

SIMULATIONS PLUS INC  
Form 10-Q  
January 14, 2013

SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

FORM 10-Q

S Quarterly Report Pursuant to Section 13 or 15(d) of the Security Exchange Act of 1934  
for the quarterly period ended **November 30, 2012**

OR

£ Transmission Report Pursuant to Section 13 or 15(d) of the Security Exchange Act of 1937  
for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: **001-32046**

**Simulations Plus, Inc.**

(Name of registrant as specified in its charter)

California 95-4595609  
(State or other jurisdiction of Incorporation or Organization) (I.R.S. Employer identification No.)

42505 10<sup>th</sup> Street West

**Lancaster, CA 93534-7059**

(Address of principal executive offices including zip code)

**(661) 723-7723**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) 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 filings 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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer  Accelerated filer  
 Non-accelerated filer (Do not check if a smaller reporting company)  Smaller reporting company

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

The number of shares outstanding of the registrant's common stock, par value \$0.001 per share, as of January 11, 2013 was 16,021,309 and no shares of preferred stock were outstanding.

**Simulations Plus, Inc.**

**FORM 10-Q**

**For the Quarterly Period Ended November 30, 2012**

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## SIMULATIONS PLUS, INC. CONDENSED BALANCE SHEETS

at November 30, 2012 (Unaudited) and August 31, 2012 (Audited)

## ASSETS

|   | November<br>30,<br>2012 | August 31,<br>2012 |
|---|-------------------------|--------------------|
| Current assets  |                         |                    |
| Cash and cash equivalents   | \$ 11,379,378           | \$ 12,701,075      |
| Income tax refund receivable  | 153,896                 | 153,896            |
| Accounts receivable, net of allowance for doubtful accounts of \$0  | 1,720,669               | 1,451,864          |
| Contracts receivable  | 140,522                 | 18,893             |
| Prepaid income taxes  | 96,022                  | -                  |
| Prepaid expenses and other current assets   | 115,764                 | 150,856            |
| Deferred income taxes   | 177,921                 | 193,712            |
| Total current assets  | 13,784,172              | 14,670,296         |
| Long-term assets  |                         |                    |
| Capitalized computer software development costs, net of accumulated amortization of \$5,266,775 and \$5,084,691 | 2,559,466               | 2,479,468          |
| Property and equipment, net (note 3)  | 98,358                  | 107,410            |
| Intellectual property, net of accumulated amortization of \$5,625 and \$3,750                                   | 69,375                  | 71,250             |
| Other assets  | 18,445                  | 18,445             |
| Total assets  | \$ 16,529,816           | \$ 17,346,869      |

## LIABILITIES AND SHAREHOLDERS' EQUITY

|                                    |            |            |
|------------------------------------|------------|------------|
| Current liabilities                |            |            |
| Accounts payable                   | \$ 194,107 | \$ 177,509 |
| Accrued payroll and other expenses | 322,805    | 312,912    |
| Accrued bonuses to officer         | 15,000     | 60,000     |
| Accrued income taxes               | -          | 733,233    |
| Deferred revenue                   | 207,228    | 131,782    |
| Total current liabilities          | 739,140    | 1,415,436  |
| Long-term liabilities              |            |            |
| Deferred income taxes              | 819,405    | 788,857    |
| Total liabilities                  | 1,558,545  | 2,204,293  |

Commitments and contingencies (note 4)

Shareholders' equity (note 5)

Preferred stock, \$0.001 par value 10,000,000 shares authorized no shares issued and outstanding

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|  |              |              |
|--|--------------|--------------|
| Common stock, \$0.001 par value 50,000,000 shares authorized 15,927,806 and 15,923,019 shares issued and outstanding | 4,399        | 4,399        |
| Additional paid-in capital   | 4,666,465    | 4,628,366    |
| Retained earnings  | 10,300,407   | 10,509,811   |
| Total shareholders' equity   | 14,971,271   | 15,142,576   |
| Total liabilities and shareholders' equity   | \$16,529,816 | \$17,346,869 |

The accompanying notes are an integral part of these financial statements.

## SIMULATIONS PLUS, INC.

## CONDENSED STATEMENTS OF OPERATIONS

For the three months ended November 30,

(Unaudited)

|   | 2012        | 2011        |
|---|-------------|-------------|
| Net sales   | \$2,290,094 | \$2,247,956 |
| Cost of sales   | 386,870     | 352,370     |
| Gross profit  | 1,903,224   | 1,895,586   |
| Operating expenses  |             |             |
| Selling, general, and administrative                                | 931,060     | 859,681     |
| Research and development  | 180,335     | 92,367      |
| Total operating expenses  | 1,111,395   | 952,048     |
| Income from operations  | 791,829     | 943,538     |
| Other income (expense)  |             |             |
| Interest income   | 13,728      | 21,873      |
| Interest expense  | —           | (3 )        |
| Miscellaneous Income  | 15,404      | —           |
| Gain on currency exchange   | 74,654      | 98,386      |
| Total other income (expense)  | 103,786     | 120,256     |
| Income from continuing operations before provision for income taxes | 895,615     | 1,063,794   |
| Provision for income taxes  | (308,629 )  | (308,695 )  |
| Income from continuing operations                                   | 586,986     | 755,099     |
| Discontinued operations:  |             |             |
| Loss from discontinued operations, net of tax                       | —           | (249,898 )  |
| Gain on sale of Words+, net of tax                                  | —           | 465,820     |
| Results of discontinued operations                                  | —           | 215,922     |
| Net Income  | \$586,986   | \$971,021   |
| Basic earnings per share:   |             |             |
| Continuing operations   | \$0.04      | \$0.05      |
| Discontinued operations   | —           | 0.01        |
| Net basic earning per share   | \$0.04      | \$0.06      |
| Diluted earnings per share  |             |             |
| Continuing operations   | \$0.04      | \$0.05      |
| Discontinued operations   | —           | 0.01        |
| Net basic earning per share   | \$0.04      | \$0.06      |

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Weighted-average common shares outstanding

|         |            |            |
|---------|------------|------------|
| Basic   | 15,927,806 | 15,572,943 |
| Diluted | 16,365,552 | 16,129,535 |

The accompanying notes are an integral part of these financial statements.



