

Section 1: 10-Q (FORM 10-Q)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017

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

(State or Other Jurisdiction of
Incorporation or Organization)

125 Nagog Park
Acton, MA

(Address of Principal Executive Offices)

58-1701987

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

01720

(Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer
Accelerated filer
Non-accelerated filer [Do not check if a smaller reporting company]
Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by checkmark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes No

The number of shares of Common Stock of the Registrant, par value \$0.005 per share, outstanding at October 20, 2017 was 5,492,053.

PSYCHEMEDICS CORPORATION
FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2017

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PSYCHEMEDICS CORPORATION
CONSOLIDATED BALANCE SHEETS
(in thousands, except par value)
(UNAUDITED)

| | <u>September 30,</u> 2017 | <u>December 31,</u> 2016 |
|--------------------------------------------------------------------------------------------------------------------------|------------------------------|-----------------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 5,604 | \$ 3,938 |
| Accounts receivable, net of allowance for doubtful accounts of \$62 in 2017 and \$50 in 2016 | 5,421 | 5,837 |
| Prepaid expenses and other current assets | <u>1,351</u> | <u>1,079</u> |
| Total Current Assets | 12,376 | 10,854 |
| Fixed Assets, net of accumulated amortization and depreciation of \$10,961 in 2017 and \$8,900 in 2016 | 12,258 | 13,358 |
| Other assets | <u>818</u> | <u>820</u> |
| Total Assets | <u>\$ 25,452</u> | <u>\$ 25,032</u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 1,103 | \$ 1,363 |
| Accrued expenses | 2,905 | 1,988 |
| Current portion of debt | <u>542</u> | <u>1,144</u> |
| Total Current Liabilities | 4,550 | 4,495 |
| Long-term debt | 928 | 2,237 |
| Deferred tax liabilities, long-term | <u>2,742</u> | <u>2,693</u> |
| Total Liabilities | <u>8,220</u> | <u>9,425</u> |
| Shareholders' Equity: | | |
| Preferred stock, \$0.005 par value, 873 shares authorized, no shares issued or outstanding | -- | -- |
| Common stock, \$0.005 par value; 50,000 shares authorized 6,160 shares issued in 2017 and 6,128 shares issued in 2016 | 31 | 31 |
| Accumulated other comprehensive gain | 37 | -- |
| Additional paid-in capital | 30,885 | 30,603 |
| Accumulated deficit | (3,639) | (4,945) |
| Less - Treasury stock, at cost, 668 shares in 2017 and 2016 | <u>(10,082)</u> | <u>(10,082)</u> |
| Total Shareholders' Equity | <u>17,232</u> | <u>15,607</u> |
| Total Liabilities and Shareholders' Equity | <u>\$ 25,452</u> | <u>\$ 25,032</u> |

