	$ 11,145,026

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 SEPTEMBER 30, 2006	THREE MONTHS ENDED SEPTEMBER 30, 2005
REVENUE	$ 6,379,962	$ 5,353,168
COST OF REVENUE	2,524,226	2,267,237
Gross profit	3,855,736	3,085,931
EXPENSES:		
General and administrative	865,735	765,758
Marketing and selling	689,808	703,731
Research and development	112,012	87,090
	1,667,555	1,556,579
OPERATING INCOME	2,188,181	1,529,352
INTEREST INCOME	77,772	34,269
INCOME BEFORE INCOME TAXES	2,265,953	1,563,621
PROVISION FOR INCOME TAXES	863,000	581,000
NET INCOME	$ 1,402,953	$ 982,621
BASIC NET INCOME PER SHARE	$ 0.27	$ 0.19
DILUTED NET INCOME PER SHARE	$ 0.27	$ 0.19
DIVIDENDS DECLARED PER SHARE	$ 0.125	$ 0.10
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING, BASIC	5,172,247	5,167,097
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING, DILUTED	5,248,503	5,179,134

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)

	NINE MONTHS ENDED SEPTEMBER 30, 2006	NINE MONTHS ENDED SEPTEMBER 30, 2005
REVENUE	$ 17,628,078	$ 16,306,247
COST OF REVENUE	6,971,776	6,656,516
Gross profit	10,656,302	9,649,731
EXPENSES:		
General and administrative	2,466,395	2,394,370
Marketing and selling	2,086,982	2,110,980
Research and development	340,662	232,891
	4,894,039	4,738,241
OPERATING INCOME	5,762,263	4,911,490
INTEREST INCOME	199,975	73,867
OTHER INCOME		1,250
	199,975	75,117
INCOME BEFORE INCOME TAXES	5,962,238	4,986,607
PROVISION FOR INCOME TAXES	2,236,000	1,855,000
NET INCOME	$ 3,726,238	$ 3,131,607
BASIC NET INCOME PER SHARE	$ 0.72	$ 0.61
DILUTED NET INCOME PER SHARE	$ 0.71	$ 0.61
DIVIDENDS DECLARED PER SHARE	$ 0.35	$ 0.26
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING, BASIC	5,169,587	5,153,178

WEIGHTED AVERAGE COMMON SHARES OUTSTANDING, DILUTED	5,232,509	5,165,060

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)

	NINE MONTHS ENDED SEPTEMBER 30, 2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 3,726,238	$ 3,131,607
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	216,658	318,073
Stock-based compensation expense	61,446	
Deferred income taxes	(18,247)	
Changes in current assets and liabilities:		
Accounts receivable	(1,003,762)	(311,699)
Prepaid expenses and other current assets	(150,748)	(185,530)
Accounts payable	(142,793)	(152,559)
Accrued expenses	(121,091)	78,456
Deferred revenue	35,123	93,807
Net cash provided by operating activities	2,602,824	2,972,155
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of short-term investments	(1,050,000)	(2,000,000)
Purchases of property and equipment	(126,144)	(163,507)
Decrease in other assets		4,299
Net cash used in investing activities	(1,176,144)	(2,159,208)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Tax benefit associated with exercise of options	8,982	35,503
Cash dividends paid	(1,809,772)	(1,340,230)
Net proceeds from the issuance of common stock	60,100	433,439
Net cash used in financing activities	(1,740,690)	(871,288)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(314,010)	(58,341)
CASH AND CASH EQUIVALENTS, beginning of period	3,352,519	3,260,178
CASH AND CASH EQUIVALENTS, end of period	$ 3,038,509	$ 3,201,837

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
(UNAUDITED)
September 30, 2006

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, 2005. 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 nine months ended September 30, 2006 may not be indicative of the results that may be expected for the year ending December 31, 2006, 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 September 30, 2006, a total of 250,000 shares of common stock were reserved for issuance under the 2006 Equity Incentive Plan.

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PSYCHEMEDICS CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS (Continued)

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 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 $32,516 and $61,446 of stock-based compensation in the accompanying statements of income for the three months and nine months ended September 30, 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 other stock-based awards were granted or modified during the nine months ended September 30, 2006.

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.