## SIMULATIONS PLUS, INC.

## CONDENSED STATEMENTS OF CASH FLOWS

For the three months ended November 30,

(Unaudited)

|  | 2012       | 2011       |
|--|------------|------------|
| Cash flows from operating activities   |            |            |
| Net income   | \$586,986  | \$971,021  |
| Adjustments to reconcile net income to net cash provided by operating activities |            |            |
| (Income)/Loss from Discontinued Operations                                       | –          | (215,922 ) |
| Depreciation and amortization of property and equipment                          | 10,690     | 9,037      |
| Amortization of customer relationships   | –          | 998        |
| Amortization of intellectual property  | 1,875      | –          |
| Amortization of capitalized computer software development costs                  | 182,085    | 157,200    |
| Stock-based compensation   | 38,099     | 26,355     |
| Deferred income taxes  | 46,339     | 250,002    |
| (Increase) decrease in   |            |            |
| Accounts receivable and Contracts receivable                                     | (390,434 ) | (66,869 )  |
| Prepaid expenses and other assets  | (60,930 )  | 17,171     |
| Increase (decrease) in   |            |            |
| Accounts payable   | 16,598     | 138,287    |
| Accrued payroll and other expenses   | 9,893      | 19,311     |
| Accrued Bonus  | (45,000 )  | 44,950     |
| Accrued income taxes   | (733,233 ) | 160,003    |
| Deferred revenue   | 75,446     | (32,709 )  |
| Net cash provided by (used in) operating activities of continuing operations     | (261,586 ) | 1,478,835  |
| Net cash (used in) operating activities of discontinued operations               | –          | (688,862 ) |
| Net cash provided by (used in) operating activities                              | (261,586 ) | 789,973    |
| Cash flows from investing activities   |            |            |
| Proceeds from sale of Words+, Inc.   | –          | 1,973,096  |
| Purchases of property and equipment  | (1,638 )   | (86,518 )  |
| Capitalized computer software development costs                                  | (262,083 ) | (201,892 ) |
| Net cash provided by (used in) investing activities of continuing operations     | (263,721 ) | 1,684,686  |
| Net cash provided by investing activities of discontinued operations             | –          | 6,532      |
| Net cash provided by (used in) investing activities                              | (263,721 ) | 1,691,218  |
| Cash flows from financing activities   |            |            |
| Declaration of dividends   | (796,390 ) | –          |
| Net cash (used in) financing activities of continuing operations                 | (796,390 ) | –          |

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|   |              |              |
|---|--------------|--------------|
| Net increase (decrease) in cash and cash equivalents from continuing operations | (1,321,697 ) | 3,163,521    |
| Net (decrease) in cash and cash equivalents from discontinued operations        | –            | (682,330 )   |
| Net increase (decrease) in cash and cash equivalents                            | (1,321,697 ) | 2,481,191    |
| Cash and cash equivalents, beginning of year                                    | 12,701,075   | 10,181,049   |
| Cash and cash equivalents, end of period  | \$11,379,378 | \$12,662,240 |
| Supplemental disclosures of cash flow information                               |              |              |
| Interest paid   | \$–          | \$3          |
| Income taxes paid   | \$1,091,545  | \$170,000    |

The accompanying notes are an integral part of these financial statements.

**Simulations Plus, Inc.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS**

November 30, 2012 and 2011

(Unaudited)

Note 1: GENERAL

This report on Form 10-Q for the quarter ended November 30, 2012, should be read in conjunction with the Company's annual report on Form 10-K for the year ended August 31, 2012, filed with the Securities and Exchange Commission ("SEC") on November 15, 2012. As contemplated by the SEC under Article 8 of Regulation S-X, the accompanying financial statements and footnotes have been condensed and therefore do not contain all disclosures required by generally accepted accounting principles. The interim financial data are unaudited; however, in the opinion of Simulations Plus, Inc. ("we", "our", "us"), the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. Results for interim periods are not necessarily indicative of those to be expected for the full year.

As further discussed in note 10 below, we sold all of the common stock of our 100% owned subsidiary, Words+, Inc. ("Words+"), on November 30, 2011.

Note 2: SIGNIFICANT ACCOUNTING POLICIES

Estimates

Our condensed financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Actual results could differ from those estimates. Significant accounting policies for us include revenue recognition, accounting for capitalized computer software development costs, valuation of stock options, and accounting for income taxes.

Revenue Recognition

We recognize revenues related to software licenses and software maintenance in accordance with Financial Accounting Standard Board (“FASB”) Accounting Standard Codification (“ASC”) 985-605, “*Software - Revenue Recognition*”. Software product revenue is recorded when the following conditions are met: 1) evidence of arrangement exists, 2) delivery has been made, 3) the amount is fixed, and 4) collectability is probable. Post-contract customer support (“PCS”) obligations are insignificant; therefore, revenue for PCS is recognized at the same time as the licensing fee, and the costs of providing such support services are accrued and amortized over the obligation period.

As a byproduct of ongoing improvements and upgrades for the new programs and new modules of software, some modifications are provided to customers who have already purchased software at no additional charge. Other software modifications result in new, additional cost modules that expand the functionality of the software. These are licensed separately. We consider the modifications that are provided without charge to be minimal, as they do not significantly change the basic functionality or utility of the software, but rather add convenience, such as being able to plot some additional variable on a graph in addition to the numerous variables that had been available before, or adding some additional calculations to supplement the information provided from running the software. Such software modifications for any single product have typically occurred once or twice per year, sometimes more, sometimes less. Thus, they are infrequent. The Company provides, for a fee, additional training and service calls to its customers and recognizes revenue at the time the training or service call is provided.

Generally, we enter into one-year license agreements with customers for the use of our pharmaceutical software products. We recognize revenue on these contracts when all the criteria are met.

Most license agreements have a term of one year; however, from time to time, we enter into multi-year license agreements. We generally unlock and invoice software one year at a time for multi-year licenses. Therefore, revenue is recognized one year at a time.

We recognize revenue from collaboration research and revenue from grants equally over their terms. However, we recognize contract study revenue using the percentage-of-completion method, depending upon how the contract studies are engaged, in accordance with ASC 605-35, “*Revenue Recognition – Construction-Type and Production-Type Contracts*”. To recognize revenue using the percentage-of-completion method, we must determine whether we meet the following criteria: 1) there is a long-term, legally enforceable contract, 2) it is possible to reasonably estimate the total project costs, and 3) it is possible to reasonably estimate the extent of progress toward completion.

#### Cash and Cash Equivalents

For purposes of the statements of cash flows, we consider all highly liquid investments purchased with original maturities of three months or less to be cash equivalents.