See accompanying notes to consolidated financial statements

PSYCHEMEDICS CORPORATION
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(in thousands, except per share amounts)
(UNAUDITED)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------|-------------------------------------|-----------------|------------------------------------|-----------------|
| | 2017 | 2016 | 2017 | 2016 |
| Revenues | \$ 10,049 | \$ 11,849 | \$ 29,942 | \$ 28,216 |
| Cost of revenues | <u>4,928</u> | <u>4,744</u> | <u>14,896</u> | <u>13,164</u> |
| Gross profit | <u>5,121</u> | <u>7,105</u> | <u>15,046</u> | <u>15,052</u> |
| Operating Expenses: | | | | |
| General & administrative | 1,471 | 1,278 | 4,278 | 3,716 |
| Marketing & selling | 1,065 | 1,375 | 3,552 | 3,804 |
| Research & development | <u>353</u> | <u>348</u> | <u>1,005</u> | <u>1,059</u> |
| Total Operating Expenses | <u>2,889</u> | <u>3,001</u> | <u>8,835</u> | <u>8,579</u> |
| Operating income | 2,232 | 4,104 | 6,211 | 6,473 |
| Interest income (expense), net | <u>13</u> | <u>(34)</u> | <u>(22)</u> | <u>(104)</u> |
| Net income before provision for income taxes | 2,245 | 4,070 | 6,189 | 6,369 |
| Provision for income taxes | <u>881</u> | <u>1,362</u> | <u>2,418</u> | <u>2,051</u> |
| Net income | <u>\$ 1,364</u> | <u>\$ 2,708</u> | <u>\$ 3,771</u> | <u>\$ 4,318</u> |
| Earnings per common share (basic) | <u>\$ 0.25</u> | <u>\$ 0.50</u> | <u>\$ 0.69</u> | <u>\$ 0.79</u> |
| Earnings per common share (diluted) | <u>\$ 0.25</u> | <u>\$ 0.49</u> | <u>\$ 0.68</u> | <u>\$ 0.79</u> |
| Dividends declared per share | <u>\$ 0.15</u> | <u>\$ 0.15</u> | <u>\$ 0.45</u> | <u>\$ 0.45</u> |
| Other comprehensive income: | | | | |
| Foreign currency translation (gross) | <u>\$ 108</u> | <u>\$ -</u> | <u>\$ 37</u> | <u>\$ -</u> |
| Total comprehensive income | <u>\$ 1,472</u> | <u>\$ 2,708</u> | <u>\$ 3,808</u> | <u>\$ 4,318</u> |

See accompanying notes to consolidated financial statements

PSYCHEMEDICS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(UNAUDITED)

| | Nine Months Ended September 30, | |
|--------------------------------------------------------------------------------------------|--------------------------------------------|-----------------|
| | 2017 | 2016 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 3,771 | \$ 4,318 |
| Adjustments to reconcile net income / (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,089 | 1,626 |
| Deferred income taxes | 49 | (17) |
| Stock-based compensation | 446 | 508 |
| Changes in assets and liabilities: | | |
| Accounts receivable | 423 | (2,733) |
| Prepaid expenses, other current assets, and income tax receivable | (272) | 634 |
| Accounts payable | (263) | 322 |
| Accrued expenses and accrued income taxes | 874 | 1,414 |
| Net cash provided by operating activities | 7,117 | 6,072 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of equipment and leasehold improvements | (411) | (1,181) |
| Cost of internally developed software | (509) | (136) |
| Other assets | (26) | (69) |
| Net cash used in investing activities | (946) | (1,386) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of stock, net of tax withholding | (165) | (149) |
| Proceeds from equipment financing | -- | 610 |
| Payments of equipment financing | (1,911) | (1,276) |
| Cash dividends paid | (2,464) | (2,448) |
| Net cash used in financing activities | (4,540) | (3,263) |
| Effect of exchange rate changes on cash and cash equivalents | 35 | -- |
| Net increase / (decrease) in cash and cash equivalents | 1,666 | 1,423 |
| Cash and cash equivalents, beginning of period | 3,938 | 2,689 |
| Cash and cash equivalents, end of period | <u>\$ 5,604</u> | <u>\$ 4,112</u> |
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash paid for income taxes | \$ 1,904 | \$ 921 |
| Cash paid for interest | \$ 53 | \$ 105 |
| Purchases of equipment through accounts payable and accrued liabilities | \$ 41 | \$ 75 |

See accompanying notes to consolidated financial statements

PSYCHEMEDICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollar and share amounts (except per share) in thousands, unless otherwise indicated)
(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 as reported in the Company's Annual Report on Form 10-K ("10-K") for the year ended December 31, 2016, filed on March 7, 2017. 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 and nine months ended September 30, 2017 may not be indicative of the results that may be expected for the year ending December 31, 2017, or any other period.

Unless the context requires otherwise, the terms "we", "us", "our", or "the Company" refer to Psychemedics Corporation and its consolidated subsidiaries.

2. Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of 90 days or less to be cash equivalents. Cash equivalents consisted exclusively of cash in the bank and bank certificates of deposits.