The assumptions used and the weighted average information are as follows:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Risk-free interest rates range		3.8%
Expected dividend yield range		2.3%
Expected lives		5 years
Expected volatility range		30.09%

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PSYCHEMEDICS CORPORATION
NOTES TO CONDENSED FINANCIAL STATEMENTS (Continued)

SFAS 123R requires the presentation of pro forma information for the comparative period prior to the adoption as if the Company had accounted for all its employee stock options under the fair value method of the original SFAS 123. The following table illustrates the effect on net income (loss) and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123R to stock-based employee compensation to the prior-year:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 982,621	$ 3,131,607
Less: Total stock-based compensation cost determined under the fair value based method for all employee awards	(9,558)	(938,440)
Pro forma net income	$ 973,063	$ 2,193,167
Income per share:		
Basic and diluted, as reported	$ 0.19	$ 0.61
Basic, pro forma	$ 0.19	$ 0.43
Diluted, pro forma	$ 0.19	$ 0.42

No options were granted for the three months ended September 30, 2005. The weighted average fair value of options granted for the nine months ended September 30, 2005 was $3.76 per share.

A summary of stock option activity for the Company s expired stock option plans for the nine months ended September 30, 2006 is as follows:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (1)
Outstanding, December 31, 2005	556,946	$ 16.09		
Granted				
Exercised	(5,150)	11.85		
Terminated	(6,438)	22.03		
Outstanding, September 30, 2006	545,358	$ 16.06	6.0 years	$ 1,069,477
Exercisable, September 30, 2006	544,508	$ 16.07	5.9 years	$ 1,062,481
Available for grant, September 30, 2006				

(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 September 30, 2006 ($16.88) 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 (Continued)

A summary of activity for SUAs for the nine months ended September 30, 2006 is as follows:

	Number of Shares	Aggregate Intrinsic Value (2)
Outstanding, December 31, 2005		
Granted	26,700	
Vested		
Terminated		
Outstanding, September 30, 2006	26,700	$ 450,696
Available for grant, September 30, 2006	223,300	

(2) The aggregate intrinsic value on this table was calculated based on the closing market value of the Company s stock on September 30, 2006 ($16.88).

As of September 30, 2006, a total of 795,358 shares of common stock were reserved for issuance under the various stock option and stock-based plans. As of September 30, 2006, the unamortized fair value of awards relating to stock options was $1,425. As of September 30, 2006, the unamortized fair value of awards relating to SUAs was $396,305.

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 and assume the full vesting of all SUAs.

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Weighted average common shares	5,172,247	5,167,097	5,169,587	5,153,178
Common equivalent shares	76,256	12,037	62,922	11,882
Weighted average common shares outstanding, assuming dilution	5,248,503	5,179,134	5,232,509	5,165,060

For the three months ended September 30, 2006 and 2005, options to purchase 200,919 and 449,207 common shares, respectively, were outstanding but not included in the diluted weighted average common share calculation as the effect would have been antidilutive. For the nine months ended September 30, 2006 and 2005, options to purchase 200,919 and 484,208 common shares, respectively, were outstanding but not

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PSYCHEMEDICS CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS (Continued)

included in the diluted weighted average common share calculation as the effect would have been antidilutive.

4. 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 (referred to as breakage). Realized gain is then recognized (as other income) when the Company can reasonably, reliably and objectively determine that an estimated amount of breakage has occurred. Breakage is deemed to occur only at the point it becomes remote that performance will be required for an estimable portion of transactions. The Company has not recorded any gain related to breakage in the first three quarters of 2006 or during all of 2005. The Company continues to monitor this to determine whether breakage can be reasonably, reliably and objectively determined. The Company expects to complete its evaluation during the fourth quarter of 2006, which is expected to result in an adjustment to recognize a portion of the deferred revenue in the results of operations, the amount of which has not been finally determined at this time.

At September 30, 2006 and December 31, 2005, the Company had deferred revenue of approximately $626,000 and $591,000, respectively, reflecting sales of its personal drug testing service for which the performance of the related test had not yet occurred.

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

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PSYCHEMEDICS CORPORATION

NOTES TO CONDENSED FINANCIAL STATEMENTS (Continued)

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 is in the process of evaluating the impact of adoption of FIN 48.

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.

7. Subsequent Event Dividends

On October 30, 2006, the Company declared a quarterly dividend of $.125 per share, which will be paid on December 22, 2006 to shareholders of record on December 8, 2006.

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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 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.

Revenue for the third quarter of 2006 was $6.4 million and was 19% above revenue of $5.4 million for the third quarter of 2005. Revenue for the first nine months of 2006 was $17.6 million and was 8% above revenue of $16.3 million for the first nine months of 2005. The Company reported net income of $0.27 per share in the quarter ended September 30, 2006 and net income of $0.71 per share for the nine months ended September 30, 2006. At September 30, 2006, the Company had $6.6 million of cash, cash equivalents and short-term investments. The Company distributed $0.52 million, $0.65 million and $0.65 million, or $0.10 per share, $0.125 per share and $0.125 per share, of cash dividends to its shareholders in the first, second and third quarters of 2006, respectively, which represented year to date totals of $1.8 million, or $0.35 per share. The Company has paid forty consecutive quarterly cash dividends.