#### Accounts Receivable

We analyze the age of customer balances, historical bad debt experience, customer creditworthiness, and changes in customer payment terms when making estimates of the collectability of the Company’s trade accounts receivable balances. If we determine that the financial conditions of any of its customers deteriorated, whether due to customer-specific or general economic issues, an increase in the allowance may be made. Accounts receivable are written off when all collection attempts have failed. Prior to the sale of our former Words+ subsidiary, the Company also estimated the contractual discount obligation for third-party funding, such as Medicaid and private insurance companies. Those estimated discounts were reflected in the allowance for doubtful accounts and contractual discounts and included in discontinued operations. Although we experienced significant collection problems with our former Words+ subsidiary, we have never had a customer fail to pay on the pharmaceutical software and services side of the business, which now constitutes our entire business.

#### Capitalized Computer Software Development Costs

Software development costs are capitalized in accordance with ASC 985-20, “*Costs of Software to Be Sold, Leased, or Marketed*”. Capitalization of software development costs begins upon the establishment of technological feasibility and is discontinued when the product is available for sale.

The establishment of technological feasibility and the ongoing assessment for recoverability of capitalized software development costs require considerable judgment by management with respect to certain external factors including, but not limited to, technological feasibility, anticipated future gross revenues, estimated economic life, and changes in software and hardware technologies. Capitalized software development costs are comprised primarily of salaries and direct payroll-related costs and the purchase of existing software to be used in our software products.

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Amortization of capitalized software development costs is calculated on a product-by-product basis on the straight-line method over the estimated economic life of the products (not to exceed five years, although all of our current software products have already been on the market for 7-15 years except for our newest MedChem Designer™ program, and we do not foresee an end-of-life for any of them at this point). Amortization of software development costs amounted to \$182,085 and \$157,200 the three months ended November 30, 2012 and 2011, respectively. We expect future amortization expense to vary due to increases in capitalized computer software development costs.

We test capitalized computer software development costs for recoverability whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

### Property and Equipment

Property and equipment are recorded at cost, less accumulated depreciation and amortization. Depreciation and amortization are provided using the straight-line method over the estimated useful lives as follows:

|                        |                                   |
|------------------------|-----------------------------------|
| Equipment              | 5 years                           |
| Computer equipment     | 3 to 7 years                      |
| Furniture and fixtures | 5 to 7 years                      |
| Leasehold improvements | Shorter of life of asset or lease |

Maintenance and minor replacements are charged to expense as incurred. Gains and losses on disposals are included in the results of operations.

### Fair Value of Financial Instruments

Assets and liabilities recorded at fair value in the Condensed Balance Sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. The categories, as defined by the standard are as follows:

Level Input: Input Definition:

- Level I Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.
- Level II Inputs, other than quoted prices included in Level I, that are observable for the asset or liability through corroboration with market data at the measurement date.
- Level III Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date.

The following table summarizes fair value measurements by level at November 30, 2012 for assets and liabilities measured at fair value on a recurring basis:

|                           | Level I       | Level II | Level III | Total         |
|---------------------------|---------------|----------|-----------|---------------|
| Cash and cash equivalents | \$ 11,379,378 | \$ -     | \$ -      | \$ 11,379,378 |
| Total                     | \$ 11,379,378 | \$ -     | \$ -      | \$ 11,379,378 |

For certain of our financial instruments, including accounts receivable, accounts payable, accrued payroll and other expenses, accrued bonus to officer, and accrued warranty and service costs, the amounts approximate fair value due to their short maturities.



### Research and Development Costs

Research and development costs are charged to expense as incurred until technological feasibility has been established. These costs consist primarily of salaries and direct payroll-related costs. It also includes purchased software and databases which were developed by other companies and incorporated into, or used in the development of, our final products.

### Income Taxes

We utilize FASB ASC 740-10, "*Income Taxes*" which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns.

Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. The provision for income taxes represents the tax payable for the period and the change during the period in deferred tax assets and liabilities.

The California Franchise Tax Board ("FTB") audited us for the fiscal years ended ("FYE") August 31, 2007 and 2008. We received refunds as we claimed; however they have now continued their audit to include FYE 2009 and 2010, and are reviewing 2007 and 2008 R&D credits since those credits were carried forward to FYE 2009 and 2010. In March 2012, we also received a notice from the Internal Revenue Service (IRS) that our fiscal year ended August 31, 2008 is subject to their examination. In October 2012, the IRS completed their examination of our 2007 tax filing. The outcome of this examination was a decrease of \$36,868 in the amount refundable.

### Intellectual property

On February 28, 2012, we bought out the royalty agreement with Enslein Research of Rochester, New York. The cost of \$75,000 is being amortized over 10 years under the straight-line method. Amortization expense for the fiscal quarter ended November 30, 2012 was \$1,875. Accumulated amortization as of November 30, 2012 was \$5,625.

### Customer relationships

The Company purchased customer relationships as a part of the acquisition of certain assets of Bioreason, Inc. in November 2005. Customer relationships was recorded at a cost of \$128,042, and is being amortized over 78 months under the sum-of-the-years'-digits method. Amortization expense for the three months ended November 30, 2012 and 2011 amounted to \$0 and \$998 respectively. Accumulated amortization as of November 30, 2012 and 2011 was

\$128,042 and \$127,169, respectively.

Earnings per Share

We report earnings per share in accordance with FASB ASC 260-10. Basic earnings per share is computed by dividing income available to common shareholders by the weighted-average number of common shares available. Diluted earnings per share is computed similar to basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. The components of basic and diluted earnings per share for the three months ended November 30, 2012 and 2011 were as follows:

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|   | 11/30/2012 | 11/30/2011 |
|---|------------|------------|
| Numerator   |            |            |
| Net income attributable to common shareholders  | \$586,986  | \$971,021  |
| Denominator   |            |            |
| Weighted-average number of common shares outstanding during the 3 months of FY13 and FY12 | 15,927,806 | 15,572,943 |
| Dilutive effect of stock options  | 437,746    | 556,592    |
| Common stock and common stock equivalents used for diluted earning per share              | 16,365,552 | 16,129,535 |

### Stock-Based Compensation

Compensation costs related to stock options are determined in accordance with FASB ASC 718-10, “*Compensation-Stock Compensation*”, using the modified prospective method. Under this method, compensation cost includes: (1) compensation cost for all share-based payments granted prior to, but not yet vested as of September 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 amortized over the options’ vesting period, and (2) compensation cost for all share-based payments granted subsequent to September 1, 2006, based on the grant-date fair value estimated in accordance FASB ASC 718-10, amortized on a straight-line basis over the options’ vesting period. Stock-based compensation was \$38,099 and \$80,139 for the three months ended November 30, 2012 and 2011, respectively, and is included in the condensed statements of operations as Selling, General and Administration (SG&A), and Research and Development expense. As of November 30, 2011, the unvested options for employees who terminated due to sale of Words+, Inc. became fully vested. As a result, the unamortized portion of such stock-based compensation for those employees was expensed in full during the first fiscal quarter ended November 30, 2011. There was no incremental cost associated with the accelerated vesting of these options.