3. Stock-Based Compensation

The Company's 2006 Incentive Plan ("the Plan") provides for cash based awards or the grant or issuance of stock-based awards. As of September 30, 2017, 199 thousand shares remained available for future grant under the Plan.

A summary of the Company's stock option activity for the nine months ended September 30, 2017 is as follows:

| | Number of Shares | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value ⁽¹⁾ |
|---------------------------------|---------------------|-------------------------------------------------|---------------------------------------------------|------------------------------------------------|
| Outstanding, December 31, 2016 | 160 | \$ 12.76 | 9.2 years | \$ 1,907 |
| Granted | 121 | \$ 18.87 | | |
| Exercised | (3) | \$ 13.82 | | |
| Forfeited | - | | | |
| Outstanding, September 30, 2017 | <u>278</u> | <u>\$ 15.40</u> | 8.9 years | <u>\$ 875</u> |
| Exercisable, September 30, 2017 | <u>56</u> | <u>\$ 12.61</u> | 8.4 years | <u>\$ 320</u> |

(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, 2017 (\$18.30) exceeded the exercise price of the underlying options, multiplied by the number of shares subject to each option.

PSYCHEMEDICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollar and share amounts (except per share) in thousands, unless otherwise indicated)
(UNAUDITED)

3. Stock-Based Compensation (continued)

A summary of the Company's stock unit award activity for the nine months ended September 30, 2017 is as follows:

| | Number of Shares | Weighted Average Price per Share ⁽²⁾ | Weighted Average Fair Value ⁽²⁾ |
|--------------------------------------------|---------------------|-------------------------------------------------------|--------------------------------------------------|
| Outstanding & Unvested, December 31, 2016 | 74 | \$ 14.62 | \$ 1,077 |
| Granted | 13 | \$ 18.87 | \$ 236 |
| Converted to common stock | (30) | | |
| Cancelled | (10) | | |
| Forfeited | (15) | | |
| Outstanding & Unvested, September 30, 2017 | <u>32</u> | <u>\$ 16.08</u> | <u>\$ 516</u> |

(2) Weighted average price per share is the weighted grant price based on the closing market price of each of the stock grants related to each grant of stock unit awards. The weighted average fair value is the weighted average share price times the number of shares.

As of September 30, 2017, a total of 509 thousand shares of common stock were reserved for issuance under the Plan. As of September 30, 2017, the unamortized fair value of awards relating to outstanding SUAs and options was \$1.1 million, which is expected to be amortized over a weighted average period of 3.0 years.

4. Basic and Diluted Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive common equivalent shares outstanding during the period. The number of dilutive common equivalent shares outstanding during the period was determined in accordance with the treasury-stock method. Common equivalent shares consisted 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 for the three and nine months ended September 30, 2017 and 2016 are as follows:

| | Three Months Ended | | Nine Months Ended | |
|-----------------------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2017 | September 30, 2016 | September 30, 2017 | September 30, 2016 |
| Weighted average common shares outstanding, basic | 5,491 | 5,460 | 5,476 | 5,442 |
| Dilutive common equivalent shares | 73 | 50 | 64 | 15 |
| Weighted average common shares outstanding, diluted | <u>5,564</u> | <u>5,510</u> | <u>5,540</u> | <u>5,457</u> |

PSYCHEMEDICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollar and share amounts (except per share) in thousands, unless otherwise indicated)
(UNAUDITED)

5. Fair Value Measurements

The Company has financial instruments, such as accounts receivable, accounts payable, and accrued expenses, which are stated at carrying amounts that approximate fair value because of the short maturity of those instruments. The carrying amount of the Company's long-term debt approximates fair value as the interest rate on the debt approximates the estimated borrowing rate currently available to the Company.

6. Subsequent Events

On October 24, 2017, the Company declared a quarterly dividend of \$0.15 per share for a total of \$824 thousand, which will be paid on November 17, 2017 to shareholders of record on November 6, 2017.