RESULTS OF OPERATIONS

Revenue was $6,379,962 for the three month period ended September 30, 2006 as compared to $5,353,168 for the comparable period of 2005, representing an increase of 19%. Revenue was $17,628,078 for the nine month period ended September 30, 2006 as compared to $16,306,247 for the comparable period of 2005, representing an increase of 8%. The increase in revenue for the third quarter of 2006 was due to an increase of 24% in testing volume from both new and existing clients, while the average revenue per sample decreased by 4% as compared to the comparable period of 2005. The increase in revenue for the nine months ended September 30, 2006 was due to an increase of 10% 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 2005.

Gross margin was 60% of revenue for the three month period ended September 30, 2006, as compared to 58% for the comparable period of 2005. Gross margin was 60% of revenue for the nine month period ended September 30, 2006, as compared to 59% for the comparable period of 2005. Even though average revenue per sample decreased by 4%, gross margin increased primarily due to the increase in testing volume of 24% as fixed and semi-variable direct costs were spread over a greater number of tests performed along with a slight decrease in material costs for the three months ended September 30, 2006, as compared to the same period of 2005. Fixed and semi-variable direct costs were also spread over a greater number of tests performed for the nine month period ended September 30, 2006, as compared to the same period of 2005. In addition, reduced depreciation and amortization expense contributed to a decline in fixed costs for the three month period and the nine month period ended September 30, 2006 as compared to the comparable periods of 2005.

General and administrative (G&A) expenses were $865,735 for the three month period ended September 30, 2006 as compared to $765,758 for the comparable period of 2005, representing an increase of 13%. G&A expenses were $2,466,395 for the nine month period ended September 30, 2006 as compared to $2,394,370 for the comparable period of 2005, representing an increase of 3%. The increase in general and administrative expenses for the three month period ended September 30, 2006 as compared to the comparable period of 2005 was due primarily to an increase in personnel expenses and business insurance costs. All other general and administrative expenses remained relatively constant. The increase in general and administrative expenses for the nine month period ended September 30, 2006 as compared to the comparable period of 2005 was due primarily to an increase in personnel expenses and business insurance costs, partially offset by reduced professional fees related to Sarbanes-Oxley compliance work performed mostly in the first quarter of 2005, reduced legal fees and a decrease in bad debt expense. All other general and administrative expenses remained relatively constant. As a percentage of revenue, G&A expenses were 14% for the three month periods ended September 30, 2006 and September 30, 2005 and decreased to 14% for the nine months ended September 30, 2006 from 15% for the comparable period of 2005. The Company expects general and administrative expenses to remain relatively constant in absolute dollars and decrease as a percentage of revenue during the remainder of 2006.

Marketing and selling expenses for the three month period and the nine month period ended September 30, 2006 remained relatively flat as compared to the comparable periods of 2005, decreasing by only 2% and 1%, respectively. Marketing and selling expenses were $689,808 for the three month period ended September 30, 2006 as compared to $703,731 for the comparable period of 2005, a decrease of 2%. Marketing and selling expenses were $2,086,982 for the nine month period ended September 30, 2006 as compared to $2,110,980 for the comparable period of 2005, a decrease of 1%. The variation in marketing and selling expenses for both the three month and nine month periods ended September 30, 2006 as compared to the comparable periods of 2005 was due primarily to short-term fluctuations in personnel expenses pertaining to

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the Company s sales and support staff. Total marketing and selling expenses represented 11% of revenue in the third quarter of 2006 and 13% of revenue in the third quarter of 2005. Total marketing and selling expenses represented 12% of revenue for the nine month period ended September 30, 2006 and 13% of revenue for the nine month period ended September 30, 2005. The Company expects marketing and selling expenses to increase slightly during the remainder of 2006 as compared to 2005.

Research and development (R&D) expenses for the three month period ended September 30, 2006 increased by $24,922 from the comparable period of the prior year to $112,012, an increase of 29%. Research and development (R&D) expenses for the nine month period ended September 30, 2006 increased by $107,771 from the comparable period of the prior year to $340,662, an increase of 46%. The increase for both periods was primarily due to an increase in personnel expenses. R&D expenses represented 2% of revenue for the three month period and the nine month period ended September 30, 2006 as compared to 2% of revenue for the three month period and the nine month period ended September 30, 2005. The Company expects research and development expenses to increase slightly during the remainder of 2006 as compared to 2005.