### Recently Issued Accounting Pronouncements

In September 2009, the FASB issued ASU 2009-14 which amends Statement of Position (“SOP”) 97-2, “Software Revenue Recognition”, to exclude tangible products containing software components and non-software components that function together to deliver the product’s essential functionality. ASU 2009-14 applies to revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early application permitted with EITF 08-1. We adopted this standard in the first quarter of fiscal 2011. We believe adoption did not have a material effect on the Company’s financial statements.

In September 2009, the FASB issued ASU 2009-13, “Revenue Arrangements with Multiple Deliverables” (“EITF 08-1”). ASU 2009-13 amends EITF 00-21, “Revenue Arrangements with Multiple Deliverables”, to require an entity to use an estimated selling price when vendor-specific objective evidence or acceptable third-party evidence does not exist for any products or services included in a multiple element arrangement. The arrangement consideration should be allocated among the products and services based upon their relative selling prices, thus eliminating the use of the

residual method of allocation. ASU 2009-13 also requires expanded qualitative and quantitative disclosures regarding significant judgments made and changes in applying the guidance. ASU 2009-13 applies to fiscal years beginning after June 15, 2010, with early application permitted. We adopted this standard in the first quarter of fiscal 2011. We believe adoption did not have a material effect on the Company's financial statements.

In May 2011, the Financial Accounting Standards Board (“FASB”) issued ASU 2011-04, *Fair Value Measurement* (“ASU 2011-04”), which amended ASC 820, *Fair Value Measurements* (“ASC 820”), providing a consistent definition and measurement of fair value, as well as similar disclosure requirements between U.S. GAAP and International Financial Reporting Standards. ASU 2011-04 changes certain fair value measurement principles, clarifies the application of existing fair value measurement and expands the disclosure requirements. We adopted this standard in the first quarter of 2012. We believe adoption did not have a material effect on the Company’s financial statements.

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income* (“ASU 2011-05”). ASU 2011-05 requires the presentation of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. We adopted this standard in the first quarter of 2012. We believe adoption did not have a material effect on the Company’s financial statements.

In September 2011, the FASB issued ASU 2011-08, *Testing Goodwill for Impairment* (“ASU 2011-08”), which amends the guidance in ASC 350-20, *Intangibles—Goodwill and Other – Goodwill*. ASU 2011-08 provides entities with the option of performing a qualitative assessment before calculating the fair value of the reporting unit when testing goodwill for impairment. If the fair value of the reporting unit is determined, based on qualitative factors, to be more likely than not less than the carrying amount of the reporting unit, the entities are required to perform a two-step goodwill impairment test. We adopted this standard in the first quarter of 2012. We believe adoption did not have a material effect on the Company’s financial statements.

In December 2011, the FASB issued ASU No. 2011-11, "Disclosures about Offsetting Assets and Liabilities." The amendments in this update require enhanced disclosures around financial instruments and derivative instruments that are either (1) offset in accordance with either ASC 210-20-45 or ASC 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either ASC 210-20-45 or ASC 815-10-45. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The amendments are effective during interim and annual periods beginning after February 28, 2012. We adopted this standard in the first quarter of 2013. We believe adoption did not have a material effect on the Company’s financial statements.

In July 2012, the FASB issued ASU 2012-02, *Testing Indefinite-Lived Intangible Assets for Impairment*, which amended the guidance in ASU 2011-08 to simplify the testing of indefinite-lived intangible assets other than goodwill for impairment. ASU 2012-02 becomes effective for annual and interim impairment tests performed for fiscal years beginning on or after September 15, 2012 and earlier adoption is permitted. We adopted this standard in the first quarter of fiscal year 2013. We believe adoption did not have a material effect on our financial statements.

Property and equipment as of November 30, 2012 consisted of the following:

|   |            |
|---|------------|
| Equipment                                       | \$ 123,062 |
| Computer equipment                              | 274,200    |
| Furniture and fixtures                          | 48,813     |
| Leasehold improvements                          | 53,898     |
| Sub total                                       | 499,973    |
| Less: Accumulated depreciation and amortization | (401,615)  |
| Net Book Value                                  | 98,358     |

## Note 4: COMMITMENTS AND CONTINGENCIES

Employment Agreement

On July 22, 2012, the Company entered into an employment agreement with its President/Chief Executive Officer that expires in August 2013. The employment agreement provides for an annual base salary of \$300,000 per year, and a performance bonus in an amount not to exceed 10% of Employee's salary, or \$30,000 per year, at the end of each fiscal year. The specific amount of the bonus to be awarded will be determined by the Compensation Committee of the Board of Directors, based on the financial performance and achievements of the Company for the previous fiscal year. The agreement also provides Employee stock options, exercisable for five years, to purchase fifty (50) shares of Common Stock for each one thousand dollars (\$1,000) of net income before taxes at the end of each fiscal year up to a maximum of 120,000 options over the term of the agreement. The Company may terminate the agreement upon 30 days written notice if termination is without cause. The Company's only obligation would be to pay its President the greater of a) 12 months salary or b) the remainder of the term of the employment agreement from the date of notice of termination.

For fiscal year 2012, the Compensation Committee awarded a \$30,000 performance bonus to Walter Woltoz, our President/Chief Executive Officer, which was paid in September 2012.

Litigation

We are not a party to any litigation at this time and we are not aware of any pending litigation of any kind.

## Note 5: SHAREHOLDERS' EQUITY

Dividend

The Board of Directors declared cash dividends during fiscal year 2012. The details of dividends paid are in the following table:

| Record Date | Distribution Date | Number of Shares Outstanding on Record Date | Dividend per Share | Total Amount |
|-------------|-------------------|---|--------------------|--------------|
| 02/21/2012  | 03/01/2012        | 15,813,844                                  | \$0.05             | \$790,692    |
| 04/27/2012  | 05/08/2012        | 15,923,019                                  | \$0.05             | \$796,151    |
| 08/07/2012  | 08/10/2012        | 15,923,019                                  | \$0.05             | \$796,151    |

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Total \$2,382,994

The Board of Directors also declared cash dividend during the first quarter of fiscal year 2013.

| Record Date | Distribution Date | Number of Shares<br>Outstanding on<br>Record Date | Dividend per<br>Share | Total Amount |
|-------------|-------------------|---|-----------------------|--------------|
| 11/08/2012  | 11/13/2012        | 15,927,806  | \$0.05                | \$796,390    |
| Total       |                   |   |                       | \$796,390    |

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Stock Option Plan

In September 1996, the Board of Directors adopted, and the shareholders approved, the 1996 Stock Option Plan (the "Option Plan") under which a total of 1,000,000 shares of common stock had been reserved for issuance. In March 1999, the shareholders approved an increase in the number of shares that may be granted under the Option Plan to 2,000,000. In February 2000, the shareholders approved an increase in the number of shares that may be granted under the Option Plan to 4,000,000. In December 2000, the shareholders approved an increase in the number of shares that may be granted under the Option Plan to 5,000,000. Furthermore, in February 2005, the shareholders approved an additional 1,000,000 shares, resulting in the total number of shares that may be granted under the Option Plan to 6,000,000. The 1996 Stock Option Plan terminated in September 2006 by its term.