7. Commitments and Contingencies

The Company is subject to legal proceedings and claims which arise in the ordinary course of its business including, without limitation, the legal matters discussed in the 10-K. We continue to believe the lawsuits described in the 10-K are without merit and we intend to vigorously defend them. While the ultimate outcome of individual legal claims is inherently unpredictable, we believe that the final resolution of these actions will not have a material adverse effect on our results of operations, financial position, liquidity or capital resources.

8. Debt and Other Financing Arrangements

On March 20, 2014, the Company entered into an equipment financing arrangement ("Loan Agreement") with Banc of America Leasing & Capital, LLC, which it amended on September 15, 2015 and March 23, 2016. The terms of this arrangement are detailed in the 10-K.

The weighted average interest rate for all notes related to the Loan Agreement for the quarter ended September 30, 2017 was 3.2%, and represented \$12 thousand of interest expense as compared to a rate of 2.5% and interest expense of \$34 thousand for the comparable period in 2016. As of September 30, 2017, the interest rate was 3.2% and there was \$1.5 million of outstanding debt related to the loan. The Company was in compliance with all loan covenants as of September 30, 2017.

PSYCHEMEDICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollar and share amounts (except per share) in thousands, unless otherwise indicated)
(UNAUDITED)

8. Debt and Other Financing Arrangements (continued)

The annual principal repayment requirements for debt obligations as of September 30, 2017 were as follows:

| | |
|----------------------------------------------|---------------|
| 2017 | \$ 136 |
| 2018 | 542 |
| 2019 | 475 |
| 2020 | 287 |
| 2021 | <u>30</u> |
| Total long-term debt | 1,470 |
| Less current portion of long-term debt | <u>(542)</u> |
| Total long-term debt, net of current portion | <u>\$ 928</u> |

9. Significant Customers

The Company had one customer that exceeded 10% of revenue for the three and nine months ended September 30, 2017 and September 30, 2016. The Company had one customer that exceeded 10% of the total accounts receivable balance as of September 30, 2017 and December 31, 2016.

10. Recent Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases, which introduces the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous guidance. The new standard establishes a right-of-use ("ROU") model that requires a lessee to record an ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. The new standard will become effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years, with early adoption permitted. The Company is currently evaluating the impacts the adoption of this accounting guidance will have on its financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, 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.

PSYCHEMEDICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollar and share amounts (except per share) in thousands, unless otherwise indicated)
(UNAUDITED)

10. Recent Accounting Pronouncements (continued)

The standard's implementation date, as amended by ASU 2015-14, is effective for annual periods beginning after December 15, 2017, 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 in the process of analyzing our sales contracts and related performance obligations and expect to complete this review at the end of November. Based on our evaluation to date, we believe the implementation of this standard should not have a material impact to the Company. We plan to start drafting footnote disclosures under ASU 2014-09 during Q4 2017 as well as making our final determination of implementation approach.

11. Summary of Significant Accounting Policies

See December 31, 2016 10-K for summary of significant Accounting Policies. Additional significant policies adopted this year are as follows:

Foreign Currency Translation: The functional currency of our Brazil subsidiary is the Brazilian Real. Foreign currency denominated assets and liabilities are translated into U.S. dollars using the exchange rates in effect at the consolidated balance sheet date. Results of operations and cash flows are translated using the average exchange rates throughout the period. The effect of exchange rate fluctuations on translation of assets and liabilities that are in the functional currency is included as a component of shareholders' equity in accumulated other comprehensive income (loss).

Basis of Consolidation: The consolidated financial statements incorporate the financial statements of the Company and its subsidiaries. The financial statements of the Company and its subsidiary companies have been consolidated on a line-by-line basis by adding together like items of assets, liabilities, income and expenses. All significant intercompany transactions and balances have been eliminated.