Interest income for the three month period ended September 30, 2006 increased by $43,503 and increased by $126,108 for the nine month period ended September 30, 2006 as compared to the comparable periods of 2005 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 2006 as compared to 2005 caused the increase in interest income.

During the three months ended September 30, 2006 and September 30, 2005, the Company recorded tax provisions of $863,000 and $581,000 representing effective tax rates of 38.1% and 37.2%, respectively. During the nine months ended September 30, 2006 and September 30, 2005, the Company recorded tax provisions of $2,236,000 and $1,855,000 representing effective tax rates of 37.5% and 37.2%, respectively.

LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2006, the Company had approximately $6.6 million of cash, cash equivalents and short-term investments. The Company s operating activities provided net cash of $2,602,824 in the nine months ended September 30, 2006. Investing activities used $1,176,144 in the nine month period while financing activities used a net amount of $1,740,690 during the period.

Cash provided by operating activities of $2,602,824 principally reflected net income of $3,726,238 adjusted for depreciation and amortization of $216,658, partially offset by an increase in accounts receivable along with a lesser decrease in accrued expenses and accounts payable and a lesser increase in prepaid expenses. The increase in accounts receivable was due to the increase in revenue during the third quarter of 2006. The decrease in accrued expenses was due to the payment during the first three quarters of increased income tax amounts and of bonus expense that was accrued as of December 31, 2005. The increase in prepaid expenses was due primarily to the payment of annual insurance premiums during the first quarter of 2006.

Capital expenditures in the first nine months of 2006 were $126,144. The expenditures primarily consisted of new equipment, including laboratory and computer equipment.

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The Company currently plans to make capital expenditures of approximately $300,000 in 2006, 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 $4 million, which the Company expects to fund primarily through its operating cash flows.

During the nine months ended September 30, 2006, the Company distributed $1,809,772 in cash dividends to its shareholders. The Company did not repurchase any shares for treasury during the nine months ended September 30, 2006. The Company has authorized 500,000 shares for repurchase since September of 1998, of which 466,351 shares have been repurchased.

Contractual obligations as of September 30, 2006 were as follows:

	Less Than One Year	1-3 Years	4-5 years	After 5 Years	Total
Operating leases	$ 483,000	$ 905,000	$ 742,000	$ 362,000	$ 2,492,000
Purchase commitment	272,000				272,000
	$ 755,000	$ 905,000	$ 742,000	$ 362,000	$ 2,764,000

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 $407,874 for the nine months ended September 30, 2006 as compared to $370,727 for the comparable period of 2005. The Company expects to purchase approximately $136,000 for the remainder of 2006. 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 September 30, 2006, the Company s principal sources of liquidity included an aggregate of approximately $6.6 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 September 30, 2006, the Company had no long-term debt.

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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 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 (referred to as breakage). Realized gain is then recognized (as other income) when the Company can reasonably, reliably and objectively determine that an estimated amount of breakage has occurred. Breakage is deemed to occur only at the point it becomes remote that performance will be required for an estimable portion of transactions. The Company has not recorded any breakage in the first three quarters of 2006 or during all of 2005. The Company continues to monitor this to determine whether breakage can be reasonably, reliably and objectively determined. The Company expects to complete its evaluation during the fourth quarter of 2006, which is expected to result in an adjustment to recognize a portion of the deferred revenue in the results of operations, the amount of which has not been finally determined at this time.

Cash Equivalents and Short-Term Investments

The Company considers all highly liquid investments with original maturities of 90 days or less to be cash equivalents. Cash equivalents consist of money market accounts at September 30, 2006 and 2005.

The Company maintains a short-term investment portfolio consisting principally of money market securities and Taxable Auction Rate Preferred, 7 and 28 day Dutch Auction securities. The Company does not use derivative financial instruments for speculative or trading purposes.

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.

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 and Taxable Auction Rate Preferred, 7 and 28 day Dutch Auction securities that are not sensitive to sudden interest rate changes. The Company does not use derivative financial instruments for speculative or trading purposes.

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Item 4. Controls and Procedures

As of the end of the period covered by this report, our Chief Executive Officer and Chief Financial 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 and Chief Financial 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 2005 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: November 8, 2006	By: /s/ Raymond C. Kubacki, Jr.
	Raymond C. Kubacki, Jr. Chairman and Chief Executive Officer
Date November 8, 2006	By: /s/ Peter C. Monson
	Peter C. Monson Vice President, Treasurer & Chief Financial Officer

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