On February 23, 2007, the Board of Directors adopted and the shareholders approved the 2007 Stock Option Plan under which a total of 1,000,000 shares of common stock had been reserved for issuance.

Qualified Incentive Stock Options (Qualified ISO)

As of November 30, 2012, employees hold Qualified ISO to purchase 709,800 shares of common stock at exercise prices ranging from \$1.00 to \$5.06 which were granted prior to November 30, 2012.

| Transactions in FY13           | Number of Options | Weighted-Average Exercise Price Per Share | Weighted-Average Remaining Contractual Life |
|--------------------------------|-------------------|---|---|
| Outstanding, August 31, 2012   | 689,800           | \$ 1.74                                   |   |
| Granted                        | 20,000            | \$ 5.06                                   |   |
| Outstanding, November 30, 2012 | 709,800           | \$ 1.84                                   | 4.29  |
| Exercisable, November 30, 2012 | 473,100           | \$ 1.44                                   | 3.81  |

Non-Qualified Incentive Stock Options (Non-Qualified ISO)

As of November 30, 2012, the outside members of the Board of Directors hold options to purchase 36,600 shares of common stock at exercise prices ranging from \$1.67 to \$6.68, which were granted prior to November 30, 2012.

| <u>Number of Options</u> | Weighted-Average | Weighted-Average |
|--------------------------|------------------|------------------|
|--------------------------|------------------|------------------|

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| Transactions in FY13           |        | Exercise Price   | Remaining<br>Contractual Life |
|--------------------------------|--------|------------------|-------------------------------|
|                                |        | <u>Per Share</u> |                               |
| Outstanding, August 31, 2012   | 36,600 | \$ 3.47          |                               |
| Outstanding, November 30, 2012 | 36,600 | \$ 3.47          |                               |
| Exercisable, November 30, 2012 | 19,400 | \$ 3.14          |                               |

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The weighted-average remaining contractual life of options outstanding issued under the Plan, both Qualified ISO and Non-Qualified ISO, was 5.00 years at November 30, 2012. The exercise prices for the options outstanding at November 30, 2012 ranged from \$1.00 to \$6.68, and the information relating to these options is as follows:

| Exercise Price | Awards Outstanding |         |           | Awards Exercisable                          |                                 |           |   |
|----------------|--------------------|---------|-----------|---|---------------------------------|-----------|---|
|                | Low                | High    | Quantity  | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Quantity  | Weighted Average Remaining Contractual Life |
| \$1.00         | \$1.50             | 382,700 | 4.5 years | \$1.07                                      | 311,900                         | 4.1 years | \$1.08                                      |
| \$1.51         | \$3.00             | 154,600 | 3.9 years | \$1.88                                      | 122,200                         | 3.0 years | \$1.73                                      |
| \$3.01         | \$4.50             | 185,100 | 4.7 years | \$3.26                                      | 54,400                          | 4.8 years | \$3.10                                      |
| \$4.51         | \$6.68             | 24,000  | 4.8 years | \$5.33                                      | 4,000                           | 4.8 years | \$6.68                                      |
|                |                    | 746,400 | 4.5 years | \$1.92                                      | 492,500                         | 3.9 years | \$1.51                                      |

#### Note 6: RELATED PARTY TRANSACTIONS

As of November 30, 2012, included in bonus expenses to officers was \$45,000, of which \$15,000 was accrued bonus representing an estimated quarterly amount of bonus payable to the Corporate Secretary, Virginia Woltosz, as part of the terms of the sale of Words+ to Simulations Plus in 1996. The other \$30,000, paid in September 2012, was FY2012 performance bonus to Walter Woltosz, our President/Chief Executive Officer, which was approved by the compensation committee during the quarter ended November 30, 2012.

#### NOTE 7: CONCENTRATIONS AND UNCERTAINTIES

Revenue concentration shows that International sales accounted for 55% and 41% of net sales for the three months ended November 30, 2012 and 2011, respectively. Four customers accounting for 22%, 14% (a dealer account in Japan representing various customers), 12%, and 8% of net sales during the three months ended November 30, 2012, compared with four customers accounting for 25%, 10%, 9% (a dealer account in Japan representing various customers), and 8% of net sales during the three months ended November 30, 2011.

Accounts receivable concentration shows that four customers comprised 17% (a dealer account in Japan representing various customers), 16%, 11%, and 7% of accounts receivable at November 30, 2012, and three customers comprised

21% (a dealer account in Japan representing various customers), 19%, and 8% of accounts receivable at November 30, 2011.

We operate in the computer software industry, which is highly competitive and changes rapidly. Our operating results could be significantly affected by our ability to develop new products and find new distribution channels for new and existing products.

The majority of our customers are in the pharmaceutical industry. During the current economic downturn, we have seen consolidations in the pharmaceutical industry, especially in this first fiscal quarter of 2013. Although we have not seen any significant reduction in total revenues to date, our growth rate has been affected. Continued consolidation and downsizing in the pharmaceutical industry could have an impact on our revenues and earnings going forward.

## Note 8: Segment and Geographic Reporting

We allocate revenues to geographic areas based on the locations of our customers. Geographical revenues for the three months ended November 30, 2012 and 2011 were as follows (in thousands):

|                   | North<br>America | Europe | Asia   | South<br>America | Total    |
|-------------------|------------------|--------|--------|------------------|----------|
| November 30, 2012 | \$ 1,033         | \$ 598 | \$ 659 | \$ -             | \$ 2,290 |
| November 30, 2011 | 1,313            | 395    | 531    | 10               | 2,249    |

Prior to the sale of Words+ on November 30, 2011, the Company operated in two business segments, which consisted of the pharmaceutical software and services business and the augmentative communication device business. Upon the sale of Words+ on November 30, 2011, the Company ceased operations in the augmentative communication device business. The results of this former business segment are presented as discontinued operations in the accompanying financial statements. The pharmaceutical software and services segment, which represents the Company's ongoing business, is presented as continuing operations.