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, profitability, margins, pricing, 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 and the enforcement of such laws and regulations, including effective dates of such 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 laws and regulations), risks associated with the delay in the implementation of new regulations, risks associated with foreign currency fluctuations, R&D spending, competition (including, without limitation, competition from other companies pursuing the same growth opportunities), the Company's ability to maintain its reputation and brand image, the ability of the Company to achieve its business plans, cost controls, leveraging of its global operating platform, risks of information technology system failures and data security breaches, the uncertain global economy, the Company's ability to attract, develop and retain executives and other qualified employees and independent contractors, including distributors, the Company's ability to obtain and protect intellectual property rights, litigation risks, 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.

Given these uncertainties, you should not place undue reliance on these forward-looking statements. Forward-looking statements represent the Company's estimates and assumptions only as of the filing date of this Report. The Company expressly disclaims any duty to provide updates to forward-looking statements, and the estimates and assumptions associated with them, after the filing date of this Report, in order to reflect changes in circumstances or expectations, or the occurrence of unanticipated events, except to the extent required by applicable securities laws. All of the forward-looking statements are qualified in their entirety by reference to the factors discussed above and under "Risk Factors" set forth in Part I Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as well as the risks and uncertainties discussed elsewhere in this Report. The Company qualifies all of its forward-looking statements by these cautionary statements. The Company cautions you that these risks are not exhaustive. The Company operates in a continually changing business environment and new risks emerge from time to time.

OVERVIEW

Revenue for the third quarter of 2017 was \$10.0 million compared to \$11.8 million in 2016, a decrease of 15%. The Company reported net income of \$1.4 million, or \$0.25 per diluted share for the three months ended September 30, 2017 versus \$2.7 million, or \$0.49 per diluted share for the same period in 2016, a decrease of 50%. Revenue for the nine months ended September 30, 2017 was \$29.9 million compared to \$28.2 million for the same period in 2016, an increase of 6%. The Company reported net income of \$3.8 million, or \$0.68 per diluted share for the nine months ended September 30, 2017 versus \$4.3 million, or \$0.79 per diluted share for the same period in 2016, a decrease of 13%. Our 2016 third quarter revenue and earnings represented the Company's record results in these two areas. Earnings were impacted by the decline in total revenue, revenue mix and tax impacts from our corporate structure in Brazil noted last quarter. The Company distributed \$2.5 million or \$0.45 per share of cash dividends to its shareholders in the nine months ended September 30, 2017. The Company has paid 84 consecutive quarterly cash dividends.

RESULTS OF OPERATIONS

Revenues were \$10.0 million for three months ended September 30, 2017 and \$11.8 million for the same period in 2016, representing a decrease of 15%. As noted above, the third quarter in 2016 represented the company's record revenue. The decline in revenues resulted primarily from our international business; and from a fall-off in our oil and gas sector, partially attributable to Hurricane Harvey. Revenues for the nine months ended September 30, 2017 were \$29.9 million, representing an increase of 6% from the comparable period of 2016 of \$28.2 million.

Gross profit was \$5.1 million for the three months ended September 30, 2017, compared to \$7.1 million for the same period in 2016, a decrease of \$2.0 million. Direct costs increased by \$184 thousand or 4% for the three months ended September 30, 2017 compared to the same period in 2016. The gross profit margin was 51% for the three months ended September 30, 2017 and 60% for the comparable period of 2016. The decrease in margin was attributable to a mix of business, the inclusion of Brazil sales taxes and additional depreciation from equipment placed in service. Gross profit for the nine months ended September 30, 2017 was \$15.0 million relatively unchanged from the comparable period in 2016. Direct costs increased by \$1.7 million or 13% for the nine months ended September 30, 2017 when compared to the same period in 2016. The gross profit margin for the nine months ended September 30, 2017 was 50% compared to 53% for the comparable period in 2016.

General and administrative ("G&A") expenses increased \$0.2 million to \$1.5 million for the three months ended September 30, 2017 compared to \$1.3 million for the same period in 2016. As a percentage of revenue, G&A expenses were 15% for the three months ended September 30, 2017 and 11% for the same period in 2016. The increase in expenses was driven by additional costs related to our Brazil subsidiary, which was created in 2017, and increased professional fees. General and administrative expenses were \$4.3 million for the nine months ended September 30, 2017 compared to \$3.7 million for the same period in 2016. As a percentage of revenue, G&A expenses were 14% and 13% for the nine months ended September 30, 2017 and 2016, respectively.

Marketing and selling expenses were \$1.1 million for the three months ended September 30, 2017 compared to \$1.4 million for the same period in 2016. The decrease was primarily driven by lower personnel costs. Total marketing and selling expenses represented 11% of revenue for the three months ended September 30, 2017 and 12% for the comparable period in 2016. Marketing and selling expenses were \$3.6 million for the nine months ended September 30, 2017 compared to \$3.8 million for the same period in 2016. Total marketing and selling expenses represented 12% of revenue for the nine months ended September 30, 2017, compared to 13% for the comparable period of 2016.

Research and development (“R&D”) expenses for the three months ended September 30, 2017 were \$353 thousand compared to \$348 thousand for the comparable period of 2016. R&D expenses represented 4% and 3% of revenue for the three months ended September 30, 2017 and 2016, respectively. Research and development expenses for the nine months ended September 30, 2017 were \$1.0 million compared to \$1.1 million in the prior year. R&D expenses represented 3% and 4% of revenue for the nine months ended 2017 and 2016, respectively.

Provision for income taxes Our provision for income taxes consists primarily of federal and state income taxes in the United States and income taxes in Brazil. We estimate income taxes in each of the jurisdictions in which we operate. During the three months ended September 30, 2017 and 2016, the Company recorded tax provisions of \$881 thousand and \$1,362 thousand, respectively. These provisions represented effective tax rates of 39% for the three months ended September 30, 2017 and 33% for the comparable period of 2016. The increase in tax rate was attributable to the creation of a Brazil subsidiary which resulted in a new tax jurisdiction and tax liability. During the nine months ended September 30, 2017 and September 30, 2016, the Company recorded tax provisions of \$2.4 million and \$2.1 million, respectively. These provisions represented effective tax rates of 39% for the nine month period ended September 30, 2017 and 32% for the comparative period last year. The Company expects the year-end tax rate to be between 39% and 42%.

LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2017, the Company had approximately \$5.6 million of cash. The Company's operating activities generated net cash of \$7.1 million for the nine months ended September 30, 2017. Investing activities used \$946 thousand of cash while financing activities used \$4.5 million of cash during the first nine months of 2017.

Cash provided by operating activities of \$7.1 million reflected net income of \$3.8 million adjusted for depreciation and amortization of \$2.1 million, stock-based compensation of \$446 thousand and an increase of deferred income taxes of \$49 thousand. This was affected by the following changes in assets and liabilities: a decrease in accounts receivable of \$0.4 million, an increase in prepaid expenses, other current assets and income tax receivable of \$0.3 million, a decrease in accounts payable of \$0.3 million and an increase in accrued expenses and income taxes of \$0.9 million.

Cash used in investing activities included purchases of equipment and leasehold improvements of \$411 thousand and internally capitalized software of \$509 thousand. We anticipate spending \$0.1 million to \$0.3 million in additional capital purchases for the remainder of 2017.

Cash used by financing activities of \$4.5 million included cash dividends to shareholders of \$2.5 million and \$1.9 million from payments on long term debt. On October 24, 2017, the Company declared a quarterly dividend of \$0.15 per share for an estimated total of \$824 thousand, which will be paid on November 17, 2017 to shareholders of record on November 6, 2017.

Contractual obligations and other commercial commitments as of September 30, 2017 were as follows:

| | Less Than One Year | 1-3 Years | 4-5 Years | After 5 Years | Total |
|------------------|-----------------------|-----------------|---------------|------------------|-----------------|
| Debt principal | \$ 542 | \$ 867 | \$ 61 | \$ - | \$ 1,470 |
| Operating leases | 905 | 1,039 | 93 | - | 2,037 |
| Total | <u>\$ 1,447</u> | <u>\$ 1,906</u> | <u>\$ 154</u> | <u>\$ -</u> | <u>\$ 3,507</u> |

At September 30, 2017, the Company's principal sources of liquidity included an aggregate of approximately \$5.6 million of cash. The Company had \$7.8 million and \$6.4 million of working capital as of September 30, 2017 and December 31, 2016, respectively. Management currently believes that such funds, together with cash generated from operations and future equipment financing, 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.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Sensitivity. The long-term debt agreement entered into in March 2014 (and amended), 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.