## Note 9: EMPLOYEE BENEFIT PLAN

We maintain a 401(K) Plan for all eligible employees, and we make matching contributions equal to 100% of the employee's elective deferral, not to exceed 4% of total employee compensation. We can also elect to make a profit-sharing contribution. Our contributions to this Plan amounted to \$20,814 and \$19,132 for the three months ended November 30, 2012 and 2011, respectively.

## Note 10: DISCONTINUED OPERATIONS

On November 30, 2011, we sold our interest in Words+, Inc. for \$1,973,096 in cash. Words+ operations are now presented as discontinued operations in accordance with accounting rules related to the disposal of long-lived assets.

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We recognized a gain of \$465,820, net of tax, from this sale, which is included in income from discontinued operations in our condensed statement of operations for the fiscal quarter ended November 30, 2011. The revenue and expenses of discontinued operations for the first fiscal quarter of 2011 and the fiscal year ended August 31, 2011 are as follows:

| (in thousand)  | Period<br>from<br>09/01/11<br>to 11/30/11 | For the<br>fiscal<br>year<br>ended<br>08/31/11 |
|--|---|--|
| Net sales  | \$ 479                                    | \$ 2,981                                       |
| Cost of sales  | 265                                       | 1,381  |
| Gross profit   | 214                                       | 1,600  |
| Selling, general and administrative                            | 563                                       | 1,466  |
| Research and development                                       | 55  | 64   |
| Total operating expenses                                       | 618                                       | 1,530  |
| Income (Loss) from discontinued operations                     | (404)                                     | ) 70   |
| Other income   | -   | 2  |
| Income (Loss) from discontinued operations before income taxes | (404)                                     | ) 72   |
| (Provision for) income taxes                                   | 154                                       | -  |
| Results from discontinued operations, net of tax               | \$ (250)                                  | ) \$ 72  |

The carrying amount of the assets and liabilities of discontinued operations at August 31, 2011 and just prior to the date of the sale on November 30, 2011 were as follows:

| (in thousands)                              | - 11/30/11 | 08/31/11 |
|---|------------|----------|
| Cash and cash equivalents                   | \$6        | \$143    |
| Receivables, net                            | 357        | 603      |
| Inventory                                   | 392        | 392      |
| Prepaid and other current assets            | 33         | 57       |
| Capitalized software development costs, net | 212        | 220      |
| Property and equipment, net                 | 91         | 120      |
| Total Assets                                | 1,091      | 1,535    |
| Accounts payable                            | 72         | 116      |
| Accrued payroll and other expenses          | 109        | 219      |
| Accrued warranty and service costs          | 37         | 44       |
| Total Liabilities                           | 218        | 379      |
| Net liabilities of discontinued operations  | \$873      | \$1,153  |

#### Note 11: SUBSEQUENT EVENT

From December 1, 2012 to January 11, 2013, an additional 93,503 shares were issued as a result of options exercised.

As a tax benefit to our shareholders considering the increase in federal income tax for capital gains in 2013, the Board of Directors declared an accelerated cash dividend, \$0.14 per share, on December 13, 2012, consisting of all of the planned February 2013 distribution of \$0.05 per share, plus \$0.03 per share of the planned \$0.05 per quarter per share for the remaining three fiscal quarters ending in calendar year 2013.

Item 2. Management's Discussion and Analysis or Plan of Operations

**Forward-Looking Statements**

This document and the documents incorporated in this document by reference contain forward-looking statements that are subject to risks and uncertainties. All statements other than statements of historical fact contained in this document and the materials accompanying this document are forward-looking statements.

The forward-looking statements are based on the beliefs of our management, as well as assumptions made by and information currently available to our management. Frequently, but not always, forward-looking statements are identified by the use of the future tense and by words such as “believes,” “expects,” “anticipates,” “intends,” “will,” “may,” “could,” “would,” “projects,” “continues,” “estimates” or similar expressions. Forward-looking statements are not guarantees of future performance and actual results could differ materially from those indicated by the forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause our or our industry’s actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements.

The forward-looking statements contained or incorporated by reference in this document are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (“Securities Act”) and Section 21E of the Securities Exchange Act of 1934, as amended (“Exchange Act”) and are subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. These statements include declarations regarding our plans, intentions, beliefs or current expectations.

Among the important factors that could cause actual results to differ materially from those indicated by forward-looking statements are the risks and uncertainties described under “Risk Factors” in our Annual Report and elsewhere in this document and in our other filings with the SEC.

Forward-looking statements are expressly qualified in their entirety by this cautionary statement. The forward-looking statements included in this document are made as of the date of this document and we do not undertake any obligation to update forward-looking statements to reflect new information, subsequent events or otherwise.

**General**

**Business**



Simulations Plus, Inc., incorporated in 1996, develops and produces software for use in pharmaceutical research and for education, as well as provides contract research services to the pharmaceutical industry. Simulations Plus also took over responsibility for producing a personal productivity software program called Abbreviate! originally spun out of products for the disabled by its former subsidiary, Words+, for the retail market. Words+, founded in 1981, produces computer software and specialized hardware for use by persons with disabilities. The Words+ subsidiary was sold effective November 30, 2011, and has been treated as “discontinued operations” in the financial statements.

We currently offer five software products for pharmaceutical research: ADMET Predictor™, MedChem Designer™, MedChem Studio™, DDDPlus™, and GastroPlus™. We call the combination of ADMET Predictor, MedChem Studio, and MedChem Designer our ADMET Design Suite™.

### ADMET Predictor

ADMET (Absorption, Distribution, Metabolism, Excretion and Toxicity) Predictor is a computer program that takes molecular structures as inputs and predicts over 140 different properties for them at the rate of about 200,000 compounds per hour on a laptop computer. ADMET Predictor has been consistently top-ranked in peer-reviewed, independent comparison studies for predictive accuracy, while generating its results at this very high throughput rate. This capability lets a pharmaceutical scientist rapidly screen large numbers of molecules. The current state-of-the-art of this type of software allows identifying molecules that are highly likely to fail as potential drug candidates before synthesizing and testing them. Thus, millions of “virtual” compounds can be created and screened in a day, compared to potentially months of work to synthesize and test as little as a few tens or hundreds of actual compounds. This capability enables chemists to investigate a much larger “chemical space” in their search for new medicines.