Foreign Exchange Risk. Starting in Q2 2017, with the creation of a Brazilian subsidiary, we became exposed to foreign currency risk in the ordinary course of business. See item 1-A of Part II for further explanation of Foreign Exchange Risk.

Based on our ability to access our cash and cash equivalents, our expected operating cash flows and our other sources of cash, we do not anticipate that any lack of liquidity will materially affect our ability to operate our business.

Item 4. Controls and Procedures

As of the end of the period covered by this report, the Company's management under the supervision and with the participation of, the Company's Chief Executive Officer and 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 reported 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 has been no significant change in the Company's internal control over financial reporting during the most recent fiscal quarter that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1A. Risk Factors

See risk factors in our 2016 Annual Report on Form 10-K. Additional risks identified since the Annual Report include:

Foreign Exchange Risk: With the creation of a foreign entity in Brazil, the Company now can have fluctuations in foreign currencies relative to the United States Dollar (USD) and this can result in significant differences in period to period financial results. Since a significant portion of the Company's sales are invoiced in Brazil Real (BRL) and consolidated financial results are reported in USD terms, a stronger USD can have negative revenue effects. Conversely, a weaker USD would increase the Brazil subsidiary operating costs in USD terms.

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

There were no purchases of treasury stock in the first nine months of 2017.

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.

Psychomedics Corporation

Date: October 26, 2017

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

Date: October 26, 2017

By: /s/ Neil L. Lerner
Neil L. Lerner
Vice President - Finance
(principal accounting officer)

PSYCHEMEDICS CORPORATION
FORM 10-Q
September 30, 2017
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 |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase |

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Section 2: EX-31.1 (EXHIBIT 31.1)

Exhibit 31.1

**CERTIFICATION PURSUANT TO
SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Raymond C. Kubacki, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Psychemedics Corporation (“the registrant”);
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls over financial reporting (as defined by Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of

- c) financial statements for external purposes in accordance with generally accepted accounting principles; evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 26, 2017

/s/ Raymond C. Kubacki

Raymond C. Kubacki
Chairman and Chief Executive Officer
(principal executive officer)

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Section 3: EX-31.2 (EXHIBIT 31.2)

Exhibit 31.2

**CERTIFICATION PURSUANT TO
SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Neil Lerner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Psychemedics Corporation ("the registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls over financial reporting (as defined by Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

- a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 26, 2017

/s/ Neil Lerner
Neil Lerner
Vice President - Finance
(principal accounting officer)

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Section 4: EX-32.1 (EXHIBIT 32.1)

Exhibit 32.1

**CERTIFICATION PURSUANT TO
U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Raymond C. Kubacki, Chairman and Chief Executive Officer of Psychemedics Corporation (the "Company"), certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as the principal executive officer of the Company, that:

- (1) The Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2017, as filed with the Securities and Exchange Commission on October 26, 2017 (the "Report"), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 26, 2017

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

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Section 5: EX-32.2 (EXHIBIT 32.2)

Exhibit 32.2

**CERTIFICATION PURSUANT TO
U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Neil Lerner, Vice President - Finance of Psychemedics Corporation (the "Company"), certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as the principal accounting officer of the Company, that:

- (1) The Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2017, as filed with the Securities and Exchange Commission on October 26, 2017 (the "Report"), fully complies with the requirements of Section 13(a) or 15(d) of the

Securities Exchange Act of 1934; and

- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 26, 2017

/s/ Neil Lerner

Neil Lerner

Vice President - Finance

(principal accounting officer)

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