The ADMET Modeler™ subprogram that is integrated into ADMET Predictor enables scientists without model-building experience to use their own experimental data to quickly create high-quality, proprietary predictive models using the same powerful modeling methods we use to build our top-ranked property predictions. Pharmaceutical companies spend enormous amounts of money conducting a wide variety of experiments on new molecules each year, resulting in large databases of experimental data. Using this proprietary data to build predictive models can provide a second return on their investment; however, model building has traditionally been a tedious activity performed by specialists.

We released Version 6.0 of ADMET Predictor in May 2012. This new version incorporates a new feature that enables users to generate likely metabolites for any molecule using an embedded version of our MedChem Designer program. It also increases the number of predictive models for metabolism and toxicity, and refines many of our earlier predictions. We are also progressing with curating the scientific literature for a much larger data set for certain enzymes known as the cytochrome P450 (“CYP”) family to further enhance our predictive capabilities for metabolism. These improvements to metabolism and metabolite prediction are available via MedChem Designer and MedChem Studio for customers who also license ADMET Predictor.

### MedChem Designer

MedChem Designer was launched in February 2011. It was initially a molecule drawing program, or “sketcher”, but now has capabilities beyond those of other molecule drawing programs because of its integration with both MedChem Studio and ADMET Predictor. We provide MedChem Designer for free because we believe that in the long run it will help to increase demand for ADMET Predictor and MedChem Studio. Most other existing molecule drawing programs are also free. The free version includes a small set of ADMET Predictor property predictions, allowing the chemist to modify molecular structures and then see a few key properties very quickly. The chemist also sees that with a paid ADMET Predictor license, over 140 predictions would be available.

When coupled with a license for ADMET Predictor, MedChem Designer becomes a *de novo* design tool for medicinal chemists. With it, they can draw one or more molecular structures, then click on the ADMET Predictor icon and have over 140 properties for each structure calculated in seconds, including our proprietary ADMET Risk™ index. They can also click on an icon to generate likely metabolites and predict their properties and a ADMET Risks as well. ADMET Risk provides a single number that tells the chemist how many threshold values for more than 20 predicted properties were crossed (or violated) by each structure. Thus, in a single number, the chemist can instantly compare the effects of different structural changes in more than 20 dimensions. As chemists attempt to modify structures to improve one property, they often cause others to become unacceptable. Without ADMET Risk, the chemist would have to separately examine many key properties for each new molecule to check whether any became unacceptable as a result of changing the structure.

We released MedChem Designer 2.0 in May 2012 with its new capabilities, including showing the most likely metabolites that would be produced from a parent molecule by the most common CYP enzymes. With this capability, the chemist can not only see predicted likely metabolites, but can also use ADMET Predictor to assess whether any of the predicted metabolites would be likely to result in unacceptable adverse effects. When a molecule that could have been a good medicine is converted into a toxic metabolite, it can be rendered dangerous or useless. The ability to predict likely metabolites and their properties is another way to reduce the number of molecules that are taken forward into development only to fail at a later stage after considerable time and money have been expended.

### MedChem Studio

Over the past several years, MedChem Studio updates have resulted in a very powerful tool for medicinal and computational chemists for both data mining and for designing new drug-like molecules.

While MedChem Designer can be used to refine a small number of molecules, refining a very large number of molecules down to a few promising lead candidates is the primary function of MedChem Studio (with ADMET Predictor). MedChem Studio has features that enable it to generate very large numbers of new molecular structures using a variety of *de novo* design methods. Coupled with ADMET Predictor, we believe the two programs provide an unmatched capability for chemists to search through large libraries of compounds that have undergone high-throughput screening experiments to find the most promising classes (groups of molecules with a large part of their structures the same) and molecules that are active against a particular target. In addition, MedChem Studio with ADMET Predictor can take an interesting (but not acceptable) molecule and very quickly generate many thousands of high quality analogs (i.e., similar new molecules) using a variety of design algorithms to generate new molecules that are predicted (via ADMET Predictor) to be both active against the target as well as acceptable in a variety of ADMET properties. MedChem Designer (see above) is also a part of MedChem Studio, so the user can click on the MedChem Designer icon and bring up the drawing window to investigate how further modifications to the structures of interesting molecules generated by MedChem Studio can improve their properties.

MedChem Studio version 3.0 was released in May 2012.

### NCE Project

In March 2011, we initiated our own project to design new molecules (NCEs, or New Chemical Entities) using the ADMET Design Suite (MedChem Studio/MedChem Designer/ADMET Predictor) based on our belief in the suite's exceptional capabilities. We selected as a target the malaria parasite *Plasmodium falciparum*, both because there is an unmet need for a very low-cost cure, and because we believed that external funding opportunities might exist if we were successful in generating high-quality lead compounds using our software. We completed the design process in September 2012 and we announced that we had requested quotations from chemical synthesis companies for the cost and time to make a small set of molecules. Five molecules of our own design were synthesized and tested for inhibition of the parasite at the University of California at Riverside. In addition, two precursors (almost the final designed structures, but a step away in synthesis) were tested. We were hoping that at least one would show inhibition

of the growth cycle of the parasite.

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Every molecule showed activity against the parasite at less than micromolar concentrations, with two showing activity at less than 100 nanomolar concentration (high potency) against the drug-sensitive strain of the parasite. They were then tested against the drug-resistant strain of the malaria parasite, and again potency was observed, with two molecules showing nanomolar activity. Several of these molecules were sent to another outside laboratory for additional experiments to measure a few key properties to compare the values versus our ADMET Predictor predictions. Our predictions for solubility, ionization constants (pKa), and lipophilicity were all well within accepted tolerances. Metabolism by human liver microsomes was much faster than predicted, probably due to metabolism by pathways our models do not yet predict. These molecules were only expected to be good lead molecules, not to be final drug molecules, so further structural changes to these lead compounds might meet all requirements for an approved drug. We are now communicating with outside organizations to seek funding to carry on this work on a larger scale.

Recognize that our goal for this project was not actually to cure malaria, but to demonstrate that using our software tools to quickly and efficiently analyze high-throughput data, to generate new molecular structures, and to assess their qualities via ADMET Predictor, could result in high-quality lead candidates in a fraction of the time and cost usually required to reach that stage of drug development. We accomplished that and we have been presenting our results in scientific meetings and in webinars to a worldwide audience. We expect to repeat this demonstration for a different therapeutic target in the coming months.

#### DDDPlus

DDDPlus simulates *in vitro* laboratory experiments used to measure the rate of dissolution of the drug and, if desired, the additives (excipients) contained in tablets and capsules under a variety of experimental conditions. This software program is used by formulation scientists in industry and the U.S. Food and Drug Administration (FDA) to (1) understand the physical mechanisms affecting the dissolution rate for various formulations, (2) reduce the number of cut-and-try attempts to design new drug formulations, and (3) to design *in vitro* dissolution experiments to better mimic *in vivo* conditions.

Development efforts for DDDPlus during fiscal year 2012 were limited because of priorities on other programs.

#### GastroPlus

Our flagship product and largest source of revenues is GastroPlus. GastroPlus simulates the absorption, pharmacokinetics, and pharmacodynamics of drugs administered to humans and animals, and is currently in widespread use at pharmaceutical companies, the FDA, the U.S. National Institutes of Health (NIH), and other government agencies in the U.S. and other countries. Because of GastroPlus, we were the only non-European company invited to join the European Innovative Medicines Initiative (IMI) program for Oral Bioavailability Tools (“OrBiTo”). OrBiTo is a collaboration among 27 industry, academic, and government organizations working in the area of oral absorption of pharmaceutical products. Because we are outside of Europe, our participation in this project is at our own expense, while other members are compensated for their work; however, we are a full member with access to

all of the data and discussions of any other members. We believe participation in this initiative enables us to benefit from and to contribute to advancing the prediction of human oral absorption from preclinical data.

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We released version 8.0 of GastroPlus in April 2012. This new version added many new features, including:

- (1) extending the predictive capabilities for ocular and nasal/pulmonary dosing;
- (2) adding a paracellular permeability capability that distinguishes between how some drug molecules permeate the intestinal membrane by moving through gaps between the epithelial cells from the diffusion through the cells;
- (3) enhancing the PDPlus™ pharmacodynamic module to incorporate a tumor compartment model and to better deal with multiple metabolites; and
- (4) providing enhanced graphical outputs and reporting capabilities requested by customers.

We are expecting to release version 8.5 of GastroPlus in early 2013. This interim release adds several new capabilities requested by customers.

#### Contract Research and Consulting Services

Our expertise in oral absorption and pharmacokinetics is evidenced by the fact that our staff members have been speakers or presenters at over 80 prestigious scientific meetings worldwide in the past four years. We frequently conduct contracted studies for large customers (including top 5 pharmaceutical companies) who have particularly difficult problems and who recognize our expertise in solving them, as well as for smaller customers who prefer to have studies run by our scientists rather than to license our software and train someone to use it. The demand for our consulting services has been steady. Long-term collaborations and shorter-term consulting contracts serve both to showcase our technologies and to build and strengthen customer relationships.

During the first quarter of fiscal year 2013 we continued to work on our 5-year collaboration agreement with the Center for Food Safety and Applied Nutrition (CFSAN) of the FDA. FDA scientists and our scientists are using ADMET Predictor/Modeler to build predictive models for likely toxicities of food additives and contaminants. During the first year of this collaboration, we analyzed FDA databases and worked with FDA scientists to ensure that the FDA data to be used for building new predictive models is as accurate as we can reasonably make it. Both FDA scientists and our scientists are building a series of models to classify new compounds as toxic or nontoxic from FDA datasets. Included in this effort was a special modification to ADMET Predictor to allow the user to set a minimum value for specificity or sensitivity when building a model. Sensitivity refers to how well a model identifies toxic (or any other property) compounds. A model that determined all compounds are toxic would have 100% sensitivity, because all toxic compounds would be labeled as such; however, all nontoxic compounds would also be labeled toxic. Specificity refers to how well a model distinguishes between toxic and nontoxic compounds. Increasing one usually results in decreasing the other. Depending on the purpose of the model, some scientists will prefer to train models that emphasize one statistic over the other.

#### **STRATEGY**



Our business strategy is to do the things we need to do to promote growth both organically (by expanding our current products and services through in-house efforts) and by acquisition. We believe in the “Built to Last” approach - that the fundamental science and technologies that underlie our business units are the keys both to improving our existing products and to expanding the product line with new products that meet our various customers’ needs. The search for suitable acquisitions continues to be a high priority.

With our significant cash reserves, we continue to seek suitable acquisitions. Because we have been unable to identify suitable acquisitions and our cash continues to accumulate, the board of directors declared a \$0.05 per share per quarter cash dividend that began in February 2012 and was paid in May, August, and November 2012. The board declared an accelerated cash dividend consisting of the February, 2013 dividend of \$0.05 per share per quarter plus \$0.03 per share from each of the expected May, August, and November 2013 dividends of \$0.05 per share per quarter for a total of \$0.14 per share, which was distributed on December 28, 2012, in order to provide our shareholders with the income tax benefits from lower capital gains rates in 2012 over 2013. Although we expect the dividends for the 2<sup>nd</sup> through 4<sup>th</sup> quarters to consist of the remaining \$0.02 per share per quarter, there can be no assurances that such dividends will be distributed, or if so, whether the amounts will be more, less, or the same as expected. The Board of Directors must approve each dividend distribution and may decide to increase, decrease, or eliminate dividend distributions at any time.

### Discontinued Operations

On November 30, 2011 we sold our entire interest in our 100% owned Words+ subsidiary, an augmentative and alternative communication device manufacturer, for aggregate gross proceeds of \$1.97 million. We recognized a gain of approximately \$465,820, net of tax, from the sale of Words+, which is included as discontinued operations in our statement of operations for the fiscal quarter ended November 30, 2011. The difference between the sales price and the net gain is a result of adjustments to net working capital from August 31, 2011 until the closing on November 30, 2011, legal fees, auditing fees, tax specialist's fees, and severance compensation for terminated employees.

### Results of Operations

#### *Comparison of Three Months Ended November 30, 2012 and 2011.*

The following table sets forth our condensed statements of operations (in thousands) and the percentages that such items bear to net sales:

|                                     | Three Months Ended |       |          |       |
|-------------------------------------|--------------------|-------|----------|-------|
|                                     | 11/30/12           |       | 11/30/11 |       |
| Net sales                           | \$2,290            | 100 % | \$2,248  | 100 % |
| Cost of sales                       | 387                | 16.9  | 352      | 15.7  |
| Gross profit                        | 1,903              | 83.1  | 1,896    | 84.3  |
| Selling, general and administrative | 931                | 40.7  | 860 *    | 38.3  |
| Research and development            | 180                | 7.9   | 92 *     | 4.1   |
| Total operating expenses            | 1,111              | 48.5  | 952      | 42.4  |

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|                                   |     |      |     |      |
|-----------------------------------|-----|------|-----|------|
| Income from continuing operations | 792 | 34.6 | 944 | 42.0 |
|-----------------------------------|-----|------|-----|------|